Journal of Applied Economics. Vol XVIII, No. 1 (May 2015), 71-98

DEBT REDUCTION, FISCAL ADJUSTMENT, AND GROWTH IN CREDIT-CONSTRAINED ECONOMIES

Emanuele Baldacci
Italian Statistical Institute (ISTAT)

Sanjeev Gupta and Carlos Mulas-Granados*
International Monetary Fund (IMF)

Submitted April 2014; accepted October 2014

This paper assesses the effects of fiscal consolidations associated with public debt reduction on medium-term output growth during periods of private debt deleveraging. The analysis covers 107 countries and 79 episodes of public debt reduction driven by discretionary fiscal adjustments during the 1980–2012 period. It shows that expenditure-based, front-loaded fiscal adjustments can dampen growth when there are credit supply restrictions. Instead, fiscal adjustments that are gradual and rely on a mix of revenue and expenditure measures can support output expansion, while reducing public debt. In this context, protecting public investment is critical for medium-term growth, as is the implementation of supply-side, productivity-enhancing reforms.

JEL classification codes: H30, E62
Key words: debt consolidation, fiscal adjustments, output growth, credit constraints, bank deleveraging

---

* Carlos Mulas Granados (corresponding author) and Sanjeev Gupta: International Monetary Fund (IMF), 700 19th St., N.W., Washington, D.C. 20431, USA; e-mails: cmulasgranados@imf.org; sgupta@imf.org. Emanuele Baldacci: Italian National Institute of Statistics (ISTAT), Via Cesare Balbo, 16, Roma 00184, Italy; email: baldacci@istat.it. The paper has benefited from helpful comments by Emre Alper, Cristina Brandimarte, Benedict Clements, Daniel Leigh, Takuji Komatsuzaki, Jeta Menkulasi, Joanna Pereira, Tigran Poghosyan, Sergio Sola and by participants at IMF and Italian Treasury seminars and the 2013 Banca d'Italia conference on public finance in Perugia. The paper has also improved thanks to the comments by Jorge M. Streb (Jae's editor) and two anonymous referees. The authors wish to thank Ibraheem Mehmood and Haoyu Wang for excellent research assistance. The usual disclaimer applies.

I. Introduction

The recent increase in the ratio of public debt to GDP in advanced economies has been accompanied by the assumption of banking sector liabilities by the public sector following the inception of the global crisis in 2007.[1] The average contribution of financial-sector support to gross public debt has been over 10 percent of GDP.[2] This has worsened public debt dynamics in some countries, raised market pressure on credit risk spreads, and undermined output recovery. In addition, access to credit by the private sector has been hampered by the deterioration in balance sheets of the banking sector, owing to the accumulation of non-performing assets, funding pressures from credit markets, and poor quality of collateral. As a result, output has been shrinking or growing modestly in advanced economies, while fiscal and financial sector weaknesses remain to be addressed (IMF 2012a).

Under these conditions, fiscal consolidations have not succeeded in lowering public debt in relation to GDP (IMF 2012b). Fiscal deficit-reducing measures in the presence of credit restrictions have worsened budget positions without being compensated by a substantial increase in private sector's activity. As a result, domestic demand, economic activity, and government revenues have declined. The beneficial effect of fiscal adjustment on interest rates (and thus private credit growth) has been limited because of the perceived link between sovereign and financial sector credit risks.[3] Furthermore, monetary policy effectiveness has been limited by impaired financial sector transmission channels.

This paper studies the effects of fiscal adjustment on output growth by focusing on credit conditions that typically follow financial crises. The center of analysis is episodes of public debt reduction arising from discretionary fiscal adjustment. In doing so, the paper departs from the existing literature on the nexus between fiscal adjustment and growth, which typically side-steps the question of whether public debt was ultimately reduced in the process. By focusing on the medium term, the paper complements recent studies on shortterm fiscal multipliers (Guajardo, Leigh and Pescatori 2011; Corsetti, Meier, and Muller 2012).

[1] This has happened during other periods in history as well: see Rogoff and Reinhart (2009) and Laeven and Valencia (2008; 2012).

[2] It is 6 percent if Ireland is excluded from the calculations. See Table 7 in IMF (2012).

[3] While the recent experience in Europe shows that credit restrictions can also be partially due to fiscal problems, the sample used in this paper shows that the correlation between the budget balance and credit variables was below 8 percent in the past.

Download English Version:

https://daneshyari.com/en/article/7356185

Download Persian Version:

https://daneshyari.com/article/7356185

Daneshyari.com