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The Journal of Economic Asymmetries

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Sustainability of budget deficits and public debts in selected European Union countries [☆]

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ARTICLE INFO

Article history:

Received 28 July 2014

Received in revised form 12 September 2014

Accepted 15 October 2014

Available online 23 December 2014

Keywords:

Debt

Budget deficits

Sustainability

European Union

ABSTRACT

This paper presents a thorough empirical analysis of fiscal developments in the European Union over the past three decades. After an evaluation of major fiscal and financial developments in France, Germany, Greece, Ireland, Italy, Portugal and Spain, the paper uses the Present Value Constraint (PVC) framework to analyze whether European Union's debts and deficits are sustainable. It is shown that some EU's countries could be heading towards a debt and fiscal crisis, which could degenerate into a banking crisis similar to the 2001 Argentinean crisis, unless timely fiscal adjustment/austerity measures are introduced in the near future.

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1. Introduction

The last two decades have witnessed a dramatic and fundamental shift in the expenditure and taxation policies of many developed economies. Balanced budgets have virtually disappeared, and government deficit financing has prevailed. This resulted into the numerous debt crises that have been registered since the early 2000s. Those recent debt and financial crises and their respective negative spillover effects on several emerging economies have brought forward the potential damage on the world economy emanating from weak financial and public sectors' finances. Policy makers and academics have thus been recently devoting efforts in trying to predict financial and debt crises before they occur given the potential damage on the world economy, in general, and on the emerging economies, in particular, that are seldom exposed to various domestic fiscal, financial, and external imbalances. These efforts are primarily devoted to first assess the soundness of the financial/public sectors, and then attempt to forecast whether budget deficits and public debts are sustainable. In the instance where debt is not sustainable, then reforming fiscal/financial policies through the introduction of various austerity measures will be a must in avoiding fiscal, financial and banking crises.

However, the timing of the introduction of the various austerity measures remains a concern, given the recessionary environment that the European Union (EU) has been experiencing since the 2008 United States (US) financial crisis. It is believed that the newly introduced fiscal adjustment measures would keep the EU countries in recession which will further worsen the existing debt burden and hamper any future effort to grow out of the accumulated public debt through

[☆] A paper prepared for presentation at the 12th Biennial Athenian Policy Forum Conference on: "Economic and Financial Asymmetries, National Debts and Government Policies". Ryerson, University, Toronto, Canada, June 12–13, 2014. Financial support from the Institute of Financial Economics of the American University of Beirut is greatly acknowledged. The author is grateful to Constantine Angyridis, two anonymous referees, the Editor and Managing Editor of the Journal, and to Rawan Nassar and Nasser Badra for superb research assistance.

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higher real Gross Domestic Product (GDP) growth rates. Moreover, it should be noted that the accumulated EU's national debts are the result of both economic but more importantly of political/institutional factors. Therefore, austerity measures alone may not resolve the current fiscal problems but should be accompanied with other political/institutional corrective measures.

In the wake of the recent EU debt crises, the 2008 US financial crisis and the worldwide triple dip recession of the past five years, the solvency of some EU countries has become a major source of concern for the EU, endangering its financial/economic integration efforts, and the successful monetary unification through the introduction of the euro currency. It is well known that Greece, Portugal, Ireland, Italy and Spain have been running budget deficits for the past two decades averaging between 10 and 15 percent of GDP, resulting in a EU's public debt averaging above 110 percent of GDP in 2013.

As a result, policy makers have introduced various austerity measures in order to curb and limit further deteriorations in the EU's fiscal position, despite genuine fear that these measures could collapse aggregate demand, worsen the already high unemployment rates, and further lower prices. If domestic prices decline through aggressive wage and income cuts as dictated by the various austerity programs, the respective real exchange rate will depreciate so as to make domestic goods more competitive internationally. While this policy may improve the external deficits of Greece, Portugal, Spain and Italy, it is expected to lead to painful domestic adjustment measures, as a significant number of domestic firms will likely shut down, worsening further the EU's unemployment rates. Furthermore, deflation would also worsen the real burden of the EU's national debt.

With the above in mind, and in light of the various austerity programs that have been introduced recently, this paper will attempt to assess the sustainability of the EU's current fiscal policies, and evaluate whether they are violating the inter-temporal budget constraint for the public sector. Broadly speaking, such a constraint stipulates that a fiscal policy is sustainable when it is expected to generate sufficient net revenues in the future to repay the accumulated debt and its service. However, a fiscal policy becomes unsustainable if the government intends to finance its future interest expenses by issuing further debt, and is unable to generate adequate revenues even via seigniorage.

The macroeconomic literature analyzing public sector's fiscal and financial vulnerabilities have considered closely the issue of fiscal/financial sustainability. Fiscal sustainability can be determined in various ways, and the literature is rich in studies trying to assess the financial vulnerability of the public sector. This paper will make use of the Present Value Constraint (PVC) framework to look at the issue of fiscal sustainability in the EU's countries of France, Germany, Greece, Ireland, Italy, Portugal and Spain. With the exception of perhaps Germany, all remaining six countries have recently introduced various austerity measures to tackle their budget deficits and debt burdens.

The rest of the paper is divided as follows. In the next section we review the macroeconomic developments in France, Germany, Greece, Ireland, Italy, Portugal and Spain over the past three decades with a close look at the development of fiscal and other macroeconomic variables. After a literature review, Section 3 explores empirically the issue of public debt sustainability in the above EU countries using the PVC framework. Section 4 concludes the paper with some policy implications.

2. Fiscal and macroeconomic developments in the European Union: 1977–2013

In this section, we overview the recent macroeconomic developments in the EU's countries of France, Germany, Greece, Ireland, Italy, Portugal and Spain over the period 1977–2013. We highlight the dynamics of the following fiscal variables: government spending and revenues, fiscal deficits, and public debts. The yearly fiscal data are from the following reliable sources: Euromonitor International from national statistics, Eurostat, Organization for Economic Co-operation and Development (OECD), and the International Monetary Fund (IMF's) World Economic Outlook (WEO). We gather data on government revenues and expenditures, budget balance, and government total debt.

Figs. 1–7 highlight the major fiscal developments in the EU's selected sample countries over the period 1977–2013. For all the countries in the sample there exists a steady increase in government revenues since the late 1970s, accompanied by a steady increase in government spending inclusive of debt service. However, Greece, Ireland and Spain have been experiencing a decrease in government revenues with a clear widening gap between both government expenditures and revenues since the 2008 US financial crisis. Another key variable for analyzing debt sustainability is the fiscal deficit. A steady increase in the budget deficit would increase the likelihood of debt becoming unsustainable and would contribute to the worsening of the management of public debt. Moreover, a continuous increase in the fiscal deficit through insufficient tax revenues or increased government expenditures or debt service would render debt unsustainable by (1) increasing the real interest rate, (2) reducing the rate of growth of real GDP, and (3) through increasing the overall level of debt. Germany and Italy's deficits appear to be oscillating between 0 and 4 percent of GDP, since the late 1990s, pointing to relatively sustainable and sound fiscal policies (Figs. 2 and 5). In France, the deficit is slightly higher hovering between 2 and 7 percent of GDP over the same period (Fig. 1). Wider budget deficits are registered in Greece, reaching 15 percent of GDP in 2010 during the Greek fiscal crisis, 29 percent in Ireland over the same year, and 10 percent for Portugal (see Figs. 3, 4, and 6 respectively). While Ireland and Spain's budget deficits have been close to zero since the early 1980s, they experienced a huge deterioration in 2010, reaching a low of euros 50 and 120 billion in 2010 respectively (Figs. 4 and 7).

The accumulation of consecutive budget deficits, coupled with high interest rates, high levels of government spending with no adequate revenues led to the accumulation of a huge EU's public debt. Total public debts have been increasing for all EU's countries since 1977. While Ireland's debt was stable at around euros 40 billion in between 1980 and 2006,

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