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Public Finance Sector Stability in Central European Countries (Part 2)

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In 2022, among eleven Central European countries, five of them had budget deficits that exceeded the agreed limit of 3% of GDP. According to the latest data from Eurostat, the highest budget deficits, and consequently, the greatest challenges for the stability of the public finance sector, were recorded in Hungary and Romania. Hungary, thanks to its expansive fiscal policy, achieved positive results in the form of a low unemployment rate. In Romania, on the other hand, we can observe an excessive budget deficit and a trade balance deficit, despite relatively high economic growth, which may suggest an overly expansive fiscal policy.

Budget deficits in Central European countries. As a result of the crises caused by the COVID-19 pandemic („Komentarze IEŚ", nr 383) and the war between Russia and Ukraine, many Central European countries have exceeded the budget deficit limits established in the Maastricht Treaty, which largely stemmed from the necessity to finance economic stimulus and support packages aimed at boosting the economy („Komentarze IEŚ", nr 916). According to the latest data from Eurostat, the largest budget deficits in 2022 occurred in Hungary and Romania (6.2%), followed by Latvia (4.4%), Poland (3.7%), and the Czech Republic (3.6%). A budget surplus was only recorded in Croatia (0.4%). It's worth recalling that in 2020, Croatia had one of the largest deficits among EU countries, standing at 7.3%. However, in the following years, efforts have been made to balance the budget in connection with its planned accession to the Eurozone in 2023.

Post-pandemic struggles with the deficit in Hungary. The financial situation in Hungary worsened primarily during the COVID-19 pandemic. In 2020, the deficit in the sector of government and local institutions amounted to 7.5%. Higher deficits in Central European countries were recorded only in Romania (9.2%) and Slovenia (7.7%) at that time. Still, in 2022, the budget deficit in Hungary remained at a high level (6.2%). This was a result not only of the expansive fiscal policy adopted in the wake of the pandemic but also of the pressure related to the energy crisis. However, as early as July 2022, i.e., after the April parliamentary elections („Komentarze IEŚ", nr 583), the budget for 2023 was approved, assuming a reduction of the budget deficit to 3.5%.

Despite these optimistic assumptions, according to the economic forecasts of the European Commission published in May 2023 for the member states of the European Union, "European Economic Forecast. Spring 2023", covering the years 2022-2024, it is predicted for Hungary that the budget deficit in 2023 will fall to 4.0%, therefore, above the government's assumptions. This decrease will be supported by temporary taxes, extraordinary profits (achieving 1.5% of GDP in 2023) as well as a significant increase in revenues driven by high inflation („Komentarze IEŚ", nr 674). Additionally, it is anticipated that the recent reduction in natural gas prices will contribute to reducing subsidies for energy companies in the next heating season, related to energy price regulation, which will reduce fiscal burdens in 2024.

Challenges on the horizon. Despite improving macroeconomic prospects and anticipated lower energy carrier prices, the Hungarian budget deficit is expected to remain high in 2024, amounting to 4.4% of GDP. It is predicted that revenue growth will be hampered by the planned phasing out of temporary taxes in accordance with their expiration clauses. At the same time, expenditures will remain at an elevated level due to rising debt service costs and expenditure pressures related to high inflation. In 2022, with high inflation and GDP growth at 4.6%, the debt-to-GDP ratio decreased by 3.3 percentage points – to 73.3%. A further decline to 70.7% is anticipated in 2023.

However, in 2024, this ratio is expected to rise again to 71.1%, mainly due to the high deficit and slower GDP growth („Komentarze IEŚ", nr 750).

With a high budget deficit, Hungary's unemployment rate in 2022 remained at a relatively low level of 3.6%. Forecasts for the coming years suggest a slight increase in this value – to 4.2% in 2023 and 4.0% in 2024. Meanwhile, projected scenarios suggest that there will be issues with shortages of skilled labour in the job market, further exacerbated by an ageing society. In terms of economic growth, the forecasts for 2024 are optimistic. It is anticipated that this indicator will reach 2.8%, exceeding the average economic growth of the EU (1.7%) by 1.1 percentage points.

Excessive deficit of Romania despite economic growth. Romania is in a difficult situation regarding its budget deficit, ranking just behind Hungary („Komentarze IEŚ", nr 108). The financial situation significantly worsened during the COVID-19 pandemic, nonetheless, there are clear signs of improvement. Forecasts indicate a decline in the budget deficit from 6.2% in 2022 to 4.7% in 2023. This positive turnaround is a result of rapid GDP growth, high revenues from taxes related to the energy sector, and a reduction in current expenditures, particularly in terms of wages in the public sector. Planned actions such as subsidies for retirees, changes in the tax system, compensation systems for households affected by the rise in energy prices, and a new law restricting public spending in 2023, should contribute to further budget consolidation. It is expected that in 2024 the deficit will decrease even further to 4.4% of GDP. Regarding the level of public debt in Romania, it is moderate compared to many other EU countries. In 2022, the public debt to GDP ratio stood at 47.3%. Forecasts suggest its gradual decrease to 45.6% in 2023, although in 2024 it may increase slightly, reaching 46.1%. These forecasts show that Romania remains in relatively good condition concerning the level of indebtedness.

Labour Market and Net Export. Although the expansion of fiscal policy and expected GDP growth may seem promising in the context of improving economic conditions, demographic challenges and mass emigration pose obstacles to creating new jobs. Too expansive a fiscal policy in the face of such challenges may cause effects that are not as beneficial as would be expected. Certainly, some mitigating factors are anticipated to ease tension in the labour market such as the influx of refugees from Ukraine and visas for workers from outside the EU. Forecasts indicate a relatively low unemployment rate, which will drop to 5.4% in 2023 and 5.1% in 2024. Another significant challenge is the value of Romanian net exports; it is expected that it will not contribute to GDP growth. Although energy prices are falling and trade conditions are improving, strong domestic demand may still lead to a trade deficit. Forecasts suggest that the deficit on the balance sheet may remain at 7.6% of GDP in 2023, which is a source of concern for the external stability of the economy from the medium-term perspective.

Conclusions

In 2022, five Central European countries had budget deficits exceeding the agreed limit of 3%, which continue to adversely affect the stability of their public finance sectors. According to Eurostat data, the greatest threat to stability occurred in Hungary and Romania. Forecasts from the European Commission suggest that the stability of public finance in Hungary in 2024 will be moderate. However, considering the low unemployment rate, it can be acknowledged that the expansive fiscal policy has yielded positive results. In Romania, despite high economic growth, an excessive budget deficit is observed, which may suggest an overly expansive fiscal policy. Additionally, Romania has weak employment growth prospects, which may limit further economic development, and a further issue is the negative trade balance.

Although the economic forecasts from the European Commission indicate that the gradual withdrawal from expansive fiscal policies will lead to a deficit reduction in the EU, the problem of excessive deficits will remain visible in Central European countries. It is worth drawing from the experiences of early 2010, which showed a certain tendency among economically developed countries. Most governments that vigorously stimulated their economies through expansive fiscal policy experienced large budget deficits. Consequently, in the following years, these same countries had to apply a more restrictive fiscal policy. This usually entailed government spending cuts and tax hikes. Moreover, when analysing the financial situation in Central European countries, special attention should be paid to those not belonging to the eurozone as their public finance stability and trade balances may be more exposed to risks associated with the foreign exchange market.