ICEG EUROPEAN CENTER

NEWS OF THE MONTH
on EU-10 and CIS

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Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

News of the Month, *on EU-10 and CIS*

The ICEG European Center has re-launched its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

Editor

Olivér Kovács okovacs@icegec.hu

About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

Contact information

ICEG European Center, 5/B Királyhágó Street Budapest, 1126 Hungary.
Phone: (+36) 1 248 1160. Fax: (+36) 1 319 0628 E-mail: office@icegec.hu. Webpage: www.icegec.org

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Hysteresis in Poland's economic growth?

Olivér Kovács

Nowadays there are many interesting questions concerning the possible developments in the world economy, but one of the most pivotal problems is to what extent the financial crisis will affect the growth potential of the countries. In Europe, countries are preparing themselves for a slow rebound. The extent of the decline differs from country to country. In Central- and Eastern European countries we can observe differences in the velocity of the reduction in real GDP *(Table 1)*.

Table 1. Real GDP, Current Account in selected NMS and prospective members
(% of GDP)

	Real GDP				Current Account Balance*			
	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Europe	**5.5**	**2.9**	**−5.2**	**1.8**	**−7.6**	**−7.6**	**−2.7**	**−3.6**
Turkey	4.7	0.9	−6.5	3.7	−5.8	−5.7	−1.9	−3.7
Excluding Turkey	6.0	4.1	−4.3	0.5	−8.9	−8.9	−3.2	−3.5
Baltics	**8.9**	**−0.7**	**−17.4**	**−3.7**	**−17.7**	**−11.4**	**2.3**	**2.6**
Estonia	7.2	−3.6	−14.0	−2.6	−17.8	−9.3	1.9	2.0
Latvia	10.0	−4.6	−18.0	−4.0	−21.6	−12.6	4.5	6.4
Lithuania	8.9	3.0	−18.5	−4.0	−14.6	−11.6	1.0	0.5
Central Europe	**5.5**	**3.9**	**−0.7**	**1.5**	**−5.2**	**−6.1**	**−2.4**	**−3.1**
Hungary	1.2	0.6	−6.7	−0.9	−6.5	−8.4	−2.9	−3.3
Poland	6.8	4.9	1.0	2.2	−4.7	−5.5	−2.2	−3.1
Southern and southeastern Europe	**6.1**	**6.1**	**−7.5**	**−0.1**	**−13.9**	**−13.8**	**−6.6**	**−6.0**
Bulgaria	6.2	6.0	−6.5	−2.5	−25.2	−25.5	−11.4	−8.3
Croatia	5.5	2.4	−5.2	0.4	−7.6	−9.4	−6.1	−5.4
Romania	6.2	7.1	−8.5	0.5	−13.5	−12.4	−5.5	−5.6
Memorandum								
Slovak Republic	10.4	6.4	−4.7	3.7	−5.3	−6.5	−8.0	−7.8
Czech Republic	6.1	2.7	−4.3	1.3	−3.1	−3.1	−2.1	−2.2

* Movements in consumer prices are shown as annual averages.
Source: International Monetary Fund (2009): World Economy Outlook – Sustaining the recovery

As we can observe in table 1 due to the financial turmoil – erupted in the United States in 2008 – countries face large fall in GDP, which undermines their ability to maintain their potential growth rate. Poland is an interesting exception with its positive growth rate.[1] According to our basic thesis, to a certain extent deterioration is likely to be inevitable, but its considerable hysteresis calls for an explanation. What kinds of factors do determine the present performance of the Polish economy and make it an exception from negative growth? Here we do not claim that Poland would not be affected by the crisis, but its decline will be seemingly – both in its extent and timing – different from that of other Eastern European countries.

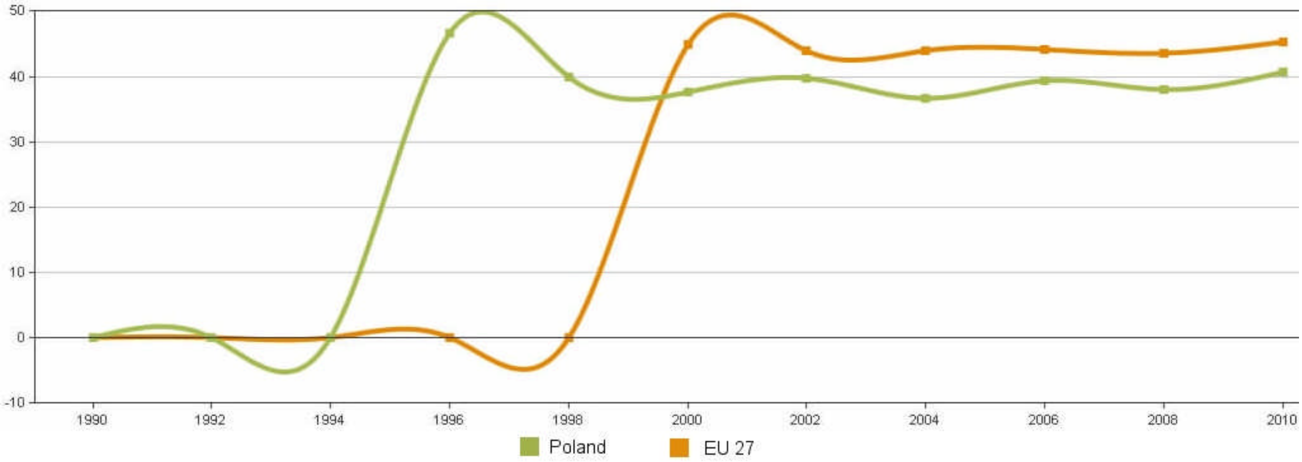
[1] Among the EU10 Poland is the only one who is performing with positive anticipated-growth rate in the forecasts. Cf. The World Bank [2009]: EU10 Regular Economic Report, 29. p.

Macroeconomic performance

Poland is a transition country which opened its economy in the early 1990s. Poland had also gone through the transformation recession, but gradually established the critical mass of the necessary stabilisation and structural reforms (e.g. reform of the pension system in 1999, which were created by among other things the awareness of demographic challenges). As a result, Poland has become one of the most successful transition economies, in accordance with trendlines theory.[2]

Behind the robust growth rate the main factors are the following: (i) inflow of foreign direct investment; (ii) investments which are in quickened demand; (iii) high consumption rate; (iv) commitment to fiscal sustainability[3] (v) dynamically growing exports. However, these factors in themselves are not able to explain why Poland could withstand to a greater extent the impact of the crisis compared to other NMS.[4] Further factors, which are related to prevailing growth theories, such as migration and remittances may help us understand this paradox. As for macroeconomic performance, we focus on the fiscal performance, because strong fiscal discipline is an important boundary condition of macroeconomic stability and development.

Chart 1. Cyclically adjusted total revenues in Poland and EU-27 ***(% of GDP)***



Source: European Commission, Annual macro-economic database (AMECO).

As far as cyclically adjusted total revenues and expenditures are concerned (*Charts 1 and 2*) even if expenditures are exceeding revenues, the budget deficit until recently was not large and was below the Maastricht criterion level. As for the debt-service, owing to the lower deficit Poland could manage its debt relatively easily, and kept it below the Maastricht threshold level. Furthermore its debt is on average 44.7 percent during the 2000-2008 period, and its composition is favourable concerning the foreign-domestic relation (EC, 2008).

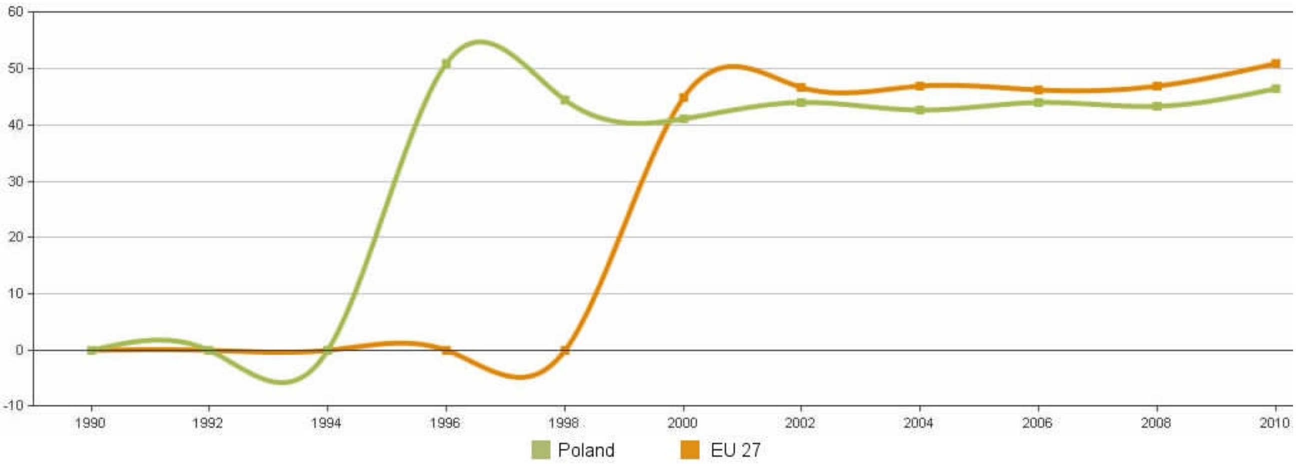
[2] According to the theory on trendlines by Ferenc Jánossy (1966) one country has passed through a successful transition when it achieved not only its performance it had had before the crisis, but only when it had already stepped back to the trendline on which it had been before, and which it would have followed without the crisis.

[3] There is a consensual view concerning national fiscal frameworks, it can complement the European Union surveillance. Poland had fiscal rules in the Polish constitution since 1999.

[4] By this we mean much slowly deterioration path than in the case of another NMS countries.

Chart 2. The cyclically adjusted total expenditures in Poland and EU-27

(% of GDP)



Source: European Commission, Annual macro-economic database (AMECO).

Re-migration: does consumption smoothing delay the decline?

Consumption smoothing refers to the outbalancing efforts of savings and spending with the aim of maintenance of the utmost living standard (e.g. some would like to consume more at present and less in the future relative to others). Since consumption is a major component of the GDP, it is important to examine its trend and sources.

As far as the structure of Polish expenditures and revenues is concerned, on the revenue side the VAT-revenues have been growing since 2001 (Hybka, 2009) as a direct consequence of the high propensity to consume. However, when the United Kingdom and Sweden opened their labour market, the upward trend of consumption came to halt temporarily due to (but not exclusively) the emigration of a large number of Polish workers, but one year later it expanded again (*Table 2*). The high Polish consumption is chiefly derived from the zero tax rate imposed on exports, which induced moderating imports and increasing exports. Through increasing exports until recently households' disposable income and domestic demand have been rising.

Table 2. Total consumption and migration data in Poland

	2000	2001	2002	2003	2004	2005	2006	2007	2008
total consumption	103.1	98.7	101.0	102.8	106.2	102.5	107.3	108.7	105.5
total investment	101.4	90.5	90.0	100.6	106.5	107.7	116.8	120.4	108.7
immigrants (in thous.)	7.3	6.6	6.6	7.0	9.5	9.3	11.0	15.0	15.3
emigrants (in thous.)	27.0	23.3	24.5	20.8	18.9	22.2	47.0	35.5	30.1
net migration (in thous.)	-19.7	-16.7	-17.9	-13.8	-9.4	-12.9	-36	-20.5	-14.9

Note: By total consumption and investment the previous year equals 100. The migration data refer to international migration for permanent residence.
Source: Poland's Central Statistical Office.

Table 2 turns our attention to the emigration and re-migration phenomenon, which might be treated as a source of growth. Migrated Polish workers have a large amount of remittances, which reduce the decline in GDP and have a strong impact on household consumption and, by an appreciation of the real exchange rate, on investment. Re-migrated Polish workers are more likely to draw on their savings and smooth their consumptions in time of crisis.

Table 2's data suggest that the much cited negative consequences of the emigration process did not appear totally unambiguous. Although more and more Polish people have left the country – which is in line with the migration history of Poland (Koryś, 2003) – it does not affect significantly the upward trend of investment and total consumption. Therefore two phenomena are obvious. First, a large number of Polish workers became migrants, but through their remittances have enriched investments as far as the migration trend went through a perceptible change when the financial crisis appeared in 2008.[5] Second, after the appearance of the crisis in Poland, analysts expected that the country's positive growth rate will fall away. But, according to data its still positive GDP growth performance slightly beats the forecasts, the sources of growth did not dry out, thanks to the relatively high consumption (by medium and larger firms too) and investment activity.[6]

In economics there is a widely accepted thesis, that the more investment, the more consumption will take a place in the long run. This happened in Poland, too, in a specific way as we have pointed out before. In the case of Poland, remittances have facilitated further the – already high – investment opportunities and this also contributes to the present positive growth.[7] In addition, the migration wave has reached an inflection point and turned, lots of emigrants are considering coming back due to various reasons: personal reasons; stable Polish currency; worsening economic climate abroad and improving business environment in Poland (OECD, 2008), and they can be additional consumers, whose spending will additionally boost the level of expanding domestic demand, and *via* this, the economic growth. They can also be consumption smoothers with the exploitation their savings. But it's hardly to be expected that its duration will be long and substantial.

According to the latest results of migration-related crisis analyses, the immigration or re-migration has a significantly positive effect on wages and real estate prices (Giovanni, 2006). Thus, the re-migration process in Poland can be a self-supporting mechanism, because it helps the desired wage expansion which attracts more emigrants to come back. Until this luring effect exists we do not expect such an enormous downturn, especially because of consumption-smoothing (*Chart 3*).

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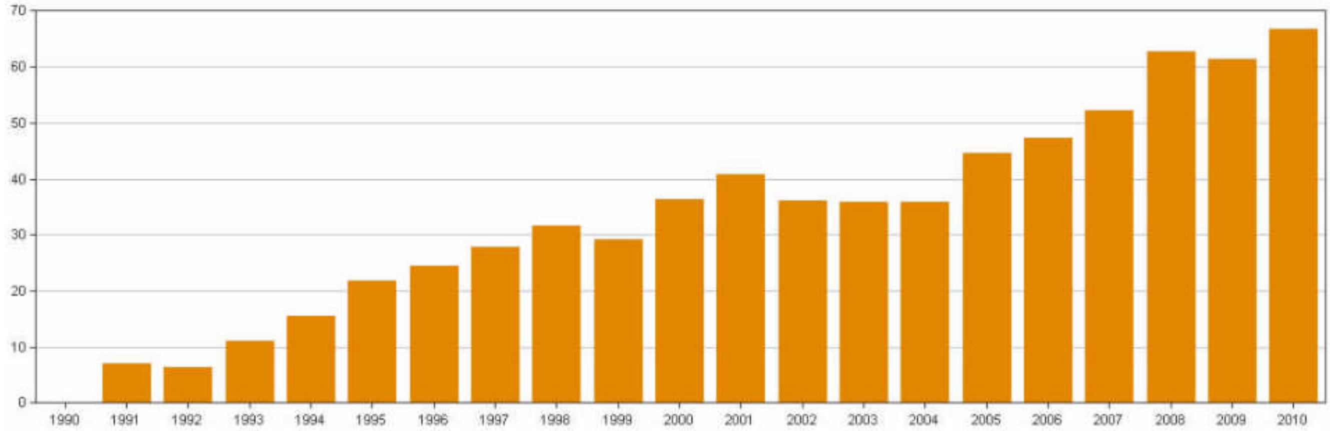
[5] This article does not assume that migration is the single cause of the experienced slowdown in investment activity. There are several other reasons why the investments have decreased by 2008. For example the shrinking amount of available credit, flight of capital and so on.

[6] These processes can be explained by the improvement in the labor market, increase in wages, inflow of EU agricultural subsidies and transfers of remittances. See also: National Bank of Poland, (2008). Available: http://www.nbp.pl/en/statystyka/bilans_platniczy/doch_en.pdf.

[7] The volume of remittances was close to 6 billion euros in 2007 by 2 million Polish living abroad; it is able to influence and help the growth potential – but in our opinion it just delays the symptoms of decline.

Chart 3. Growing savings base *(in euro)*



Note: The growing rate of savings signs us there is bigger opportunity to cover consumption from savings.
Source: European Commission, European Commission, Annual macro-economic database (AMECO)

Endangered optimistic outlook

While we have been trying to call the attention to a very interesting hysteresis-related positive growth situation in Poland, we have to emphasise that this growth condition is very fragile, and one has to expect a further depressing impact of global financial crisis. Poland has to successfully manage increasing inflation, has to resolve the problem of the shortages of working force through a very surpassing luring mechanism. The Polish government should begin the restructuring of the public sector in order to liquidate the high rent-seeking of well-organised larger interest groups and lobbies in order to make the fiscal policy sustainable in the long run before the debt level would climb up over the Maastricht threshold.

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Weaker national currency as the most obvious consequence of economic crisis in Ukraine

Liliya Levandovska

Preconditions

Notwithstanding the fact that out of all CIS countries Ukraine has ranked the highest position in the 2009 Legatum Institute Prosperity Index – 61[8] (comparing to 134 in 2008), economic crisis did affect the country's financial situation. Its most obvious consequence lies in significant weakening of the national currency which constitutes an enormous burden on ordinary Ukrainian citizens as over the last half a year they start their days with checking national currency exchange rates.

The national currency of Ukraine, hryvnia (UAH), was introduced as a result of monetary reform in 1996 to substitute former monetary units – "karbovantsi". The introduction of the national currency testified the strengthening of Ukrainian economy in the turbulent 1990s. However, the first wave of currency crisis emerged in Ukraine in the autumn of 1997 when foreign investors left Ukrainian financial markets due to unstable situation. A currency corridor was defined at the maximum level of 1.9 UAH (relating to USD).

Due to the erroneous policy of the currency emission institution – the National Bank of Ukraine – the financial crisis resulted in a 2.7-times devaluation of hryvnia, reaching to 5.3 UAH in relation to 1 USD. Nevertheless, many Ukrainian economists admit that the financial crisis of 1998-1999 led to a significant improvement of the competitive behaviour of Ukrainian enterprises as well as to faster economic growth due to higher exports in 2000. In the same year, the official currency rate was officially pegged to USD and till recently it has stayed on the level of 5.0-5.05 UAH/USD.

2008 marked a striking change in the currency rate – hryvnia rate decreased twice – from 4.65 UAH/USD at the end of August to 8-6 UAH/USD in December hitting its historic low (*see Chart 1 below*).

[8] http://www.prosperity.com/country.aspx?id=UP, *The Legatum Prosperity Index is the world's only global assessment of wealth and wellbeing; unlike other studies that rank countries by actual levels of wealth, life satisfaction or development, the Prosperity Index produces rankings based upon the very foundations of prosperity – those factors that help drive economic growth and produce happy citizens over the long term. 104 countries are ranked.

Chart 1. The course of the Ukraine Overnight Rate

According to an independent survey held by Ukrainian information analytical center FOREX over the period of September 2008 – September 2009 the official exchange rate USD/UAH decreased by 65%. Thus, Ukraine ranks the first place among the countries of CIS and Eastern Europe, as their average currency devaluation rate equals to 23% (*Table 1*); *Chart 2* explicitly shows this change.

Table 1. Currency decrease rate by countries

Country	Currency decrease rate
Ukraine	65 %
Belarus	31,3 %
Kazakhstan	26,3 %
Poland	22,5 %
Armenia	26,1 %
Russia	22,4 %
Romania	19,8 %
Moldova	15,8 %
Hungary	12.4 %
Czech Republic	0,1 %

Source: http://ua.korrespondent.net/business/970573

Reasons behind devaluation

Experts still cannot agree on "whom to blame" for such a rapid decrease in the exchange rate. However, economic analysis should take into account all the indicators and specifics of the country. In this point we would agree with Ceyla Pazarbasioglu, IMF mission chief to Ukraine, who stated that there were no fundamental economic reasons for significant UAH devaluation, as hryvnia became weaker due to political uncertainty and indistinct economic policy.

Chart 2. Devaluation process month by month

Source: National Bank of Ukraine

It is true that Ukrainian authorities cannot agree on a common policy in different areas and this problem was revealed after a rapid decline of Ukrainian currency: the government headed by Prime Minister Yuliya Tymoshenko accused the National Bank and the President of Ukraine in fixing an artificial currency exchange rate and lack of action to improve the situation in currency trade. In fact, in 2009 the National Bank of Ukraine was not very active in stabilizing the situation and reacted rather slowly. The attempts of the National Bank to change the rate by interventions were not effective and resulted in the exhaustion of gold reserves. The National Bank satisfied only 20-40% of foreign currency demand. On the other hand, it also restricted bank deposits in USD or EURO.

However, the National Bank argues that it cannot stop the tendency of currency fluctuations as various fundamental factors have an impact on the exchange rate, the GDP growth, change in import and export values, lower or higher FDI, etc. Over the first half of 2009 GDP growth of Ukraine decreased by 20.3% which also constituted another historic negative record. FDI also fell; in August this indicator was the lowest since 2006 – 118 million dollars. Deficit of National Bank balance, state external debts and state budget deficit as a result of inefficient economic policy of Ukrainian government added to rapid changes in currency exchange rate.

Consumer behavior also affected the Ukrainian currency. Due to the lack of trust in national currency and stable financial policy, Ukrainian citizens contributed to speculative activities and creating a shadow market for currency trading operations in the two following ways: buying as much foreign currency as possible (thus creating dollar deficit on the market) and massively withdrawing their deposits from the banks (thus creating hryvnia deficit for the banks). As a result of such a panic, the National Bank of Ukraine created restrictions in foreign currency operations: only banks were able to sell and buy foreign currency and they charged additional fees for such operations.

Impact of currency decrease: negative or positive?

Hryvnia devaluation had the worst impact on ordinary citizens. Together with the banking system default it led to the situation when 40% of the population was both highly indebted and out of money. Most citizens had credit accounts tied to dollar in the banks, and when hryvnia decreased twice, it meant that their credit obligations were twice higher. On the other hand, when people rushed to the banks to obtain funding (from their deposits) in order to pay off their credit obligations, the National Bank of Ukraine restricted withdrawal of deposits from the banks in order to regulate bank operations.

As for the main macroeconomic indicators, hryvnia depreciation affected both imports and exports. Nevertheless as hryvnia devaluation is faster than the rate of increase of domestic prices, it creates favorable conditions for the improvement of the competitiveness of the economy. Experts expect the currency crisis in Ukraine to stimulate exports and restrict imports what will lead to a decrease in trade deficit and create preconditions for the rehabilitation of the economy (similar to the results of the currency crisis in 1998-1999).

Stabilization need

It is obvious that the currency rate will not go back to the level it was in 2007-2008, so the main task lies in fixing it by National Bank interventions. International banks also plan to invest additional dollar amounts in their cooperation with Ukrainian banks. Another important fact is that since economic situation is tied to the political one, after the Presidential elections in February-March 2010 the citizens are expected to see stability again and to fill the banks with their savings. This fact will serve as an additional stimulus for economy development.

The most important lesson to be learned is that sound social, monetary and fiscal policy together with political stability and consensus of state authorities in Ukraine is the key to the stabilization of the national currency. Eliminating exaggerated inflation expectations, panic and speculation and avoiding populist promises is the main task for the government of Ukraine. Cooperation with IMF (Ukraine has received three tranches amounting to 11 billion USD and expects the forth stand by transfer equalling to 3.8 billion USD) in terms of fulfilling obligations may be one of the most important tools ways to save the national currency.

Bulgaria – the gathering storm?

Olivér Kovács

Our starting point in this article is that Bulgaria compared to Hungary can be treated as a well performing economy referring to the fulfilment of the Maastricht Convergence Criteria. That is why its ERM II entering process is likely to be a real perspective. In early autumn the Finance Minister of Bulgaria, Simeon Djankov proclaimed that the most important aim of the new government is to replace the lev with the euro as soon as possible; the target date is 2014. In order to fulfil this objective the government has started the discussion with the European Commission in connection with the accession to the ERM II. It means that Bulgaria is about to abrogate its till last days successful Currency Board system.

Current account deficit – anguish or not?

The only concern in Bulgaria's macroeconomic performance might be its enormous current account deficit, which has been inexorably increasing for several years. It eclipses that level which already caused currency crisis in East Asian countries. According to the classical empirical results, huge current account deficits are an explicit sign of an imminent currency crisis. The Bulgarian substantial current account deficit is well documented, therefore it is a puzzling question why the currency crisis did not take a place until nowadays. The aim of this article is to contribute to a better understanding why the Currency Board regime could be successful in Bulgaria. Our hypothesis is that even though the Currency Board is eventually a monetary „strait jacket", as it requires that the all time governments painstakingly maintain strict fiscal discipline, the Currency Board is able to stop currency crisis (Grimm, 2007).

As a result of this special manifestation of fiscal and monetary policy constellation, Bulgaria has still not still experienced currency crisis nonetheless its very ostentatious current account deficit (it was 25% relative to the GDP in 2008). If we consider other empirical findings of those countries that had current account deficit in a similar degree, we can conclude that they went through currency crisis.[9] In the light of this statement, our examination of Bulgaria can be quite relevant. Albeit the handling with potential currency crisis is not completely superfluous, we argue that the possibility of an imminent currency crisis is low. If we take into account without any nitty-gritty analysis the empirical evidences of the East-Asian financial crisis in 1997 – which was basically rooted in a different economic-societal developing model[10] – we can claim that this crisis also illustrated the connection between current account balances and currency crises.

[9] Previously lots of states went into insolvency with their current account deficits which were hardly beyond 10 percent. For example: the economic crisis in East Asia (Stiglitz – Yusuf, 2001).
[10] For example the specific phenomenon of so called *crony capitalism* from where the moral hazard could arise. Shang-Jin - Wei, Yi Wu (2001).

Table 1. Development of current account balances at the time of Asian financial crisis and nowadays among selected Eastern European countries
(% of GDP)

	1995	1996	1997		1998	2007	2008	2009	2010
Thailand	-7.9	-7.9	-2.2	Bulgaria	-0.2	-25.2	-25.5	-11.4	-8.3
Indonesia	-3.3	-3.3	-2.6	Czech Republic	-2.1	-1.5	-3.1	-2.1	-2.2
Malaysia	-10	-4.9	-4.8	Estonia	-1.1	-10.1	-9.3	1.9	2
Philippines	-4.4	-4.7	-5.4	Hungary	-9.1	-6.2	-8.4	-2.9	-3.3
South Korea	-4.4	-4.7	-2	Latvia	-9.6	-22.5	-12.6	4.5	6.4
Taiwan	2.1	4	2.3	Lithuania	-11.6	-15.1	-11.6	1	0.5
Hong Kong	-3.9	-1.3	-1.5	Poland	-3.8	-5.1	-5.5	-2.2	-3.1
Singapore	16.8	15.7	15.2	Romania	-7.3	-13.5	-12.4	-5.5	-5.6
Japan	2.2	1.4	2.2	Slovakia	-9.4	-5.1	-6.5	-8	-7.8
China	0.2	0.9	2.4	Slovenia	-1.1	-4	-5.5	-3	-4.7

Note: 2009 and 2010's data stem from estimations by European Commission.
Source: National Statistics and EC (2009).

It is not an outworn notion in the well-charted currency crisis-related economic literature that those countries were under speculative attack, which had been operating negative current account balance year by year (*Table 1*).[11] From this point of view, the fact that Bulgaria hasn't gone through a currency crisis in recent years can be surprising. As Table 1 illustrates, we could talk about seriously sizeable current account deficits only in the case of Thailand and Malaysia before and during the East Asian financial crisis. On the other hand, in the case of Eastern European countries, Bulgaria has one of the highest current account imbalances in the observed period.

Similarly to the explanation of the East Asian crisis, where the latter analysts did not try to start out from the superficial investigation of fundamental macroeconomic data, in our view it would be advisable if we could be in accordance with this deeper-watching approach. It is especially important to see deeper than the macroeconomic surface, because the well-cited usual suspects of currency crisis (slowing growth; soaring budget deficits and inflations)[12] – as the experiences of East Asian crisis showed – weren't observed in the case of the two above-mentioned countries having sizeable current account deficits (*Table 2*).

[11] See also: Bustello (1998); Benczes (2002).
[12] See also: Corsetti, Pesenti and Roubini (1998),

Table 2. Major macroeconomic indicators in Thailand and Malaysia
(% of GDP)

Thailand	1994	1995	1996	1997
budget balance	2	2.6	1.6	-0.4
Inflation	5.1	5.8	5.9	5.6
public debt	5.8	4.7	3.7	n.a
Malaysia				
budget balance	2.5	3.8	4.2	1.6
Inflation	3.7	3.4	3.5	2.7
public debt	50.1	42.8	n.a	n.a

Source: IMF (1998)

At a first glance our Bulgarian example does not show a bad macroeconomic condition like in the case of the East Asian countries before their financial crisis (*Table 3*), but owing to the substantial current account deficit of Bulgaria we have to consider the deeper circumstances if we would like to understand why the Bulgarian government is forced to support every surplus inducing mechanism.

Table 3. Major macroeconomic indicators in Bulgaria
(% of GDP)

Bulgaria	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
budget balance	0.2	-0.3	0.6	-0.8	-0.3	1.6	1.9	3	0.1	1.5
inflation	2.6	10.3	7.4	5.8	2.3	6.1	6	7.4	7.6	12
public debt	79.3	74.3	67.3	53.6	45.9	37.9	29.2	22.7	18.2	14.1

Source: European Commission, Public finance in EMU 2009.

Currency board

After the financial crisis in 1997 the Bulgarian government decided to introduce the Currency Board as a new type of monetary regime by the formation of fixed exchange rate. It pegs the lev to the euro. This may be regarded on the one hand as a monetary “strait jacket” and on the other hand a due incentive for the government to commit itself to the fiscal discipline. It needs to be explained in more detail. Through the Currency Board the national bank relinquishes its self-oriented monetary policy, that is why it is important for the government to manage fiscal policy with prudent approach, technically to accumulate huge reserves. That is to say, the Currency Board requires the intrinsic role of fiscal discipline.

Fiscal discipline is a hurdle for the government to increase its role. It is a crucial momentum if we take into account the notable crisis literature which says that crises have taken place where the public sector had grown significantly before.[13] In Bulgaria, there is a tendency of decreasing public expenditure (in 2003 its share was 40.6% of GDP; in 2007: 39.1%, and in 2008: 38%). This obligation causes limited room for fiscal policy to manoeuvre as it has been proved by the empirical

[13] See: Kam Hon Chu (2007): Financial crisis, liberalization and government size. *Cato Journal*, Vol. 27., No. 1.

evidences in Eastern European countries (Grigonyté, 2004). For almost ten years Bulgaria has a near-balance – predominantly with surpluses – budget. Without this forcing pressure Bulgaria could not have maintained the positive expectations and sentiments of foreign investors. The situation in Hungary is in a diametrically opposed condition, where the self-oriented monetary policy – with floating exchange rate – could not be able to apply properly its inflation-targeting system, and the fiscal policy was not forced to be committed to balanced budget. Owing to these facts, the values of the convergence criteria are getting far away from the allotted levels of the Maastricht Treaty.

Outlook

As for the prospects of the Bulgarian economy, we have to consider the impact of the current global financial crisis. It results in a significant relapse of the Bulgarian domestic demand, thus it will be accompanied with the dwindling inflationary pressure on economy, and as a consequence of imports decreasing more rapidly than exports, the current account deficit will moderate further. We can conclude that the current account deficit has a benevolent effect on the evolution of the crisis. According to this statement, the answer for our Bulgarian puzzle is its Currency Board regime. Ultimately we can make our standpoint that the Bulgarian Currency Board is a successful arrangement even if it means a monetary "straight jacket", because of its forcing ability to a less flexible but disciplined fiscal policy. The planned ERM II entering and the euro zone will provide the proper flexible latitude for the fiscal policy, which is particularly good in time of crisis when government intends to stimulate the economy.

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Macroeconomic crisis in oil-based economy of Russia

External expert

The President of Russia, Mr. Dmitri Medvedev announced that the Russian economy needs radical transformation from the oil-based economic structure. He stated it recognising that as a consequence of the international financial and economic crisis, speculative and real demand for oil collapsed leading to an unprecedented fall of oil prices. This turned the earlier booming Russian economy and its subsectors into deep recession, also threatening policymakers with serious disequilibrium in fiscal, growth, external issues. Medvedev implicitly graded the performance of economic policy of the last decade that assured a dominant role for the energy sector, even if effective steps have been made to treat the excessive revenues both in monetary and fiscal policy terms.

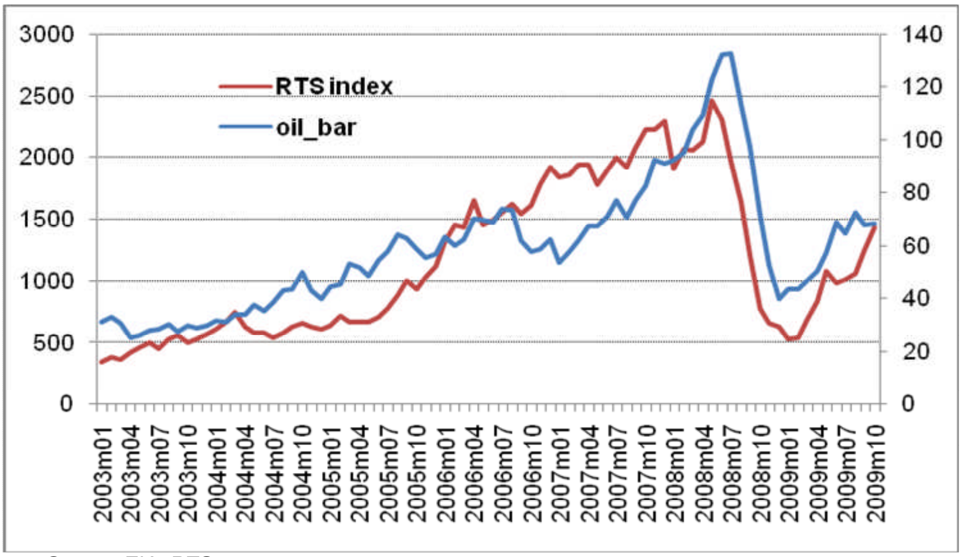
Scenarios and special characteristics

In the current crisis the general scenario of the individual country reactions consists of two effects. One comes directly from the international financial turmoil, the other from the collapsing world business cycle and external demand. While financial and real transmission channels are interconnected, one follows the other. Developed countries, as the epicentres of the crisis, were firstly affected by the problems of financial sector leading to real economy sickness.

Emerging countries like Russia, with more traditional-conservative financial sectors and less financial deepening, rather experienced a drop of external demand for their production. Of course, as financial markets are highly globalised, the local financial system cannot avoid liquidity and solvency challenges. The two effects, however, act parallel and intensify each other.

Possibly, there is no country that could avoid the crisis get in. However, the structural characteristics of an economy matter. Russia's main feature is the dominant role of fossil fuels that is proven by the almost univocal move of oil price and stock exchange index. To have a look on the asset prices, one can see in 2003-2008 a permanent and dynamic growth of oil prices. The midst of 2008 brought the collapse of Brent Spot prices, as in the course of half a year it decreased from 130 USD/barrel to 40 USD/barrel, mainly as a consequence of simultaneously bursting asset price bubble and deteriorating real demand for oil itself.

Chart 1. Oil price and Russian Stock Exchange index



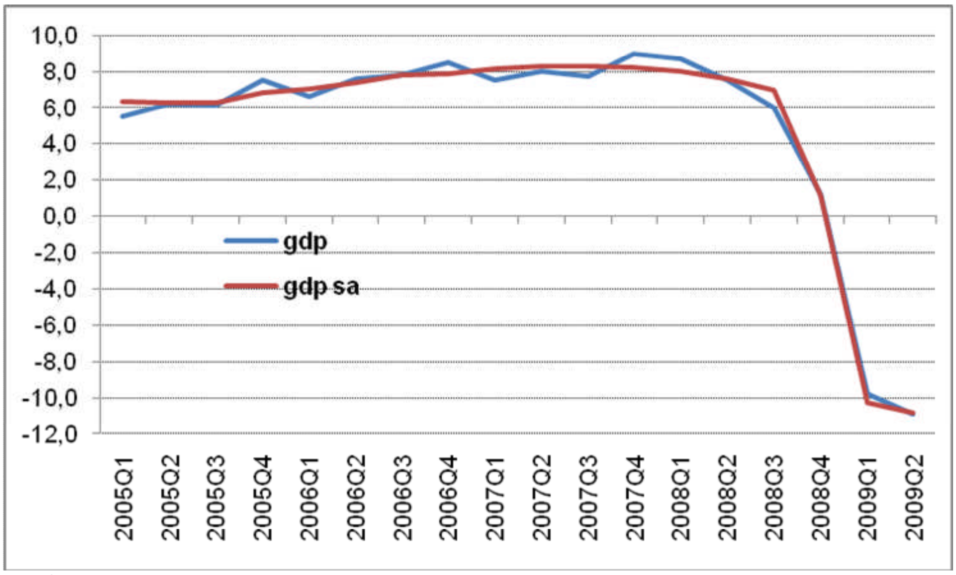
Source: EIA, RTS

Thus, Russia had to face simultaneously the effect of worldwide drop in demand for its exports, and the deterioration of the terms of trade, especially those of its main primary export products (natural resources), leading to an extreme overshoot concerning main macroeconomic indicators.

Macroeconomic implications

Concerning growth performance, one can observe the break of real GDP growth trends in the fourth quarter of 2008, and severe recession since the first quarter of 2009, when real GDP decreased by 9.8%, and in the second quarter by 10.9%. The drop was mainly generated by a considerable fall in industrial production on the supply side and the collapse of export revenues from primary exports on the demand side. Around 30% of GDP is connected directly or indirectly to the fossil fuels.

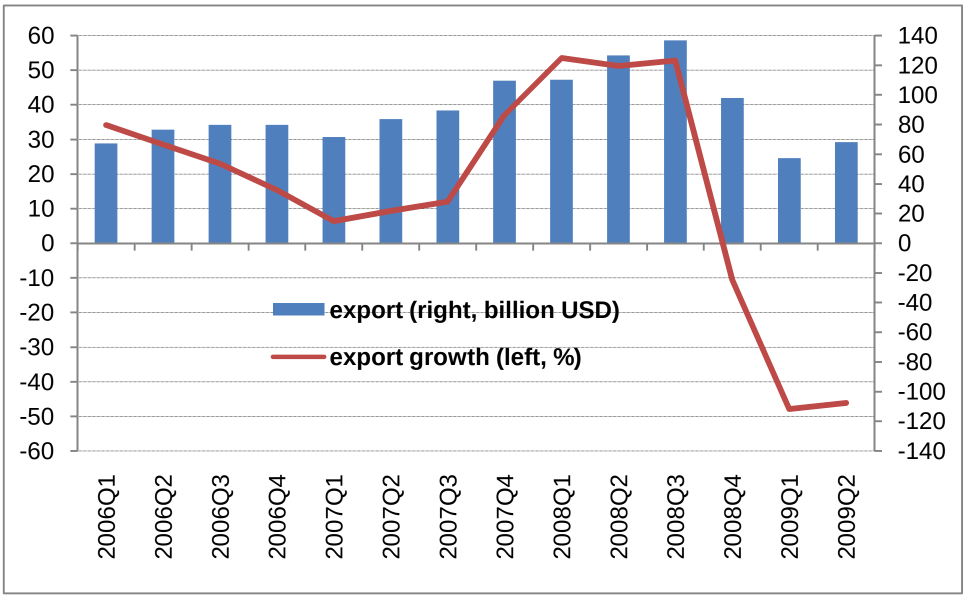
Chart 2. Real GDP growth (%, year-on-year)



Source: Rosstat

As concerning the international economic relations, external balances were also hard hit by the simultaneous drop in oil prices and demand for export products leading to nominal and volume decrease in exports. The export value of goods decreased in the second quarter of 2009 by 46%, resulting – taking into consideration the drop of imports – in a 52% contraction in trade balance. All in all, the current account balance, calculated on the basis of the last four quarters moved to 3.9% of GDP, as compared with 6.1% in 2008 and 5.9% in 2007.

Chart 3. Export of goods



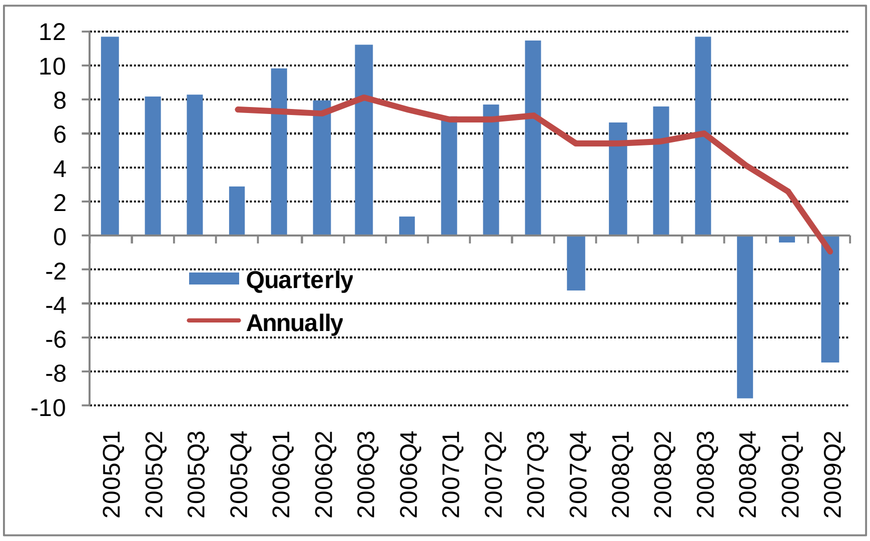
Source: Central Bank of Russia

As concerning public finance processes, the federal budget balance turned into a considerable deficit, changing the so far experienced decline in GDP-related public debt position and the long period of budget surpluses. In the second quarter of 2009, the annual budget balance turned into negative, reaching 1% of the GDP, after annual budget surpluses ranging from 4% to 8% (See Chart 4.).

Parallel, the debt of the federal budget started to soaring from the historically low 6% and expected to get above 12% in 2009. In 2008, 47% of federal budget revenues (10% of GDP) were originated from oil and gas related activities. This meant a 4.1% total budget surplus for the country, while the non-oil balance came to a 6.4% deficit in 2008. In April 2009, the government amended the budgetary law, by calculating 7.4% total, and 12.5% non-oil deficit.

As a matter of fact, the so called oil funds of the budget, the Reserve Fund and the Welfare Fund accumulated significant USD reserves based on rents from natural resource exports. However, these sources are depleting fast, especially in case of permanent need of the economy for government fiscal stimulus.

Chart 4. Federal budget balance (% of GDP)



Source: Ministry of Finance of Russian Federation, Economic Expert Group

Wide-ranging consequences

It has clearly been made obvious by recent economic and consequently political processes, that sustainable economic growth is not an easy issue. While the so-called natural resource abundance brought excessive rents both for the energy sector and for the budget itself, the institutional and structural development level of economy was not appropriate for effectively absorbing and turning such funds into competitive economic and democratic political progress. Rather, as we could experience, it gave opportunity for rent-seeking behaviour of interdependent economic and political agents. These short-run perceptions came to an end with the significant amplitude of business cycle heightened by exposure to single sector (fossil fuels).

It is hardly accidental that the current political - and in our case also economic – power recognised that in order to have the leadership on the long run, it is not enough to shave the sheep and to allocate it for votes. The first sign of recognition were the announcement of Prime Minister Vladimir Putin, who after almost a decade of ruling put in forefront the necessity of privatisation against the earlier statist behavior with the aim of building competitive economy. The other sign was the aforementioned interview with President Medvedev, who stated that without long-term market-friendly economic and political reforms, Russian economy remains – by his words – “slightingly and primitively” exposed to risks originated from one-sided economic structure.

Much has to be done – not least in the field of institutions – in order to prepare Russia to be able to avoid the theoretically well known and empirically quite strongly proven natural resource curse.