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**Article**

## Public Debt in Central, East, and Southeast Europe

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Mario Holzner

## Public Debt in Central, East, and Southeast Europe

### PUBLIC DEBT AND FISCAL POLICY

In the 23 economies of Central, East, and Southeast Europe (CESEE)<sup>1</sup>, nominal general government gross debt levels, expressed in euros, have been on the rise over the long run almost everywhere (Figure 1). Many countries in the region have started from just a few billion euros in the early 2000s, after a decade of transitional and banking crises in the 1990s. Latest annual data from 2020 depicts an average of about EUR 60 billion and a median of some 30 billion. This indicates that the region is composed of many very small economies with fairly little state capacity and a few large ones, such as Russia, Turkey, and Poland, which are the only countries in CESEE with debt levels above EUR 200 billion. Most of the others are well below EUR 100 or even EUR 50 billion. Some of the smallest economies, such as Montenegro, Moldova, and Kosovo are even below EUR 5 billion. About a third of the countries have the euro as their legal tender and most of the others have a de facto fixed exchange rate vis-a-vis the euro. Those further to the east and/or dependent on the export of gas and oil, such as Russia, Ukraine, Belarus, Kazakhstan, but also Turkey, are rather tied to the US dollar.

In relative terms, general government gross debt in percent of GDP has been declining since the early 2000s during an extensive period of economic growth to levels of below 30 percent in most CESEE economies in 2007, at the eve of the global financial crisis (Figure 2). From then on public indebtedness typically increased to around 50 percent of GDP by 2015. Then again, a period of economic recovery reduced the share of public debt in GDP by several percentage points. With the outbreak of the Covid-19 pandemic in 2020, this trend was once again reversed.

Between 2019 and 2020, the average ratio of general government gross debt to GDP jumped from around 40 percent to 50 percent (Figure 3). Economies hit particularly hard by the pandemic, such as the tourist destinations Croatia and Montenegro, as well as the car manufacturers Slovakia, Hungary, Romania, and Slovenia experienced stronger increases in public debt. Currently, only Montenegro is at a level above 100 percent of GDP. Croatia is close to 90 percent, Hungary and Slovenia around 80 percent. Albania is another outlier with public debt of

about 76 percent in GDP. All the other governments have managed to keep public debt at or well below 60 percent of GDP. Thus, by broad standards, the region is only a little indebted. In some economies, public debt is well below 30 percent (Bulgaria and Kosovo) or even 20 percent (Estonia and Russia) of GDP.

Clearly, the jump in debt levels in 2020 was induced by the functioning of automatic stabilizers during the Covid-19 crisis and related support programs such as the widely used short-time work schemes. The average general government expenditures increased from 37 percent to 43 percent of GDP (Figure 4). Particularly strong increases in public expenditures were recorded in the tourism dominated economies of Montenegro and Croatia, which are countries that also have the highest levels of public expenditures far above 50 percent of GDP.

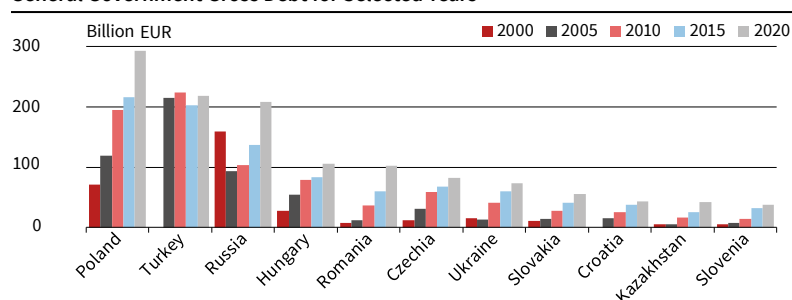
Because during crises periods revenues are also strongly affected, the net effect on the general gov-



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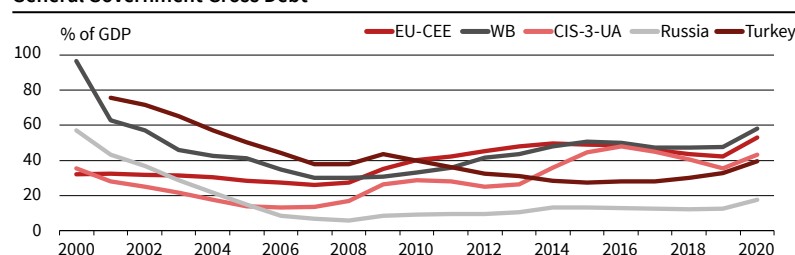
Figure 1  
General Government Gross Debt for Selected Years



Source: Wiiw Annual Database.

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Figure 2  
General Government Gross Debt

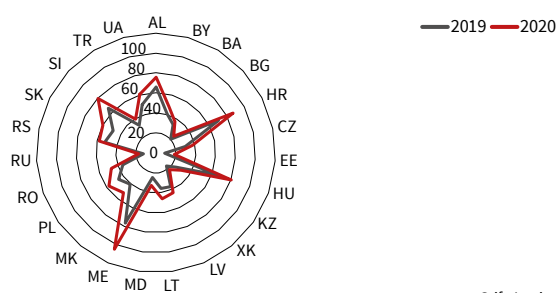


Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine.  
Source: Wiiw Annual Database.

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<sup>1</sup> Albania (AL), Belarus (BY), Bosnia and Herzegovina (BA), Bulgaria (BG), Croatia (HR), Czechia (CZ), Estonia (EE), Hungary (HU), Kazakhstan (KZ), Kosovo (XK), Latvia (LV), Lithuania (LT), Moldova (MD), Montenegro (ME), North Macedonia (MK), Poland (PL), Romania (RO), Russia (RU), Serbia (RS), Slovakia (SK), Slovenia (SI), Turkey (TR), Ukraine (UA).

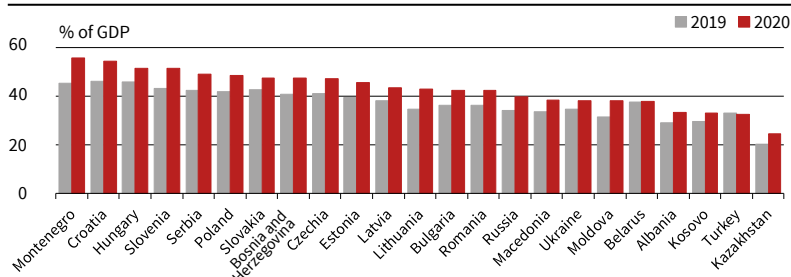
Figure 3  
General Government Gross Debt in % of GDP



Source: Wiiw Annual Database.

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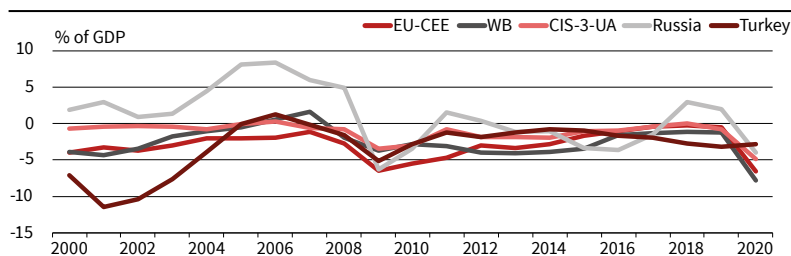
Figure 4  
General Government Expenditures



Source: Wiiw Annual Database.

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Figure 5  
General Government Balance

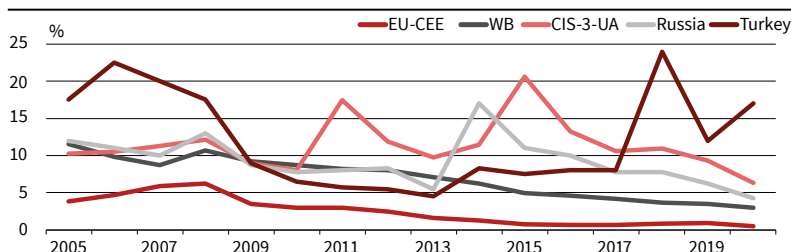


Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine. Data per annum, end of period.

Source: Author's calculations based on Wiiw Annual Database.

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Figure 6  
Central Bank Policy Rate



Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine. Data per annum, end of period.

Source: Author's calculations based on Wiiw Annual Database.

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ernment balance in 2020 is negative everywhere in the region (Figure 5). 2020 budget deficits range from 1.7 percent of GDP in Belarus, which had literally no Covid-19-related preventive measures in place, all the way to 11.1 percent of GDP in Montenegro. On average, budget deficits jumped from 0.7 percent in 2019 to 6.3 percent of GDP in 2020. Over the last

two decades the region had average budget deficits of above 2 percent of GDP, which hints at a fairly conservative fiscal policy stance. Economic recovery periods, such as the years before the outbreak of the global financial crisis and the pandemic, have even seen budget surpluses in many CESEE countries.

## THE REFINANCING OF DEBT AND EXTERNAL VULNERABILITIES

The refinancing of debt in general became easier over time. The global secular trend of falling nominal interest rates is also visible in the region's central bank policy rates (Figure 6). Most of the region saw a drop in the interest rates from double digits in the early 2000s down to around five percent most recently. In the EU member states in Central and Eastern Europe (EU-CEE), the policy rates even dropped from about five percent to close to zero since 2015. Certainly, the quantitative easing programs of the US Federal Reserve and particularly the European Central Bank (ECB) have also had their impact in the eastern periphery of Europe, where the banking sector is widely owned by banks from the euro area. In 2020, the ECB had even introduced bilateral euro liquidity lines with non-euro area central banks from CESEE.

Nevertheless, it is useful to look at the overall public and private external debt development, as this is an indicator of external vulnerability of nations. Importantly, the maturity of the total economies' gross external debt has improved in the majority of CESEE countries, when comparing the situation at the height of the global financial crisis in 2009 and the pandemic in 2020 (Figure 7). However, there are some notable exceptions that by now also have the highest shares of short-term gross external debt in GDP in the region. Slovakia, Latvia, and Czechia increased their shares from below 50, 40, and 20 percent of GDP, respectively, to almost 60 percent in the two former cases and more than 40 percent in the latter case. On average, the share in the region decreased from 21 percent to 19 percent of GDP between 2009 and 2020.

Starting from low levels of about 50 percent, overall gross external debt increased strongly in the run-up of the global financial crisis to average levels of about 70 to 100 percent of GDP (Figure 8). Recent years saw reductions to below 80 percent. In 2020 an uptick of several percentage points was observed. On average, the share of short-term gross external debt in total external debt fell between 2009 and 2020 from above to below a quarter.

The recent trend and the structure of external debt make the region more resilient during the ongoing Covid-19 crisis. However, while overall gross external debt to GDP increased on average in CESEE by about nine percent between 2019 and 2020, general government external debt increased by 19 per-

cent over the same period, from a level of around 23 percent of GDP to 27 percent of GDP (Figure 9). This corresponds to an increase in the share of public external debt in total external debt from 31 percent to 34 percent.

The biggest outlier is once again Montenegro. Before the pandemic the country already had a very high public external debt, due to its much-debated indebtedness in the wake of a Chinese highway construction project. The country until recently had no modern motorways at all. While, as a tiny, tourism-dependent nation, transport infrastructure improvements are imperative, the way this project was implemented and financed has led to strong criticism. Latest data for 2020 depicts a general government gross external debt level of almost 92 percent of GDP in Montenegro.

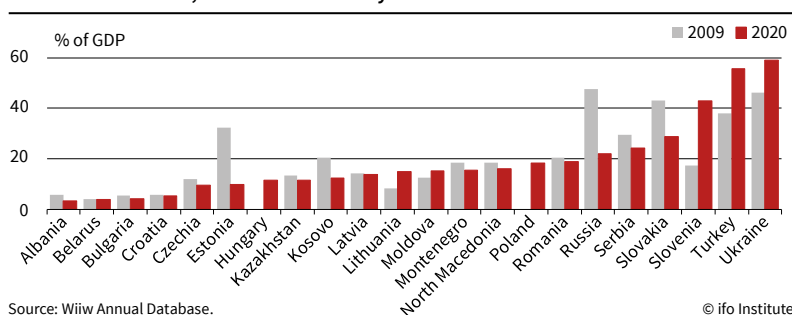
Next comes Slovenia with a level of above 50 percent of GDP. The country had to finance a very costly bailout of its banking sector in the wake of the global financial crisis with the help of external funds. Other countries have public external debt levels of well below 40 percent. Some of them have hardly any public external debt, such as Russia, Kazakhstan, and Kosovo, with levels of well below ten percent of GDP. The overall impression is that CESEE is a region that is able to refinance public debt and has fairly low levels of external vulnerability and mostly a healthy maturity mix.

## EFFECTIVE INTEREST RATES AND PUBLIC INVESTMENT

Another indication of an improved ability to refinance public debt is the effective interest rate on public debt, which has been improving substantially as compared to the situation during the global financial crisis (Figure 10). While in 2009 it was on average almost at five percent, in 2020 it was just above three percent. By comparison, in Western economies' this indicator stands at around one to two percent. In Estonia the effective interest rate on public debt was even negative in 2020.

Nevertheless, despite low levels of refinancing costs, overall investment has been declining strongly. Before the outbreak of the global financial crisis, it was increasing and contributed between two and five percentage points to economic growth (Figure 11). Over the last decade or so the GDP growth contribution of gross fixed capital formation (GFCF) dropped to around only one percentage point. Based on more detailed data available for a few CESEE countries, we know that about a third of GFCF is typically related to investment in "other buildings and structures," which is to a large extent dominated by public infrastructure investment. As is so often the case, public investment is one of the first victims of economic crises. However, given the huge investment needs that the region is suffering inter alia in

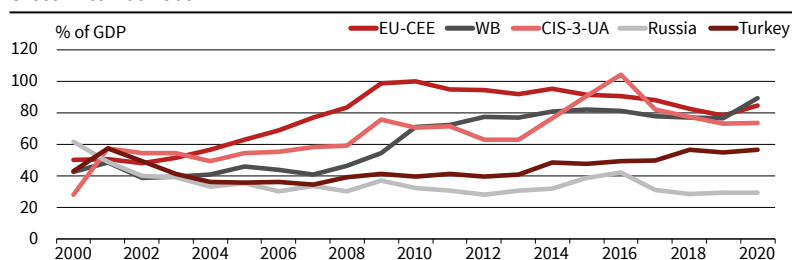
Figure 7  
Gross External Debt, Short-term Maturity



Source: Wiw Annual Database.

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Figure 8  
Gross External Debt

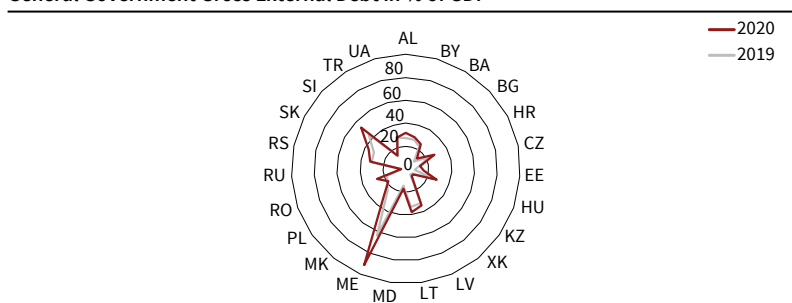


Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine.

Source: Author's calculations based on Wiw Annual Database.

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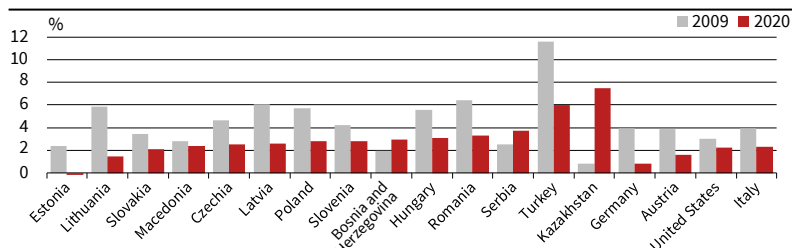
Figure 9  
General Government Gross External Debt in % of GDP



Source: Wiw Annual Database.

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Figure 10  
Effective Interest Rate on Public Debt



Note: Effective interest rate on public debt calculated as interest payments (primary budget balance - overall budget balance) divided by net public debt.

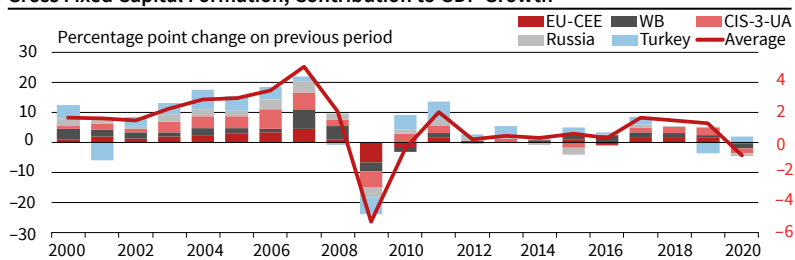
Source: Wiw calculations based on IMF.

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the fields of structural change from imitation to innovation and the European Green Deal, a stronger public investment activity is expected in the future and could from today's perspective be financed via increasing debt in the spirit of the golden rule of public finance.

Figure 11

## Gross Fixed Capital Formation, Contribution to GDP Growth



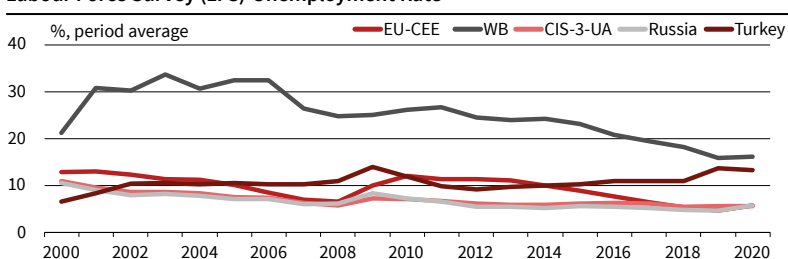
Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine.

Source: Wiiw Annual Database.

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Figure 12

## Labour Force Survey (LFS) Unemployment Rate

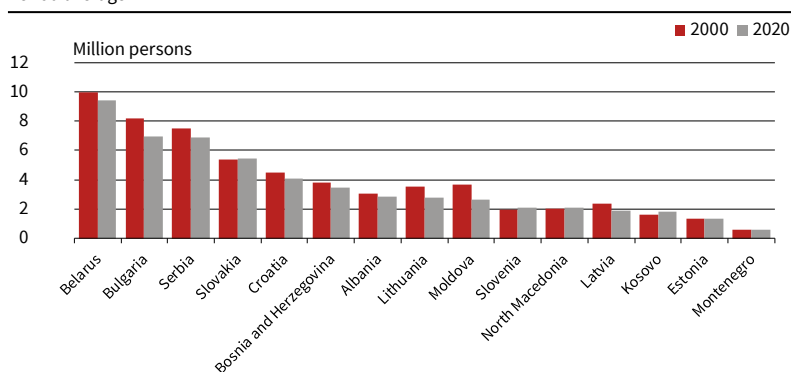


Note: EU-CEE: EU member states in Central and Eastern Europe; WB: Western Balkans; CIS-3-UA: Belarus, Moldova, Kazakhstan and Ukraine.

Source: Wiiw Annual Database.

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Figure 13

Total Population  
Period average

Source: Wiiw Annual Database.

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Moreover, although unemployment is on a secular decline in the region (Figure 12), this does not imply that the economies are overheating due to levels of high demand. With a few exceptions, demographic change was substantial in CESEE and has caused the population to either stagnate or drop (Figure 13). This involved a massive aging of the societies and a related reduction of the working age population. While there is still fairly high unemployment in the Western Balkans (WB), other parts of CESEE depict unemployment levels of only some five percent. Nevertheless, with a view on the future challenges massive investment is needed to cope with an aging society and the previously mentioned issues of structural change. Moreover, the labor market scars caused by the pandemic will likely be only visible in a few years and will be another argument for higher

public investment, also fueled by the EU's Recovery and Resilience Facility (RRF), which particularly targets the poorer EU member states in the east.

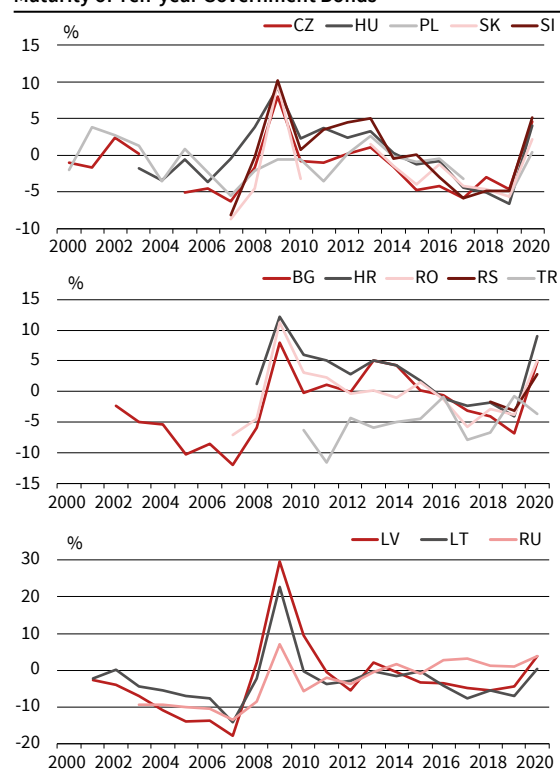
## PUBLIC DEBT SUSTAINABILITY

While it was argued above that public debt levels and related effective interest rates are by and large low in CESEE, this does not automatically imply that public debt is sustainable over the longer run. Here, it helps to compare the long-run development of deflated interest rates on public debt  $r$  and economic growth  $g$ . The former tells us about the real refinancing costs and the latter about the potential ability of the government to tax and service its debts. If most of the time  $g$  is higher or equal to  $r$ , public debt is sustainable. Our proxy for  $r$  is the yield to maturity of ten-year government bonds, deflated by the Consumer Price Index (CPI). For  $g$  we take the real growth rate of GDP.

Figure 14 presents the results for  $r$  minus  $g$  for those countries of the region for which information on ten-year government bonds is available. While refinancing costs tend to outpace economic dynamics in the crisis periods, overall and on average all the countries are on the safe side with  $r < g$  or have at least  $r = g$ . The sole exception is Croatia, with  $r$  being on average three percentage points higher than  $g$ , at least for the years where government bond yields data was available, i.e., since 2008. However, one

Figure 14

## Real GDP Growth Rate Minus the CPI Deflated Yield to Maturity of Ten-year Government Bonds



Source: Investing.com; Wiiw Annual Database; Wiiw calculations.

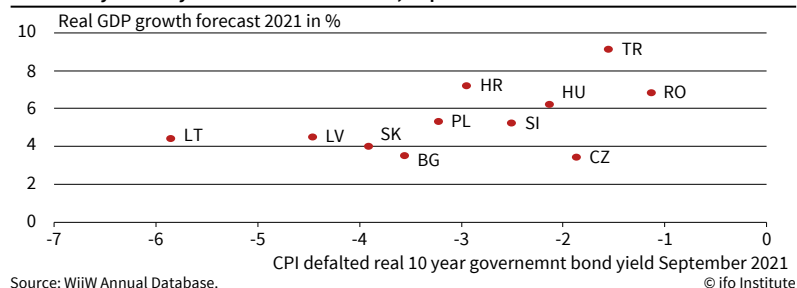
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might want to argue that Croatia is a special case, as, similarly to Montenegro, it has a beautiful coastline and related real estate can be seen as an implicit collateral that allows for extended periods of external imbalances of one way or another.

When looking at the current situation and comparing the  $r$  as of September 2021 with forecasts of year 2021  $g$  (Figure 15), we observe that given the expected strong rebound of economic activity in 2021 as compared to 2020 and currently negative real bond yields, due to higher inflation, refinancing of public debt will not be problematic anytime soon in the aftermath of the Covid-19 pandemic. Moreover, given high levels of global indebtedness, including in the US, even mild monetary tightening could cause serious problems. Higher interest rates could make it difficult to refinance public debt both in the core as well as in the peripheral economies, with a potential threat of widespread sudden stop recessions, particularly in emerging markets. This will be an incentive for the leading Central

Figure 15

**Real GDP Growth Rate Forecast for 2021 vs CPI Deflated Yield to Maturity of Ten-year Government Bonds, September 2021**



Banks to keep global interest rates close to zero and allow economic recovery to foster and thereby reduce the debt share in GDP. The countries in the CESEE region should embrace this unique opportunity and step up much-needed public investment in order to increase their long run levels of productivity and resilience.