

Emerging Markets Queries in Finance and Business

# Implications of Private Sector Behavior on Public Finance Sector

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## Abstract

This paper investigates empirically the effect of private sector behavior on public finance sector for a sample of Central and Eastern European countries over the 2000-2011 period. Among the measures of private sector behavior we used the current account balance adjusted with the government balance, the financial account balance of the balance of payments, the final consumption expenditure of households and the evolution of the real economy. We find strong empirical evidence for the hypothesis that imbalances built up in the private sector would eventually spill over to the public sector under the form of government deficit and increased public debt. In the context of European integration we conclude that the Stability and Growth Pact and the Maastricht convergence criteria would need to account for this relationship when determining critical threshold values for the macroeconomic variables.

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## 1. Introduction

Starting with the early 2000s to the end of 2007 macro-financial conditions were very favorable in a global perspective. Economic growth was robust and stable, liquidity in capital and money markets was abundant, profitability in the financial sector was high, and asset prices were constantly rising. All of these were also accompanied by an important increase in the debt levels in the private sector and public finance sector as well. Financial markets started melting in the summer of 2007 as a result of the intensification of deterioration in the US housing market. In the case of Europe we were the witness of a double spillover effect: in the first step,

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spillover came from the U.S. financial system to the European financial system, and in the second step – after roughly two years – the prolonged stress in the European financial system resulted in the deterioration of public finances. The current sovereign turmoil in the euro zone reflects how fragile can an economy become in front of the relentless forces of the market. Many economists and politicians have identified that public finances have become unsustainable, unhealthy and they undermine future growth potential.

Similarly to every phenomenon in the science of economics, the sovereign debt crises also have root causes, root driving factors which determine the path of – retrospectively – unhealthy public finances. The aim of this research is to study the effects of such a driving factor, namely the behavior of the private sector. The results of the research can serve as a useful tool for policy makers in determining policy responses addressing imbalances with respect to debt accumulation in the private and public finance sector. In the context of preparations for adopting the euro, another important feature for the policy makers would be the set up of paths and guidelines with respect to harmonization of the behavior patterns with the ones characteristic for the euro zone countries. To be more precise, we are referring to characteristics which the euro zone as a whole would commit to itself.

## 2. Literature Review

As a result of the ongoing debt crisis in Europe, not only the euro zone member states need to bring their public finances on a sustainable path, but the future member states need to show effort as well. Afonso et al. 2005, evaluate if and to what extent expenditure based consolidations have been more successful than other consolidations in Central and Eastern European countries. Using logit models, the authors have showed that since the early 1990's expenditure based consolidations have been more successful in Central and Eastern Europe comparative to the revenue based consolidations. Other studies used probit models as well to evaluate consolidation effects, for the case of OECD economies McDermott and Westcott, 1996, Alesina and Ardagna, 1998, Zaghini, 1999. Results remained robust, emphasizing the effectiveness of expenditure based consolidations for adjusting budgetary deficits.

Different studies were conducted with the aim of forecasting the evolution of fiscal variables. In this respect Perez, 2005 evaluated the effectiveness of a set of fiscal indicators as early-warning-signal tools. The main indicators used in an error correction model framework were the expenditures and revenues of the central government. Camba-Méndez and Lamo, 2004, provide estimates for quarterly balances in the case of Germany and Italy, having as explanatory variables the annual general government deficits and the GDP.

Baldacci et al., 2011, developed a fiscal stress index which provides an early warning tool to identify exposure with respect to fiscal sustainability risks and also helps identify the underlying factors which drive changes in fiscal stress risks. Results show that different indicators are relevant for advanced and emerging economies. In advanced countries the top predictors of fiscal stress are indicators of gross financing needs and fiscal solvency concerns. In emerging economies, the best predictors of fiscal stress are risks associated with public debt structure and liquidity constraints.

Furceri and Ribeiro, 2008, studied the relationship between government spending volatility and the size of the economy. Based on a simple bivariate OLS model, they show that smaller countries will usually post a more volatile government spending. Other researches regarding the volatility of fiscal deficits had at its core the investigation of the effect of business cycle on fiscal policy Gali and Perotti, 2003; Talvi and Vegh, 2005; Darby and Melitz, 2007. Alesina and Tabellini, 2008, argue that most of the pro-cyclicality of fiscal policy in developing economies can be explained by high levels of corruption.

Nickel and Vansteenkiste, 2008, use a dynamic panel threshold model to study the relationship between the current account balance and the fiscal balance. Their results show that in countries with low and medium debt levels up to a debt level of 44% of GDP the relationship is positive, i.e. an increase in the fiscal deficit leads to a higher current account deficit. In countries with debt ratios between 44% and 90% of GDP the relationship is still positive, but less significantly. In countries with very high debt ratios above 90% of GDP the relationship is

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