PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 53 (1124), 10 April 2018 © PISM

Editors: Sławomir Dębski • Bartosz Wiśniewski • Rafał Tarnogórski

Karolina Borońska-Hryniewiecka • Anna Maria Dyner • Aleksandra Gawlikowska-Fyk
Sebastian Płóciennik • Patrycja Sasnal • Justyna Szczudlik • Marcin Terlikowski • Tomasz Żornaczuk

On the Same Path as Germany: Visegrad Countries' View of Fiscal Discipline

Sebastian Płóciennik

The Visegrad countries (V4) and Germany have a common interest in maintaining and promoting financial discipline in the EU. This stems from their mutual economic ties and preferences regarding the functioning of the international economy and European integration. However, this proximity is not permanent, and it can be weakened by the tendencies in the public finances of the V4 and reforms of the euro area.

The Visegrad countries' public finances are in good shape. By debt levels, Poland, the Czech Republic, and Slovakia are easily within the 60% of GDP limit set by the EU Stability and Growth Pact. Although Hungary exceeds this index, since 2011 it has systematically lowered its debt from 80% of GDP to 71.7% in 2017. This is still much better than the euro area average, which recently amounted to 88.1% of GDP (data from the third quarter of 2017). The deficit criterion also puts the V4 in a good light. The Czech Republic has a budget surplus, the remaining countries, although they note deficits, fall within the permitted limit of 3% of GDP.

This data puts the V4 close to Germany, which is a strong promoter of sustainable public finances in the EU. The leaders of the V4 countries often refer to this argument, probably guided by the desire to improve their image, undermined by disputes with the European Commission. It may also mean sending a political signal that, in many cases, Germany can count on the support of these countries. Equally important, however, are their economic interests with Germany and preferences regarding the functioning of the international economy and European integration.

Economic Relations. Mutual trade is primary. The exports of the V4 economies to Germany total €138 billion, or about 25–30% of their sales of goods and services abroad. The reverse dependence is also significant. In 2017, total German exports to the V4 amounted to €139.4 billion, which is more than with the U.S., which leads in German trade statistics (€111.5 billion), or even France (€105.2 billion) or China (€86.2 billion). A large part of the exchange with the V4 takes place inside value chains created by German global corporations and based on a precise division of labour and specialisation perfected over the years—hence, some speak about the creation of a Central European industrial cluster. This is cemented by German indirect and direct investment, which by 2015 reached €86.2 billion, as well as incrementally growing V4 capital involvement in Germany. For these relations, a stable economic environment is crucial: the closer their macroeconomic priorities, including fiscal ones, the greater the chance of undisturbed development of cooperation and benefits for both parties. This carries over, moreover, to the broader issue of German and V4 preferences on the functioning of the international economy.

Germany's exports in 2017 reached €1.279 trillion, which is equal to about 40% of its GDP. For the V4, exports are even more important, equalling 53.4% of GDP for Poland, 79.5% for the Czech Republic, 90.1% for Hungary, and 96.3% for Slovakia. The prosperity of these countries depends, to a large extent, on the proper conditions for free trade. The threat to such trade is not only the classical tariff barriers and

regulatory protectionism but also the lack of fiscal stability among trading partners, which may destabilise exchange relations, distort competition, and even lead to crises and a collapse in demand.

Similar interests, although from different perspectives, appear in the case of capital flows. Germany is today referred to as an extreme creditor with an international net investment position of €1.7 trillion (2016). It is in its interest to ensure that the value of the debt is not reduced by inflation caused by, for example, excessive fiscal expansion, or even more so because of serious debt crises. The V4 countries, in turn, are characterised by a high level of dependence on foreign capital. All have a negative net investment position: Poland is at -€256 billion, Czech Republic at -€43.5 billion, Slovakia at -€50.6 billion, and Hungary at -€74.3 billion. For this reason, they are sometimes labelled as "dependent market economies." However, external capital is needed for their development. It is in their interest to provide investors with security of their investment and maintain discipline in public finances, which increases the credibility of such assurances.

Interests in the EU. The proximity of interests between Germany and the V4 is also visible at the level of European integration. For years, Germany has been trying to push through fiscal discipline, especially in the euro area, because that secures its liabilities. From the V4 perspective, the German agenda is beneficial. The more pressure put on the reduction of deficits and debt, the smaller the borrowing needs of the members of the monetary union. This, in turn, reduces competition for access to capital, which is particularly uncomfortable for Poland, the Czech Republic, and Hungary, which have generally lower ratings than the eurozone members. When issuing long-term bonds, they must still offer higher rates of return (Poland, 3.39%; the Czech Republic, 1.82%; Hungary, 2.55%; the euro area, 1.19%). The V4 therefore has a measurable reason to support Germany in pushing for greater discipline in fiscal policy.

The next area is the structure of the EU budget. The V4 countries are beneficiaries because of the crucial role of structural and development purposes in the common spending. But it also benefits Germany, which produces investment goods acquired by the "catching-up" economies. However, problems in the public finances of many eurozone countries may lead to pushing through an alternative budgetary target: financing rescue programmes and supporting investments in the monetary union. Germans are very cautious about this idea because such programmes carry the danger of abuse and reduce incentives to implement structural reforms. The V4 states are also reluctant to lose funds to other members that may be richer but less efficient in tackling fiscal challenges.

In addition, there is also a political dimension regarding the functioning of the fiscal framework in the EU. In the past, there has been a situation in which more influential Member States, such as France, were able to obtain from the European Commission a promise of more lenient treatment of violations of fiscal rules. From a German perspective, the politicisation of the procedure is a threat to the credibility of the Stability and Growth Pact and weakens financial discipline. In turn, for the V4 countries, this is proof of the existence of different classes of membership and unequal treatment, an argument they often raise in disputes with the Commission. All in all, it leads to a common position with Germany: demanding an independent and depoliticised assessment of the Member States' fiscal policies.

Outlook. Germany and the V4 have many interests linked to the observance and promotion of sustainable public finances. However, this state is not given once and for all. Doubts arise particularly with a more detailed analysis of the fiscal data of the V4 countries. Apart from the Czech Republic, they currently have structural deficits, which means that even in times of high growth they are pursuing expansive fiscal policy. In the event of an economic downturn, they can therefore experience a rapid deepening of nominal deficits. The probability of this scenario is raised by the emerging or already implemented plans of V4 governments to increase public investment and social spending, and to raise wages in the public sector. An additional, long-term factor is the deteriorating demographic outlook, which will lead to an increase in the burden on budgets. Therefore, it cannot be ruled out that fiscal stability will gradually give way to other priorities in economic policy.

The second problem is related to the fact that there is no common platform that would allow the common interests of Germany and the V4 to gain political weight. This is about belonging to the euro area, with only Slovakia having joined so far. As a consequence, for Germany, as it prepares for political negotiations on the future fiscal framework of the euro area, the convergence of interests with Poland, the Czech Republic, and Hungary will be less important than the expectations of monetary union members, even those with quite different fiscal preferences. Possible concessions to France and southern countries may include changes in the structure of the EU budget that are unfavourable for the V4, more flexible interpretation of fiscal rules, or the possibility of issuing joint bonds of the zone. In that case, cooperation on common interests of the V4 and Germany would be weakened.