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MEAN REVERSION OF THE FISCAL CONDUCT IN 24 DEVELOPING COUNTRIES*

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In this paper, we examine the mean reverting behaviour of fiscal deficit by analysing the fiscal position of 24 developing countries. Using annual data over the period 1970–2003 and the series-specific panel unit root test developed by Breuer *et al.* (*Oxford Bulletin of Economics and Statistics*, Vol. 64 (2002), pp. 527–546), we found the budget process for most developing countries fails to satisfy the strong-form sustainability condition. Further investigation shows the budget process for a majority of the countries is on a sustainable path (weak form) when a one-time, structural break is allowed in the model. Therefore, our empirical results suggest that the budget process in most of the sample countries is in accordance with the intertemporal budget constraint.

1 Introduction

The issue of fiscal deficits and their sustainability is of great analytical and empirical interest to both academicians and policymakers. From the theoretical perspective, a large and growing fiscal deficit would lead to a worsening of the current account and appreciation of the real exchange rate. This is also consistent with most theories that suggest a fiscal contraction will be associated with a weakening of the currency. The so-called 'twin deficits' (fiscal and current account deficits) is experienced by the developed and developing economies as well. From a policy point of view, determining whether the fiscal balance is on a sustainable path over time is important because the answer to this question may indicate the need for policy correction before the imbalances become insolvent and lead to a hard landing. An analysis of the deficit process helps to determine whether current fiscal imbalances can be maintained in the

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