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The public debt in Romania - factors of influence, scenarios for the future and a sustainability analysis considering both a finite and infinite time horizon

Bogdan Andrei Dumitrescu[a,b,c]*

[a]*The Bucharest University of Economic Studies, Piata Romana nr.6, sector 1, Bucuresti, code 010374, Romania*
[b]*Fiscal Council, Casa Academiei Romane, Calea 13 Septembrie nr. 13, Sector 5, Bucuresti, code 050711, Romania*
[c]*Center for Advanced Research in Finance and Banking - CARFIB, Piata Romana nr.6, sector 1, Bucuresti, code 010374, Romania*

Abstract

This paper, starting from the public debt equations and the intertemporal budget constraint proposes an analysis of the evolution of public debt to GDP ratio in Romania during the 2002-2013 periods, identifying the main factors of influence and also performs a sustainability analysis on both a finite and infinite time horizon. Thus, the paper determines the gap to the level of primary balance consistent with debt sustainability under different scenarios and concludes that the current level of public indebtedness, alongside with the long term projections of the underlying factors of influence ensure the fulfillment of the obligations to the creditors.

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* Corresponding author. Tel.: +40213184826; fax: +40213184826.
E-mail address: bogdan.dumitrescu@fin.ase.ro.

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1. Introduction

The accelerated growth of the public debt in the Euro area countries has shown the possibility of a rapid deterioration in the public finances position in the context of a steep economic downturn, a significant increase in the funding costs for countries perceived to be unsafe and of large primary deficits, the latter mainly resulting from lower budget revenue and expenditure rigidities. In the literature, a reasonable level of public debt is considered to have a positive role on economic growth. Thus, investment projects that exceed the resources available at a time can be financed, poor countries can be supported to grow faster, and the state can fulfill its role to stabilize the economy in the case of imbalances. However, from a point onwards, the public debt has a negative effect on economic growth, heavily indebted countries being exposed to the risk of capital outflows or of the rapidly deteriorating position of public finances in the context of an economic and financial crisis. The recent increase in risk premium on long-term sovereign bonds indicates that investors do not assign anymore a zero or very low credit risk for this type of investment. The risk premium evolution was differentiated, depending on the position of public finance specific to every economy and correlated with dependence on the foreign investors for financing the public debt.

The substantiation of a target for a sustainable level of public debt must also consider the concept of debt intolerance, as argued by (Reinhart et al., 2003). They show that emerging economies cannot sustain the same debt level as a share of GDP, that countries with advanced economies can manage, but a much lower one, mainly because of the limited access to capital markets of the countries from the former category. The phenomenon is related to the pro-cyclicality of the financial markets, that repeatedly lends large amounts to the emerging economies during the boom periods (associated with low returns in developed countries) and restrict capital flows to these when adverse shocks occur. But, the debtor states are also responsible for this problem: often, short-sighted governments prefer to temporarily encourage consumption by indebtedness, neglecting the long-term welfare of the citizens. The degree of debt intolerance of a country depends on, among other things, the past credit events, the inflation rate over time in that country, the public institutions development stage, the level and the maturity structure of the government debt.

(Reinhart and Rogoff, 2009) showed that when the debt exceeds a certain level, which may be significantly different from one country to another, the financial crises become more likely and more severe. Moreover, the negative impact on economic growth is not linear, but increases exponentially as the debt-GDP ratio is approaching 100% (considering the case of industrialized countries).

(Cecchetti et al., 2011) identified, studying also developed economies, a sustainable debt level of 85% of GDP, a superior level leading to a decrease of the economic growth rate, the negative impact being higher as we move away, upward from this level. Considering the additional costs of an ageing population and the impact of possible shocks on the economic advance and interest rates, the target would be significantly lower. The authors also show that delaying the adoption of the necessary adjustment policies will lead to the increase of future costs associated with the implementation of tardive measures.

The financial and economic crisis has fully highlighted the vulnerabilities of indebted economies, the level of public debt being extremely difficult to control in the context of an economic downturn, an increase of real interest rates and difficulties in the financial system. Levels, that were previously considered sustainable for indebtedness, are now perceived as excessive and generate serious solvency problems. The tolerance level for the public debt in emerging countries is significantly lower, probably below the one stated in the Maastricht Treaty and is also difficult to estimate. In this context, reducing the public debt is essential in order to restore the market confidence and to generate sufficient room for maneuver for the state, so that, in the event of a future crisis, macroeconomic stabilization measures can be promoted.

Further, it will be presented a framework for the analysis of the public debt-GDP ratio evolution in Romania in the period 2002-2012, depending on the representative factors, followed by scenarios for the future and an evaluation of its sustainability on finite and infinite time horizon. Thus, it will be calculated that level of primary balance, that is considered sustainable, respectively that level which leads to the achievement of a certain target regarding the public debt level or ensures full payment on long-term of the current debt, under various scenarios regarding the evolution of the relevant macroeconomic variables. It will also be presented a sensitivity analysis by which alternative scenarios for the evolution of the public debt as a share of GDP will be constructed, depending on changes in assumptions regarding the factors of influence.