

FEMISE MED BRIEF

Forward Thinking for the EuroMediterranean region

September 2018

Med Brief No 11



FEMISE Brief co-edited with CASE



Pr. Doaa Salman is professor of Economics at October University (MSA), Egypt.

She is head of economics department and Vice dean for community services and environmental affairs in Egypt. Her main research interest is in international trade and development. Her research appears in : *European Journal of Economics, Journal of International Business & Finance* and *International Journal of Green Economics*.

Email: dr.doaaslman@gmail.com



Pr. Vassilis Monastiriotis is Associate Professor of Political Economy at the European

Institute (LSE). He holds a PhD in Economic Geography (LSE, UK) and his research spans across Economics, Geography and Political Economy. He has published in journals such as the *Journal of Regional Science, Urban Studies, Journal of Applied Economics, Empirical Economics, the Review of Development Economics, Applied Economics Letters, Economic and Industrial Democracy*.

Email: v.monastiriotis@lse.ac.uk

Keywords : macro imbalances, external position, fiscal consolidation

FEMISE

CMCI
2, rue Henri Barbusse
13241 Marseille Cedex 01
Téléphone : (33) 04 91 31 51 95
Fax : (33) 04 91 31 50 38
www.femise.org

External and internal imbalances in South Mediterranean countries: Challenges and costs*

by Pr. Doaa M. Salman
& Pr. Vassilis Monastiriotis

in collaboration with :



1. Summary

This policy brief provides insights on the medium and the long term consequences of the external and internal imbalances in the South Mediterranean (South Med) countries over the period of the last twenty years [1], trying to identify the main areas of macroeconomic imbalance in these countries and the key aggregates which seem to drive wider developments in their macroeconomic and fiscal positions. The results indicate that macroeconomic imbalances in the South-Med region have to do predominantly with the external position of these countries (external debt, net foreign asset positions and, less so, the current account balance) and are only secondarily related to problems of the domestic fiscal position (budget deficits and government debt).

This diagnosis seems to be at odds with recent policy measures in the region, which prioritised fiscal consolidation as a means for correcting macroeconomic imbalances. Instead, it highlights the importance of focusing on the real part of the economy, and addressing specifically issues of market functioning, business competitiveness, sectoral specialization, labour productivity, and the efficiency of investments. We argue that such issues require policy responses that will combine attention to structural reforms (especially in the direction of raising the efficiency of public administration and tax collection mechanisms) with careful interventions aiming to support domestic savings and production diversification and re-specialisation, not least through public assistance to entrepreneurial risk-taking and private investment. Such interventions may have a longer-run horizon but they also have the potential to produce more economically sustainable and more socially desirable outcomes.

2. Introduction

South-Med countries continue to reel from sporadic economic and political uncertainty. External and internal imbalances imposed by, and intertwined with, current political, demographic and social challenges, urge for targeted policies aiming at achieving sustainability. The importance of this has been made particularly visible following the economic turbulence that engulfed parts of the North Mediterranean region after the global financial crisis. In the South-Med countries, such imbalances can be argued to create additional challenges, increasing the uncertainty of the transition steps, especially in the light of the growing socio-economic problems and political instability after the Arab spring.

Fig 1. Government debt in South-Med Countries (1990-2015)

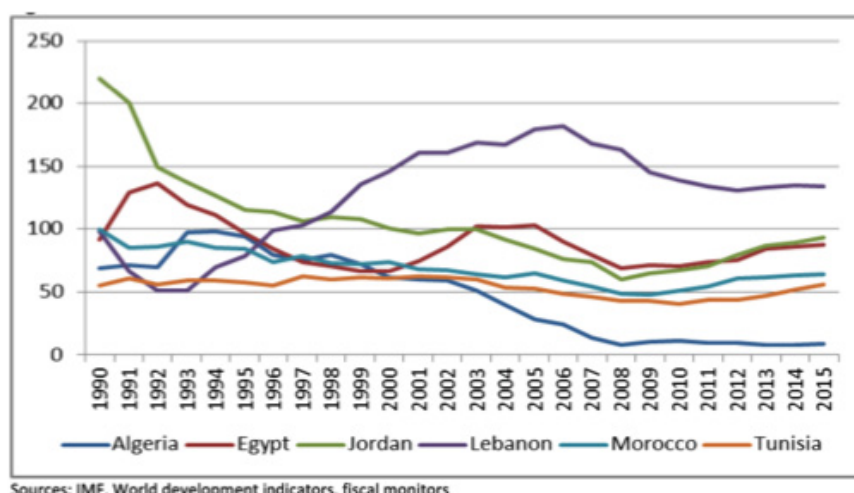
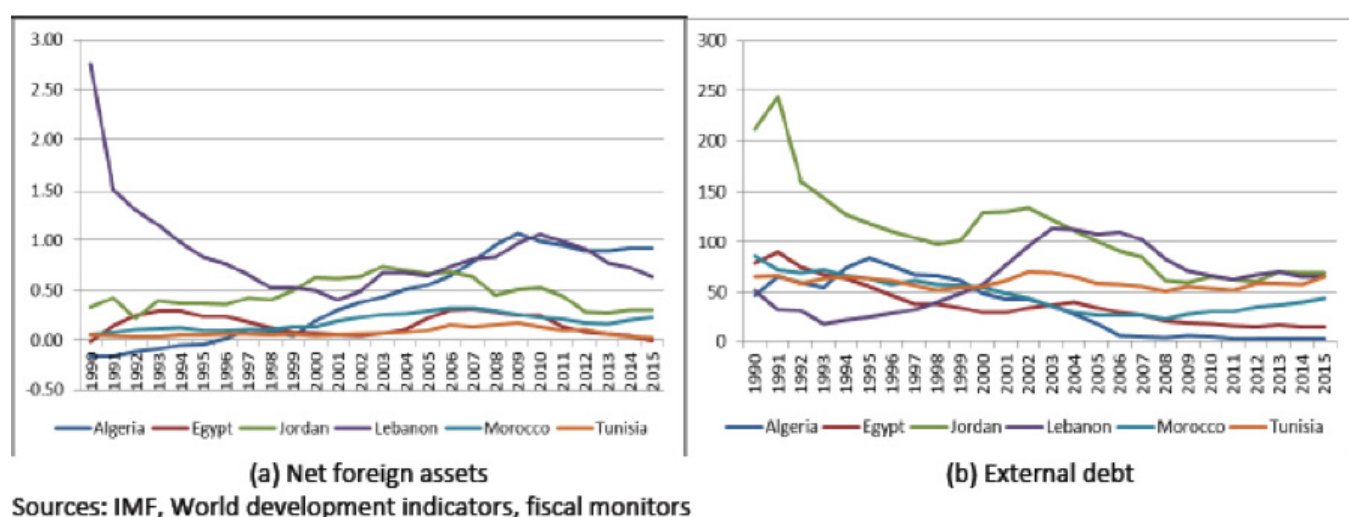


Fig 2. Net foreign asset position and external debt in South-Med Countries (1990-2015)



Notably, South-Med countries were affected negatively by a weak Eurozone growth rates (from 3.1 percent before the financial crisis to 2.1 percent in 2011 and 1.4 percent in 2014 – World Bank, 2016), with their gross public debt increasing notably, at least in the majority of countries (Fig1). As high levels of indebtedness create fiscal pressures, not only with regard to debt financing, but also more broadly, they necessitate fiscal consolidation measures which inevitably hit on public expenditures and taxation.

Additionally, external indebtedness often lead to currency depreciation and thus to inflationary pressures domestically, which in turn lead to real-terms increases in the level of external debt, putting foreign-currency reserves under pressure (Fig 2). On the whole, internal imbalances and threats to debt sustainability are linked to deterioration in primary fiscal balances, interest rate growth, sudden changes in asset-liabilities valuation (including due to exchange-rate depreciation), weaker productivity growth, as well as to business and political cycles.

3. Approach and Results

In our research, we tested for sustainability of the external and internal imbalances and whether the multiple crises of the period 2008-2011 (global financial crisis, Eurozone crisis, Arab spring) have affected the

sustainability of internal and external aggregates, such as the fiscal budget, the trade and current account balances, the external debt, and others. Additionally, we tested the link between external (current account) and internal imbalances (budget deficit) and whether one is driven by the other. We implemented this analysis separately for six South-Med economies (Algeria, Egypt, Jordan, Lebanon, Morocco, and Tunisia), applying advanced time-series econometric techniques, including unit-root and cointegration tests that allow for structural breaks and non-linearities in the estimated relationships.

Our empirical analysis presents a picture which deviates slightly from conclusions drawn from simple observation of the data – which show generally rather high and often persistent external and internal imbalances. Concerning external imbalances, our econometric analysis finds indeed some signs of concern, specifically for the cases of foreign debt (which is found to be unsustainable in all six countries examined) and of net foreign assets (which are found to be unsustainable in all countries except Egypt). At the same time, however, evidence of external unsustainability is much more mixed when looking at the current account (which includes the trade balance as its main component and is a typical measure of competitiveness). In this case, we obtain evidence against sustainability for the cases of Algeria and Tunisia; but for countries such as Egypt and Morocco the evidence of current-account unsustainability is mixed, while for Jordan and Lebanon current account unsustainability is econometrically rejected.

Regarding internal imbalances, the evidence is again less alarming, suggesting that on the whole the internal fiscal positions in the six South-Med countries (in the form of budget deficits and public debt) are not an issue of major concern. Non-sustainability in these aggregates was found to be of some concern only in Morocco and Egypt (for the fiscal balance only) and not at all in Jordan; while for Algeria, Lebanon and Tunisia any evidence of non-sustainability was scant and unsystematic. Further, our subsequent causality analysis indicated that not only the fiscal positions are broadly sustainable, but also that they cannot be taken as a driver (in the temporal-causality sense) of external imbalances. If anything, causality runs in the opposite direction, with the implication that it is external vulnerabilities that tend to destabilise internal fiscal positions. In particular, our analysis found that current account imbalances tend to inflate ('cause') fiscal derailments and, similarly, net foreign assets imbalances tend to destabilise government debt in the majority of cases.

4. Recommendations and policy implications

As the result of the analysis conducted indicate, governments in the South-Med countries often possess imperfect information about their countries' macroeconomic sustainability and the severity (let alone the causes) of their internal and external imbalances. The concept of sustainability is in many respects rather elusive and different notions of it may lead to very different readings of a given country's position. In policy terms, sustainability (and thus macroeconomic risks) is often defined with regard to some ad hoc pre-determined threshold – for example, a current account deficit above 6 percent of GDP or a public debt level above 60 percent of GDP.

On this basis, the internal fiscal positions of many South-Med countries, including the six examined here, seemed rather unsustainable, especially in the period immediately following the global financial crisis and the Arab spring. As a result, significant policy effort was exerted, often with the active encouragement by international financial institutions such as the IMF, to achieve fiscal consolidation within a dual strategy of improving public finances (raising taxes and reducing governments expenditures) and implementing structural reforms (to liberalise markets and raise economic competitiveness). Relevant measures ranged from public sector hiring freeze and cuts in energy subsidies in Algeria; public sector pay-cuts and VAT hikes in Egypt; rationalisation of tax exemptions and implementation of various structural reforms in Jordan; some,

rather small, tax increases in Lebanon; pension cuts in Morocco; and other expenditure cuts in Tunisia. Together with some well-executed exchange rate adjustments, the policy responses seem to have worked, in the sense that no significant liquidity, balance of payments, or solvency crisis emerged while fiscal and current account imbalances have largely been contained. At the back of this rather successful policy response, however, there is a general perception that economic outcomes may have become somewhat less equitable, hurting disproportionately the poor and the most vulnerable groups in society.

Despite this relative success, the evidence presented here casts some doubts on the appropriateness and usefulness of this policy response. As noted already, the evidence broadly suggests that the main problems of macroeconomic sustainability in the six South-Med countries analysed were related to the external balance, especially with regard to income and capital flows, and not to the internal fiscal position of these countries. Thus, the policy focus on the latter (fiscal sustainability) not only may have caused unnecessary social hardship but it may also have not been successful in targeting the root-cause of the macroeconomic problems of these countries.

Based on our results, the latter can perhaps be traced down to two sets of problems, concerning (a) the weak export performance (linked to current account and exchange rate vulnerabilities^[2]) and (b) the vicious-circle-type link between government debt and external debt. We argue that these problems do not call for aggressive fiscal consolidation but rather for two sets of carefully implemented **policy solutions**:

- **Targeted structural reforms** aiming to raise domestic productivity (for improving export performance) by liberalising dynamic sectors of the economy which have the potential to bring-in new entrepreneurial activity and product/market development; and

- **Public investment and incomes policies** aiming at raising domestic savings and private investment (as a means to help de-link government debt from external debt) but without fuelling imports.

In the longer-term, this policy mix can be supported by a range of measures aiming at enhancing and diversifying the economic (and tax) base of the countries concerned. Such measures include:

- **Selective assistance with the modernisation of key sectors** of the economy (including agriculture) through 'new' forms of industrial policies aiming at the support of new activities, product diversification and entrepreneurial risk-taking;

- **Targeted public investment** (both in physical and in human capital), as a means for raising the productivity of firms and removing skill shortages and bottlenecks in supply chains;

- **Administrative reforms** aiming at expanding the tax base and improving tax collection measures, so as to strengthen the public finances and make them more resilient;

- **More effective tax scaling**, which, in turn, will allow for a further expansion of the tax base via reduced informality and tax evasion;

- **Encouraging private entrepreneurship and investments** (including via targeted public investments and government subsidies) in key sectors of the economy, which should expand the production base in the country and help to reduce the import dependence (and high import propensities) present in most of the countries under research.

Given the hierarchy and causal links of the macroeconomic imbalances evidenced in this study – namely the role of foreign debt (primarily) and current account imbalances (secondarily) in destabilising domestic fiscal positions – it appears that it is indeed **production diversification and the establishment of a more effective tax system** that can contribute most effectively to raising productivity (and export competitiveness), reducing import-dependence (and current account deficits) and, ultimately, addressing these countries' vulnerability to external shocks. Shorter-term measures of fiscal consolidation, aiming at reducing the size of the government and raising tax revenues from the existing tax base, can bring short-term gains – if they do not lead to dampening domestic demand and investment – but will be less effective in deadling with the core of the problems faced by these countries.

FEMISE MED BRIEF

* The main source of this policy Brief is a FEMISE Research project (FEM 42-13) titled «External and internal imbalances in South Mediterranean countries: Challenges and costs», conducted by Dr. Doaa Salman (October University for modern sciences and arts, Egypt) and Dr. Vassilis Monastiriotis (London School of Economics, United Kingdom).

Notes

1. Countries under study are: Algeria, Egypt, Jordan, Lebanon, Tunisia, and Morocco. The analysis covers the period between 1990 and 2015.
2. The recent (i.e. beyond our data coverage) destabilisation of countries such as Algeria, owing almost exclusively to external developments with regard to international oil prices, help to emphasise this point further.

Bibliography

World Bank (2016), Egypt overview strategy, retrieved from: <http://www.worldbank.org/en/country/egypt/overview>

FEMISE is a Euromed network established in June 2005 as a non-profit, non-governmental organisation (NGO) following 8 years of operation.

FEMISE is coordinated by the Economic Research Forum (Cairo, Egypt) and the Institut de la Méditerranée (Marseille, France) and gathers more than 100 members of economic research institutes, representing the 37 partners of the Barcelona Process.

Its main objectives are:

- *to contribute to the reinforcement of dialogue on economic and financial issues in the Euro- Mediterranean partnership, within the framework of the European Neighbourhood Policy and the Union for the Mediterranean,*
- *to improve the understanding of priority stakes in the economic and social spheres, and their repercussions on Mediterranean partners in the framework of implementation of EU Association Agreements and Action Plans,*
- *to consolidate the partners of the network of research institutes capable of North-South and South-South interactions, while it sets into motion a transfer of know-how and knowledge between members.*

All FEMISE Policy Briefs are available at our website:

www.femise.org



The policy brief has been produced with the financial assistance of the European Union within the context of the FEMISE program. The contents of this document are the sole responsibility of the authors and can under no circumstances be regarded as reflecting the position of the European Union.