Reconciling Fiscal Consolidation and Growth

- *While most CESEE countries continue to grow at a healthy pace, Russia and other CIS economies are in recession. The forecast for the region as a whole is little changed from the spring 2015 projections,*
- *…but the risks have shifted to the downside, with weaker growth in emerging markets and economic disruptions due to the refugee crisis adding to other long-standing risks.*
- *Policy priorities depend on how far along the economies are in the post-crisis adjustment. Where the recovery is well advanced, priorities shift towards rebuilding fiscal buffers and structural reforms.*
- *Many CESEE countries have made progress with consolidating the public finances. Some also improved the quality of their budgets, by cutting unproductive transfers, reforming public entitlement programs, and shifting the tax burden from income to indirect taxes. This said, fiscal reform remains critical to boost CESEE countries' long-term growth prospects.*

While most CESEE countries are growing at a healthy pace, Russia and other CIS economies are in recession. The CESEE region as a whole is expected to return to positive growth in 2016, as CIS economies stabilize and start recovering:

- *Continued expansion in CEE, Turkey, and most of the SEE:* Growth is driven by robust domestic demand and supported by low oil prices and better euro-area growth prospects. Several EU countries also benefited from a temporary boost to investment from a sharp increase in utilization of EU Structural and Cohesion Funds. Activity is more muted in the Baltics due to weak demand from the CIS.

- *Abating recession in Russia, Ukraine, and other CIS countries:* stabilization is expected for 2016, as the Russian economy adjusts to low oil prices and sanctions, and as yields from reforms and reduced economic dislocations materialize in Ukraine.

More Even Growth Ahead

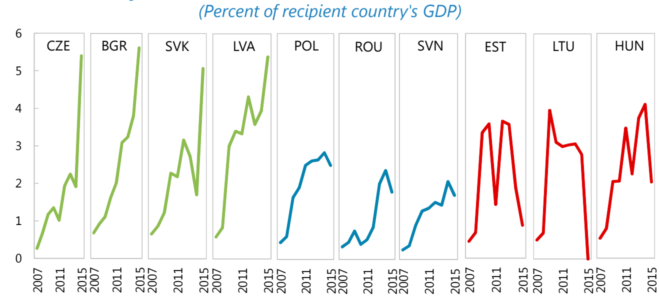
CESEE: Outlook for Real GDP Growth *(Percent)*

		Projection	
	2014	**2015**	**2016**
CESEE[1]	1.4	**-0.6**	**1.3**
Baltics[1,2]	2.8	**1.9**	**2.9**
Central and Eastern Europe[1,3]	3.1	**3.4**	**3.1**
Southeastern Europe[1,4]	1.3	**2.2**	**2.4**
Other CIS[1,5]	-3.9	**-7.1**	**0.7**
Russia	0.6	**-3.8**	**-0.6**
Turkey	2.9	**3.0**	**2.9**

Note: [1] Weighted average. Weighted by GDP valued at purchasing power parity. [2] Estonia, Latvia, and Lithuania; [3] Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia; [4] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia FYR, Montenegro, Romania, and Serbia; [5] Belarus, Moldova, and Ukraine.
Souce: IMF World Economic Outlook database.

Utilization of EU Funds

CESEE: Payouts from 2007-13 EU Structural and Cohesion Funds
(Percent of recipient country's GDP)



Source: European Commission and IMF staff estimates.
Note: 2015 data is until June and is divided by half of projected 2015 GDP.

New risks to the outlook –related to China's slowdown and ongoing refugee crisis – have emerged that shift the balance of risks to the downside. While direct trade links with China are relatively small, the CESEE region is vulnerable to souring of investor sentiment towards the broader emerging markets. The refugee crisis in Europe, at least in the short-run, could put pressure on public finances and disrupt trade flows.

Policy priorities depend on how far along the economies are in the postcrisis adjustment and their exposure to external risks.

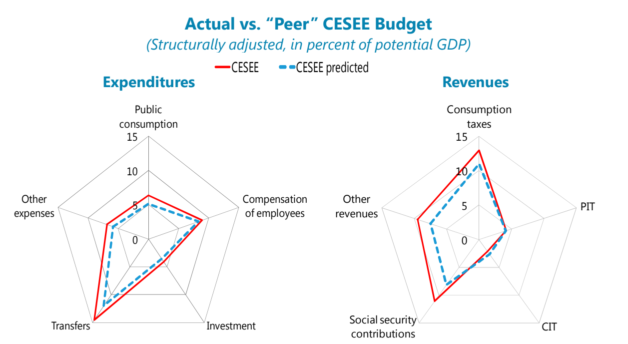
- *Where the recovery is well advanced*, priorities increasingly shift toward the medium term, including rebuilding fiscal buffers and continuing with reforms to improve the business environment and address structural weaknesses. That said, key crisis legacies—high nonperforming loans and debt overhangs—require further work in some countries.

- *For economies that are in recession*, the key challenge is to steer the adjustment to terms-of-trade and other shocks with a view to supporting weak demand and reducing high inflation.

- *Countries vulnerable to external shocks* need to be prepared to deal with market pressures by using exchange rate flexibility as a shock absorber alongside macro-prudential policies to contain the buildup of financial sector risks.

Improving the growth friendliness of government budgets remains a key policy challenge. Budgets in the region are relatively growth unfriendly, as a relatively large portion is spent on unproductive uses such as transfers and public consumption. On the revenue side, relatively high labor taxes—especially social security contributions that can generate employment and poverty traps—are unfavorable to growth.

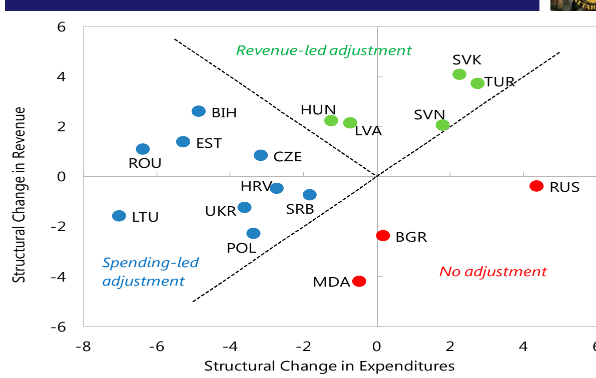
The quality of budget structures in CESEE compares unfavorably to peers



Sources: IMF World Economic Outlook database; and IMF staff calculations.

Budget structures have changed markedly in the past 7 years, as governments came under pressure to consolidate the public finances in the aftermath of the global financial crisis. Total fiscal adjustment exceeded 5 percentage points of potential output in some cases and was typically frontloaded. Most countries achieved the largest part of consolidation by reducing expenditures rather than increasing revenues.

Fiscal Adjustment, 2008-14



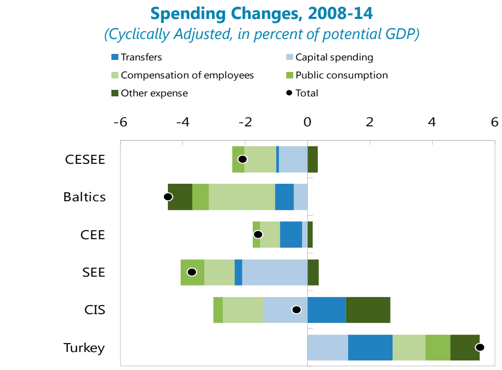
Sources: IMF World Economic Outlook database; and IMF staff calculations.

Consolidation tended to have a positive impact on the quality of budgets.

- On the ***revenue side,*** many countries suffered structural declines in corporate income tax in the wake of the global financial crisis, but offset these by increasing growth-neutral forms of taxation, such as Value Added Tax.

- On the ***spending side***, large savings came often from reforming entitlement programs and reducing public consumption. At the same time, many Baltic and Central European countries—that have access to EU structural and cohesion funds—managed to avoid growth-harmful cuts in public capital spending. Investment cuts were larger in South-Eastern and CIS countries.

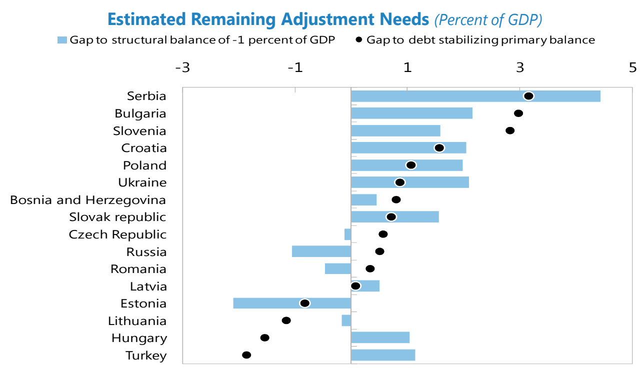
Structure of Expenditure Consolidation



Sources: IMF World Economic Outlook database; and IMF staff calculations.

Growth-friendly consolidation and budget reform is critical to strengthen long-term growth prospects. In many countries, adjustment has not yet run its course, many of them in South-Eastern Europe. Key policy priorities should include:

Large *adjustment needs* remain



Note: -1 percent of GDP is European Commission's Medium Term Objective for many CESEE countries.

Sources: IMF World Economic Outlook database; and IMF staff calculations.

- reducing *unproductive transfers* and reform further entitlement programs—including public pension systems—while protecting productive spending on health, education, and public infrastructure

- reforming *public employment* where the public sector wage bill is high, either because of excessive employment or disproportionately high public sector wages.

- leveraging access to *EU structural and cohesion funds*—where available—so as to avoid cuts in public investment.

- shifting taxation from income to consumption—notably the VAT—and considering the introduction or strengthening of carbon and property taxes.

Countries with *a sustainable fiscal stance* could also benefit from fiscal reform that enhances long-term growth prospects. Priorities include enhancing the efficiency of public spending, shifting the tax burden away from income taxes and social security contributions that are harmful to growth, broadening tax bases, and reducing marginal tax rates.