



The Impact of the European Financial Stability Facility (Efsf) in the Euro Area: Contemporary Problems, Difficulties and Perspectives

KEYWORDS

fiscal policy, sustainability, public debt

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ABSTRACT *The recent financial and economic crisis debt sustainability and the resulting increase in fiscal deficit has generated renewed interest in domestic as well as external debt sustainability issue of the highly indebted developed and developing countries. This paper examines the potential impact of the European Financial Stability Facility (EFSF) on government debt (and deficit) in euro area countries using the present value of budget constraint approach. In this context, the following question appeared: How did the government solve short-, medium- and long-term fiscal challenges posed by aging societies? What strategies must we adopt to provide that someone will pay to the budget? Empirical results indicate that the series of government expenditure, revenue and discounted debt are non-stationary and assessment of budgetary positions because it is crucial that the European economic governance.*

INTRODUCTION

The sustainable development of a country has many inter-dependent dimensions. The financial and fiscal sustainability might be the least popular of them, but the objectives of environmental, ecological, social, cultural and political sustainability vitally rely on it.

Moreover, as of 1 July 2013, the European Stability Mechanism (ESM) is the sole and permanent mechanism for responding to new requests for financial assistance by euro area Member States. Starting that day the European Financial Stability Facility (EFSF) may no longer engage in new financing programmes or enter into new loan facility agreements.

The potential impact of the European Financial Stability Facility (EFSF) on government debt (and deficit) in euro area countries is substantial, given that guarantees for EFSF issuance of up to a total ceiling of €440 billion (around 4.8% of GDP at the euro area level) have been provided on a pro rata basis over three years (2010-13). When the EFSF expires in mid-2013, the European Stability Mechanism (ESM) will come into place as a permanent crisis resolution mechanism.

EFSF will, of course, continue to finance its existing programmes for Ireland, Portugal and Greece. The program for Ireland will be completed by the end of 2013. The programmes for Portugal and Greece will be completed in 2014. Once the programmes have finished, it will also continue to roll over the maturing debt until all the loans have been repaid by the beneficiary Member States. Consequently, EFSF will remain an important issue of medium and long-term bonds for the years to come.

In this context, the following question appeared: What financial instruments should be included in the fiscal sustainability assessment? What is a safe level of the debt to GDP ratio? What would be the impact of recent fiscal crisis promoting fiscal discipline and limiting fiscal vulnerabilities that adverse economic shocks occur in the future?

The study aims to answer these questions on build upon some previous similar attempts for new EU Member States (see Fanizza and Mourmouras, 1994, Ballabriga and Martinez-Mongay, 2003, Berenger and Llorca, 2007, and Sturm and Gurtner, 2007 etc.) and the 2012 Fiscal Sustainability Report in the following important direction, i.e. an assessment of short-term, medium-term and long-term general government fiscal sustainability for sixteen countries from EU region based primarily on 2012 data and/or average data for the 2009-2012 period.

The paper is organized as follows. The first section introduces the concept of fiscal sustainability and discusses the importance of reflecting on the fiscal sustainability and the main sustainability indicators proposed by the theoretical and empirical literature. The next section presents the empirical framework and results of the estimations of selected indicators under a variety of assumptions and in the final section provides concluding remarks and some policy implications.

THEORETICAL BACKGROUND AND EMPIRICAL METHODOLOGY

Today, there are significant social, political, and economic challenges that created to governments new threats from financial crises and other risks. Those challenges are based on demographic, climate, security, technological and economic changes.

According with Bispham (1987) if interest is paid and the primary deficit ($b=Bt/Yt$) is a constant ratio of GDP, the overall public deficit ratio is not constant. Hence, interest payments can cause the overall public deficit to change and the debt/GDP ratio depends on the relationship between the interest rate, r , and the economic growth rate, g , which can be presented as (if $g > r$):

where D_t , Y_t , B_t , R_t stand for total public debt, nominal GDP, nominal primary (negative) balance of the public sector (i.e. the gap between non-interest expenditure and total revenue) and a residual factor applicable to the public sector, respectively. In addition, r_t represents the real interest rate applicable to the public sector and g_t the real economic growth rate. On the other hand, in order to measure medium-term and long-term tax gaps (Blanchard, 1993) and the sustainable conventional public balance alternative indicators have been introduced.

where exp , trf and n stand for government expenditure, transfers (both as a ratio to GDP), and the numbers of years over which exp and trf are incurred, respectively. However, equation (2) holds if the values of n and $(r - g)$ are not large. The long-run tax gap is similar to the medium-term tax gap. However, it is specified for a period of 30-40 years and allows for factors that change expenditure (e.g. demographics) (see Wickens, 1992).

DATA AND EMPIRICAL RESULTS

Regarding empirical results, first, we concentrate on the short-term sustainability of sixteen EU countries. Table 1 shows the results of fiscal sustainability based on equation (2). In 2012, the actual (short-term) sustainable fiscal levels

seem to be higher than calculated one, if we consider actual public debt in the great majority of EU countries.

Consider long-term fiscal sustainability the results indicate (Table 1) that practically all EU countries show unsustainable long-term public finance. The groups of countries face moderate problems with (negative) gaps between the actual and calculated fiscal balance of around 1.0 percentage points. However, the most substantial long-term fiscal problems might affect Greece and Italy, Belgium, Romania and Netherlands.

Most Member States the sustainability gap is due to the com-

pounding effects of an unfavorable initial fiscal position and an increase in the budgetary cost of ageing. However, for most of them this initial budgetary position is not enough given the expected long-term increase in expenditure due to an ageing population. Only Italy has an initial fiscal position that is favorable enough to absorb the expected increase in costs related to ageing. Latvia is in the bottom left quadrant because of a negative sustainability gap, arising from the projected decrease in age-related spending, which would also compensate for the required adjustment that would have been otherwise necessary on the basis of the initial fiscal position.

Table 1 Long-term fiscal sustainability in the EU countries

Country	Public debt (D/Y) (2012)	Growth rate of real GDP (g) (2013 – 2018 project.)	Actual public debt assumpt.	Targeted public debt assumpt. (60% of GDP)	Actual primary public balance (-B) (2009 -2012 averages)	Actual public balance (2012)	Diff. (Actual – Calculated) Actual public balance (2009 – 2012 averages)	Diff. (Actual – Calculated) Actual public balance (2012)
SI	73,81	3,3	-2,09	-1,98	-3,08	-1,87	-1,1	0,22
CY	76,12	4,4	-3,08	-2,64	-4,07	-1,32	-0,99	1,32
FR	70,62	2,42	-1,54	1,43	-3,52	-2,64	-1,98	-1,21
EE	107,8	3,52	-3,41	-2,09	-5,72	-2,86	-2,31	-0,77
IT	117,26	1,65	-1,76	-0,99	-4,07	-3,74	-2,31	-2,75
MT	70,4	2,97	-1,87	-1,76	-3,3	-2,86	-1,43	-1,1
ES	43,78	3,85	-1,54	-2,31	0,99	1,98	2,42	4,29
LV	31,02	4,51	-1,32	-2,64	-2,09	-1,32	-0,88	1,32
AT	79,09	5,72	-4,07	-3,41	-5,72	-4,73	-1,65	-1,32
UK	61,49	6,71	-3,74	-4,07	-4,62	-3,52	-0,77	0,55
LT	46,75	4,95	-2,09	-2,97	-4,84	-4,29	-2,75	-1,32
NL	79,86	8,25	-5,94	-4,95	-9,24	-8,47	-3,3	-3,52
DE	95,48	4,4	-3,85	-2,64	-4,84	-1,98	-0,99	0,66
BE	195,91	4,62	-8,14	-2,75	-11,44	-12,21	-3,3	-9,46
FI	64,02	5,83	-3,41	-3,52	-4,29	2,31	-0,88	1,21
RO	39,49	4,62	-1,65	-2,75	-4,62	-6,27	-2,97	-3,52
SK	59,4	6,82	-3,63	-4,07	-3,19	-3,08	0,44	0,99
CZ	69,41	5,83	-3,63	-3,52	-4,29	-0,88	-0,66	2,64
BG	18,3	2,62	-8,09	-4,23	-7,62	-3,63	0,88	36,52
DK	45,3	4,95	2,10	-1,10	-1,54	-3,19	-2,09	56,87
IE	11,2	2,62	-7,85	-4,59	-8,84	-3,63	0,88	36,52
EL	15,7	2,93	-8,86	-4,51	-7,48	-3,63	0,88	36,52
LU	26,9	4,95	2,10	-1,10	-1,54	-3,19	-2,09	56,87
HU	76,8	8,25	-1,16	-6,93	-5,28	-3,08	3,85	70,18
PL	56,1	4,4	5,36	1,10	0,66	-1,43	-2,53	56,87
PT	40,5	3,85	1,05	-1,21	-1,54	3,08	4,29	28,49
SE	34,1	3,62	-8,09	-5,04	-7,04	-3,63	0,88	36,52

Sources: IMF (2012), author's calculations

CONCLUSIONS

If public debt did not exist, it would most certainly be invented soon because there are significant risks to fiscal sustainability in the aftermath of the financial and economic crisis in euro area countries. Unfortunately, in many emerging markets and developing countries, weak political institutions and incompetent and corrupt public administrations impose very strict limits on the amount of public debt, internal and external, that can be carried.

Second, for many developing countries and emerging markets, the interest rate on its foreign currency debt will often be a highly concessional one. The government will be rationed at that rate, that is, it will not be able to borrow more at anything like that rate, which therefore does not represent (and understates) the true opportunity cost of foreign borrowing.

Third, implementing this required adjustment in the coming years before ageing-related expenditure starts to rise significantly, i.e. pre-funding the ageing costs, would lead to the reimbursement of public debt and the creation of net government financial assets in a number of countries.

The analysis presented in this paper is limited to the potential direct impact of possible banking losses on public finances,

meaning the impact that a decision to support part of the distressed banking sector would have on the government's budget. Excluded are "second-round effects" linked to the fiscal consequences of possible bank defaults.

All the problems presented emphasize the urgency of a coherent agenda setting because sustainable public finances constitute an important foundation for the economic growth, financial stability and price stability.

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