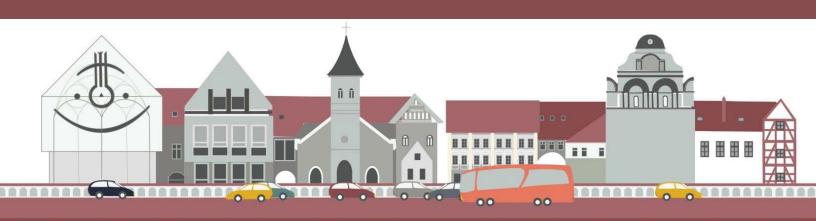


DEVELOPMENT IN ECONOMICS: THEORY AND PRACTICE

12th International Prof. Vladas Gronskas Young Researchers Scientific Conference

Reviewed Selected Papers





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STABILITY AFTER CRISIS: CHANGES IN DEBT HOLDERS

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ABSTRACTIn this paper author finds links among changes in private and public debt during and after economic downturn. Financial deepening in years before economic downturn resulted in growth of indebtedness among agents within the economy that sustained afterwards. The European Union has not become less indebted during and after economic meltdown, but the structure of debt holders has changed. The growth of private debt in upturn phase resulted in qualitatively new level of economy. However, in order to sustain the same level after economic downturn public sector was forced to increase its debt. As a result, interactions among financial stability and fiscal sustainability have become more pronounced as monetary financial institutions experienced deleveraging from private sector and increase of leverage from public sector. In this paper financial stability is and fiscal sustainability are analyzed by employing flow-of-funds data that shows balanced interlinkages among real and financial flows. Recent discussions on sovereign debt instability and suggestions to diminish public debt whatever it costs lack appropriate answer who will replace it as flow-of-funds in economy is always in balance.

KEYWORDS: Financial stability, fiscal sustainability, flow-of-funds analysis, interconnectedness, balance sheet approach.

INTRODUCTION

The significant transformation of financial markets, institutions and infrastructures over the last few decades has substantially enhanced the role of finance in the economy. In majority of countries the increase in financial assets and (or) liabilities was several times faster than the growth rate of countries' income (gross domestic product, GDP). Along with the evident advantages of financial deepening, however, a number of disadvantages emerged as well. Notably, during economic, financial or other types of crises, the financial burden built-up earlier greatly aggravates the position of indebted economic agents, resulting in slower output growth afterwards. Additionally, the substitution of debt holders occurs within the economy. Deleveraging by private and financial sectors' is substituted by increase of public sector leverage because economy is adjusted to new level (new normal). One the one hand this is a result of expansionary fiscal policy and growth of need for resources especially for countries with lack of reserves in down-turn phase. On the other hand, this is result of substantially higher national income level that was previously supported by strong increase in private leverage.

Level of indebtedness is one of the core measures by discussing financial stability and fiscal sustainability issues both in a local and a global context. Taking into account its complexity, safeguarding financial stability and fiscal sustainability has become a challenging task for policy makers. The rising interconnectedness between sectors and economies has made the analysis even more complicated. Demand for comprehensive and consistent data sources which could be of help in assessing interconnectedness and spill-over effects has increased. The role of national and financial accounts' (real and financial flow-of-funds) data could play important role here.

The aim of this paper is to discuss interconnections among financial stability and fiscal sustainability by showing the real structural reasons of public sector debt growth after economic down turn. National and financial accounts of European Union countries are used in order to support the idea that public debt is a result of former build-up of other sectors' debt rather than a cause of economic downturn. Original balance sheet approach is used in order to disclose debt holder change issue within the economy. The paper is organized as follows: Section 2 presents the interaction between finance, economy and government,