MEAN REVERSION OF THE FISCAL CONDUCT IN 24 DEVELOPING COUNTRIES*

by

AHMAD ZUBAIDI BAHARUMSHAH
Universiti Putra Malaysia (UPM)

and

EVAN LAU†
Universiti Malaysia Sarawak (UNIMAS)

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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