

## **Fiscal sustainability vs. fiscal vulnerability**

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### **Abstract**

There are many recent studies that brought into attention that fiscal policy in many advanced economies has confronted multiple difficulties over the last decades. For instance, Fatas and Mihov (2009) and Afonso, Agnello, Furceri and Sousa (2009) pointed out that fiscal policy in the euro area has been mildly pro-cyclical, and that the adoption of the common currency and the constraints imposed by the Stability and Growth Pact had not a large impact on the cyclical behavior of the structural balance. Afonso (2000) and Afonso and Rault (2008) indicated fiscal sustainability issues for the European Union member states. Corsetti and Roubini (1996), Alesina (2000), Kotlikoff and Hagist (2005) also predicted that current fiscal policies of most EU countries based on growing social spending will become unsustainable in the future. Scott (2010), Ghosh, Kim, Mendoza, Ostry and Qureshi (2011) and Reinhart and Rogoff (2011) also showed the increasing tendency of public debt and expressed their concern that it will reach unsustainable levels.

Studying fiscal sustainability has great importance given the recent macroeconomic developments and the economic recession worldwide, but we believe that similar significance has also understanding fiscal vulnerability. Hemming, Kell and Schimmelpfennig (2003) indicated, for instance, that fiscal vulnerabilities were central in at least 6 of the 11 cases of past crises. They found that public sector solvency and liquidity problems culminated in sovereign debt default for Russia and Ecuador, led to negotiations for debt restructuring under the shadow of default in the case of Ukraine or Pakistan whilst persistent and growing fiscal deficits were central cause that put pressure on Bulgarian and Brazilian currencies. A flexible fiscal policy can play a crucial role in absorbing shocks and avoiding transforming them into systemic risk.

Therefore, the aim of this paper is to present on a much detailed manner aspects related to fiscal sustainability and vulnerability. There is a 'thin red line' that separates the two concepts and the literature is still very confusing in that sense. There are discussed issues concerning theoretical background, methodological aspects and tools of investigation, and also empirical results.

**Keywords:** fiscal policy, budget balance, primary balance, public debt, fiscal reaction function, fiscal sustainability, fiscal vulnerability

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