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Public Finance Sector Stability in Central European Countries (Part 1)

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During deep recessions such as those triggered recently by the COVID-19 pandemic and the war between Russia and Ukraine, ensuring stability in the public finance sector is not an easy task. In EU countries, this stability is associated with maintaining budget deficits and public debt below the levels required by the Maastricht criteria. In 2022, many Central European countries experienced high deficit levels. Although economic recovery is conducive to returning to the said definition of stability, in both Central European countries and the EU economy as a whole, it is essential to limit expansive fiscal policy and coordinate it with monetary policy.

Fiscal Policy and Public Finance Deficit in EU Countries. The stability of the public finance system in EU countries, and thus also in Central European countries belonging to the EU, is identified with maintaining a budget deficit and public debt at a level lower than that required by the Maastricht criteria. According to these criteria, the annual deficit should not be higher than 3% of the Gross Domestic Product (GDP), and the total public debt cannot exceed 60% of GDP. The deficit of the public finance sector is directly influenced by an expansive fiscal policy, which involves increasing public expenditure and lowering taxes. Such a strategy may be attractive for the Central European region, heavily dependent on investments and external demand. In recent years, it has been applied multiple times as a response to crises, allowing various governments to stimulate demand and revive the economy.

The criteria for deficits and public debt are, in the opinion of many experts, important for maintaining economic stability not only in eurozone countries. This is because asymmetrical stimulation of economic growth through expansive fiscal policy in countries forming a single European market, where several currencies exist, may lead to changes in trade competitiveness, thereby leading to the economic growth of one country at the expense of another. Another problem, no less important, is maintaining the integrity of interest rates with a diversified fiscal policy under the classic assumptions of Mundell-Fleming. This integrity, also regulated in the nominal criteria of Maastricht, affects the monetary policies of the European Central Bank and the central banks of member states outside the eurozone, for example, in Poland, Hungary, Romania, Bulgaria, and the Czech Republic.

The fact is that during deep recessions such as those triggered by the financial crisis of 2008 or more recently by the COVID-19 pandemic and the war between Russia and Ukraine, many EU countries have exceeded this limit to finance stimulus and aid packages aimed at reviving the economy. In such situations, a temporary relaxation of the nominal convergence criteria seems justified. It should be noted that in many economically developed countries, budget deficits significantly exceeded the EU's 3% threshold. In 2020, the deficit of the USA was 14.5%, and Japan's was 10.3%.

Temporary Suspension of Fiscal Rules. It is noteworthy that the debate regarding the adjustment of the EU's multi-annual fiscal rules to [better fit] the economic reality shaped by successive crises is gaining momentum. From a financial stability perspective, many economists find it disconcerting that the European Commission (EC) considers the general framework to be outdated and inadequate for the dynamically changing economic landscape and the transition to a carbon-neutral society. Currently, the EC intends to maintain both the 3% and 60% targets. Given the emerging doubts, this likely presents a good opportunity to assess the existing architecture of public finances in countries forming the single European market. This is especially pertinent as the less economically developed and less competitive Central European countries respond differently to economic shocks, meaning that intuitively perceiving expansive fiscal policy as a remedy for economic difficulties is not necessarily evident in this case. Conclusions from forecasts presented by the EC and the International Monetary Fund suggest recommendations for moderate use of fiscal policy instruments. In a way, the economic policy direction of the eurozone, to which six out of the eleven analysed Central European countries belong, was suggested by the German Finance Minister Christian Lindner in May, who stated, "Inflation must be fought. For this purpose, monetary policy and the government's fiscal policy must cooperate. Thus, the times of expansive fiscal policy are coming to an end."

The enforcement of fiscal rules has been suspended since the onset of the coronavirus pandemic („Komentarze IEŚ", nr 273) and is set to resume in 2024, but as announced – in a changed form. The reform proposed by the EC envisages greater responsibility and flexibility for governments, which will be obliged to develop their own medium-term fiscal plans aimed at restoring public debt to a balanced level. Plans for individual countries will be negotiated between each government and the EC, then approved by the EU Council, in a similar manner to the way the COVID-19 recovery fund was negotiated.

Trends in the EU. The ongoing economic expansion, particularly the improvement in the cyclical component of the budget and discretionary policies, is contributing to a reduction of the EU deficit. According to Eurostat data, starting from a historically high level of 6.7% of GDP in 2020, the aggregated deficit of government and local government institutions in the EU fell to 4.8% in 2021 and to 3.4% in 2022. During this time, unemployment decreased to its lowest point since 2008; 5.9% in the EU and 6.5% in the eurozone (as per data from May 2023). It is important to highlight these notable achievements of simultaneously restoring budget stability and labour market balance. However, despite the continuous increase in worker mobility and labour market flexibility, significant differences in unemployment rates among individual countries of the single European market persist. For instance, the highest unemployment rates in April 2023 were in Spain (12.7%) and Greece (11.2%), while the lowest were in Poland and the Czech Republic (2.7%), Malta (2.8%), and Germany (2.9%). Among Central European countries, the highest unemployment rate was in Lithuania (7.6%), and yet, despite this, there were significant challenges in finding workers in its labour market („Komentarze IEŚ", nr 902).

It is also worth noting that the gradual withdrawal of temporary measures related to the COVID-19 pandemic has been offset by support measures aimed at alleviating the negative impact of high energy prices on households and businesses. Additionally, the EU deficit in 2022 was affected by the costs of sheltering and integrating refugees fleeing the war in Ukraine, estimated at 0.1% of GDP. Moreover, interest expenses increased by over 0.2 percentage points of GDP in 2022, due to higher interest rates and higher yields of inflation-indexed government bonds.

Similar to the entire EU economy, the economic revival in Central European countries favoured budget deficit reduction. Despite this trend, many countries still had high deficits. Out of eleven Central European countries, five had budget deficits exceeding 3%. According to Eurostat data, in 2022, the largest deficits were in Romania and Hungary (-6.2%), followed by Latvia (-4.4%), Poland (-3.7%), and the Czech Republic (-3.6%) („Komentarze IEŚ", nr 887). A budget surplus was only observed in Croatia, which in 2022 was preparing to join the eurozone from 1 January 2023 („Prace IEŚ", nr 5/2020, „Komentarze IEŚ", nr 320).

Conclusions

- Although the Maastricht criteria regarding deficits and public debt are crucial for economic stability in EU countries, during deep recessions such as the financial crisis or the COVID-19 pandemic, many countries exceed these limits, indicating the need for a temporary relaxation of nominal convergence criteria. Given the changing economic reality and the transition to a climate-neutral society, there is a growing need to adjust the EU's fiscal rules, and also to take into account the specific reactions of less economically developed Central European countries to economic shocks. While expansive fiscal policy has been used as a response to crises, the current direction of the eurozone's economic policy points to the necessity of moderate use of fiscal instruments and their greater coordination with monetary policy. This emphasis on moderation and coordination suggests a cautious approach towards fiscal measures, aligning them with broader economic and climate goals while ensuring the resilience and stability of the EU's economy in the face of diverse economic challenges and varying national circumstances.