



Twin deficits and financial integration in EU member-states

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Abstract

In this paper, we find that changes in general government balances in the EU-15 member-states are matched to a large extent by opposite changes in the private savings–investment gap, implying that changes in public sector deficits have a rather small relationship with current account deficits. Also, using an empirical framework implied by a well-known, intertemporal model of the current account, we find that current account developments in Greece are explained by factors which are related to financial and economic integration, such as interest rate spreads and growth differentials, as well as to the general government balance.

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1. Introduction

One of the central issues in both economic policy and open-economy macroeconomics is the relationship between public sector (general government) deficits and current account deficits. It is often argued that the two deficits are related strongly and positively (“twin deficits”) and this is the way that this relationship is usually presented in the financial press. If this is true, national or world current account imbalances can be (easily?) tackled to the extent that public sector deficits are, more or less, under government control.

However, the relationship between public sector and current account deficits is more complicated, depending on the behavior of the private sector savings/investment gap, since the

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well-known national account identity states that the current account deficit is equal to the sum of the public sector deficit (that is, the difference between government investment and government saving) and the private sector deficit (that is, the difference between private sector investment and saving).

Almost every contribution to the literature on open-economy macroeconomics examines the macroeconomic implications of a higher public sector deficit and, in particular, its effects on the real exchange rate, output, private savings, private investment and the current account. The Mundell–Fleming–Dornbusch model might be said to remain the standard paradigm although many authors are also using the new, open-economy macroeconomics framework (for differences and similarities between the different models see, among others, Lane (2001), Obstfeld and Rogoff (1996), Vines (2003)).

According to the standard paradigm, the effects of a higher public sector deficit are transmitted through two channels of influence, namely the goods market (via the real exchange rate) and the capital account (via the real interest rate). A higher public sector deficit is associated with an appreciation of the real exchange rate and higher output (as aggregate demand increases). As a consequence, it is also associated with a deterioration of the current account. In addition, a current account deficit results in net asset decumulation and higher foreign debt. The impact of this on expenditure, as well as long-term considerations regarding the need to raise taxes to repay the public sector debt, are additional transmission mechanisms through which public deficits might affect external deficits.

Two particular cases deserve special attention for being at the two opposite extremes. Firstly, the debt neutrality (Ricardian) hypothesis: according to one version this hypothesis suggests that in a world with no imperfections and infinite horizons, changes in budget deficits cause offsetting, one-to-one changes in private savings through anticipations of changes in future taxation. Therefore, national savings and the current account remain unaffected (Barro, 1988).

Secondly, complete crowding out of net exports: in a small open-economy where all goods are perfect substitutes and freely traded (that is, the law of one price holds) while domestic production is either at the full employment level or is fixed due to a rigid real product wage, a higher budget deficit causes a one-to-one increase in the current account deficit. It may be noted that this result remains valid in two other cases: (a) in the conventional Mundell–Fleming–Dornbusch model with perfect capital mobility and a floating nominal exchange rate, and (b) under the ‘New Cambridge’ assumption (Fetherston & Godley, 1978) that the private sector’s (households and corporations) net acquisition of financial assets is zero (that is, under the assumption that private disposable income is equal to private consumption and investment).

In an interesting contribution, Blanchard and Giavazzi (2002) attempt to explain current account developments in certain European Union (EU) member-states emphasizing factors related to economic and financial integration. First, the reduction in interest rate spreads and in currency risk due to nominal convergence, which, for net borrowing countries, increase private investment and reduce national savings. Unless government net lending (that is, the general government surplus) moves sufficiently in the opposite direction, this channel implies an increase in the current account deficit to GDP ratio. Second, the increase in competition through economic integration, which is expected to increase total factor productivity, improving the home country’s growth prospects. Unless the growth rate of trade partners exceeds the home country’s growth rate, this channel also implies an increase in the current account deficit to GDP ratio.

Blanchard and Giavazzi (2002) use an explicit utilitarian approach with households living for two periods and maximizing a logarithmic utility function under a two-period budget constraint. Their model is thus different than the more traditional Mundell–Fleming–Dornbusch models of

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