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Twin Deficits and the Sustainability of Macroeconomic Policies in Selected European and Mediterranean Partner Countries: Post Financial and Debt Crises*

by Pr. Simon Neaime

1. Summary

This policy brief uses the Present Value Constraint (PVC) framework and the twin deficit hypothesis to look at the issue of fiscal and macroeconomic sustainability in the European Union's (EU) countries of Greece, Ireland, Italy, Portugal and Spain and a subset of Mediterranean Partners (MPs) Egypt, Jordan, Morocco, Tunisia, and Lebanon. It answers the following question: How can the EU and MED countries in financial and debt crises curb macroeconomic imbalances (huge public debt, budget and current account deficits) at a time of low economic growth, high unemployment rates, rising inflation, and rising social demands for inclusion? Finally, this policy brief assesses past implemented International Monetary Fund (IMF) macroeconomic policies in light of the various austerity measures that have been introduced, and offers alternative potential macroeconomic policy solutions and remedies.

2. Introduction

The last two decades have witnessed a dramatic and fundamental shift in fiscal policies of many developed and developing economies. Balanced budgets and current accounts have virtually disappeared, and government deficit financing has prevailed. This resulted into the numerous debt and financial crises that have erupted since early 2000 (Neaime 2012 & 2016). Policy makers and academics have thus been recently devoting efforts to first assess the soundness of the external and public sectors, and then attempting to forecast whether macroeconomic policies are sustainable. In the instance where macroeconomic policies are not sustainable, then reforming economic policies through the introduction of various austerity and structural adjustment measures will be a must in avoiding fiscal, debt, currency and perhaps banking crises.

However, the timing of the introduction of the various austerity measures remains a concern, given the recessionary environment that the (EU and the Mediterranean (MED) regions have been experiencing since the 2008 United States (US) financial crisis. It is believed that the newly introduced fiscal adjustment measures would keep the EU and the Mediterranean Partner countries in recession which will further worsen the existing budget and current account

deficits, as well as, the debt burden and would hamper any future effort to grow out of the accumulated public debt through higher real Gross Domestic Product (GDP) growth rates. Moreover, the accumulated EU and MED national debts are the result of both economic but more importantly of political/institutional factors. Therefore, austerity measures alone may not resolve the current fiscal difficulties but should be accompanied with other political/institutional corrective measures.

On the other hand, and in the wake of the recent EU debt crises, the 2008 US financial crisis and the worldwide triple dip recession of the past nine years, the solvency of some EU countries has become a major source of concern for the EU, endangering its financial/economic integration efforts, and the successful monetary unification through the introduction of the euro currency (Neaime 2015a & b). It is well known that Greece, Portugal, Ireland, Italy, and Spain have been running budget deficits for the past two decades averaging between 5 and 10 percent of GDP, resulting in a EU's public debt averaging above 120 percent of total GDP in 2016 (Eurostat., 2016). The picture is quite similar in the MPs where social, political and military tensions have aggravated even further an already deteriorating macroeconomic situation.

As a result, policy makers have introduced various austerity measures in order to curb and limit further deteriorations in the EU and MED fiscal and macroeconomic positions, despite genuine fear that these measures could collapse aggregate demand, worsen the already high unemployment rates, and further lower prices. If domestic prices decline through aggressive wage and income cuts as dictated by the various austerity programs, the respective real exchange rate will depreciate rendering domestic goods more competitive internationally. While this policy may improve the current account deficits of Greece, Portugal, Ireland, Spain and Italy, and that of the MPs, it is expected to lead to painful domestic adjustment measures; as a significant number of domestic firms will likely shut down, worsening further the EU and MPs unemployment rates.

Turning to the macroeconomic literature, studies analyzing the twin deficit hypothesis (Neaime and Gaysset 2017, & Neaime 2008) and public sector's fiscal and financial vulnerabilities have considered closely the issues of debt sustainability and the Twin Deficit Hypothesis. Fiscal sustainability can be determined in various ways, and the literature is rich in studies trying to assess the financial vulnerability of the public sector. This policy brief use therefore the Present Value Constraint (PVC) framework and the twin deficit hypothesis to look at the issue of fiscal and macroeconomic sustainability in the EU's countries of Greece, Ireland, Italy, Portugal and Spain and a subset of MPs (Egypt, Jordan, Morocco, Tunisia, and Lebanon). This policy brief also assesses past implemented International Monetary Fund (IMF) macroeconomic policies in light of the various austerity measures that have been introduced. If traditional macroeconomic policies and their modification in the context of the global crises have not helped, are there any new directions that one can think of that will not only solve the current fiscal/debt crises but also prevent future ones from developing? Are we back to the old controversy on fiscal policy versus monetary policy in tackling macroeconomic imbalances? What about the introduction of macroeconomic stabilization programs, is there still room to use both monetary and fiscal policies in tandem to curb those macroeconomic imbalances? Policy makers need to be very careful since joint austerity measures can create a vicious circle whereby recessionary budgets, high interest rates and high levels of public debt tend to reinforce each other.

3. Approaches

This being said, and in light of the various austerity measures that have been introduced recently, this Policy brief assesses the sustainability of the EU's and MPs current fiscal and macroeconomic policies, and evaluate whether they are violating the twin deficit hypothesis and the inter-temporal budget and external constraints for the public sector.

Our empirical results validate the Twin Deficit hypothesis in both samples EU and MED sample countries; however, we find diverging findings regarding the direction of causality. While the trade balance seems to be driving the budget deficit in MED countries –thereby validating the current account targeting approach - the relationship appears to run in the opposite direction in the case of EU countries, where the budget balance appears to be driving the current account. Given the well-documented dependence of MED countries on trade with the EU and the fact that most EU countries have implemented austerity policies in the aftermath of the financial crisis – thereby restricting aggregate demand and imports - we argue that the ensuing drop in export income for MED countries has contributed to increasing the budget deficit in these countries, by virtue of the uncovered positive causality between the current account and the budget balance.

One natural response of policy makers in MED countries would be to implement austerity policies; however, such policies, which may be necessary, are socially costly in the current social context in MED countries, and would not alone permit to stabilize the budget balance given that they would leave the trade balance unaffected. Our findings thus represent a warning against such ‘ready-made’ macroeconomic policy responses and indicate that austerity policy in EU countries have unexpected consequences for fiscal stability in MED countries. We thus call for a better coordination of macroeconomic policy between the EU and its Southern peripheral countries. Other empirical results indicate that MED exports, imports, government revenues, government expenditures, current accounts, budget balances, public and foreign debts are all non-stationary series pointing to the non-sustainability of fiscal and macroeconomic policies in all five countries under investigation. Cointegration results also point to the non-existence of a long-run relationship between government revenues and expenditures, exports and imports, and exports and foreign debt. The same is true for the EU countries where exports, imports, government revenues and expenditures, current accounts, budget balances, and total public debt are all non-stationary series pointing also to the non-sustainability of fiscal and macroeconomic policies in all five EU countries under investigation. However, and for the EU panel, the results point to the existence of a long-run relationship between government expenditures and revenues. It is therefore clear that at least and over the period under consideration the EU countries under investigation have tried to keep fiscal policies, especially taxation policies, as well as, fiscal spending under control.

A major policy issue to be faced in the coming years is whether macroeconomic policies have reached a dead end and are in a bind (Mansoorian and Neaime 2003, and Neaime 2000). If traditional macroeconomic policies have not helped, are there any new directions that will not only solve the current financial/debt crises but also prevent future ones from developing? With respect to the introduction of macroeconomic stabilization programs in the EU and MED countries, there is obviously no room to use both monetary and fiscal policies in tandem to curb those macroeconomic imbalances. For the MED countries of Lebanon and Jordan with very limited fiscal space and fixed exchange rates and open capital accounts monetary policy is already ineffective in terms of macroeconomic stabilization. Egypt rendered its monetary policy more effective in dealing with external shocks after the recent move to a flexible exchange rate regime. Tunisia and Morocco seem to be also moving in that same direction. While fiscal space in the EU is also limited due to the past accumulation of huge public debts, the European Central Bank (ECB) policy remains an effective tool in preventing the EU’s unsustainable fiscal policies from developing into further debt crises similar to the Greek debt crisis.

4. Conclusion

As argued above, with the current debt crisis unfolding in some EU countries, low GDP growth rates and oil prices and high debt levels in several MED countries, fiscal policy is clearly not a macroeconomic policy option anymore due to limited fiscal space. Also with fixed exchange rates, monetary policy is not a policy option in several MED countries including Lebanon and Jordan. With one monetary policy conducted by the European Central Bank (ECB) and the absence of a political union, EU countries have registered over

the past decade significant current account and budget deficits. Quantitative Easing (QE) implemented by the ECB since 2015 is perhaps the only macroeconomic policy tool still available to avert an overall financial and debt crisis in the EU.

The EU's and MED economies appear to be in a bind due to: (1) Past accumulated public debts and large budget and current account deficits; (2) Bureaucracy, protectionist laws, and restrictive labor laws; (3) the consequences of the 2008 financial crisis and the 2010 Arab spring; (4) Austerity measures and the prolonged tightening of fiscal policy; (5) Lack of a political and fiscal union; (6) Doubts about the success of QE; and (7) BREXIT which could lead to more exits from the EU. Some EU's countries (Greece, Italy, Ireland, Portugal, and Spain) and MPs (Egypt, Morocco, Tunisia, Syria, Jordan and Lebanon) stand at a crossroads in history, with changes sweeping many of these countries and creating an environment conducive to reform. Having missed a number of chances to introduce extensive macroeconomic and institutional reforms and make substantial progress in development, the current situation presents another golden opportunity. The social movements in the MED region, the European debt crisis, and the earlier series of financial crises have exposed the weaknesses of the adopted macroeconomic models and have raised questions as to how to reshape macroeconomic and social policies most effectively and create the space to address the needs of everyone in society, reaching even the most deprived. The neo-liberal economic model (International Monetary Fund) implemented in most European and MPs which centered on fiscal and monetary stabilization and economic liberalization, has yielded a relatively acceptable level of economic growth and, in general, managed to meet the goals of economic and financial stability. Monetary, fiscal, and inflationary pressures have, overall, been smoothed. However, the impact of such macroeconomic policy choices has not led to the desired outcomes in terms of debt reductions and containment, inclusive growth, human development, human rights, and political reforms. Indeed, in certain cases, fast liberalization has actually aggravated the macroeconomic imbalances, as well as, divisions in society, with economic and political marginalization increasing. In the light of a critical reassessment of the achievements and failures of EU and MPs economic policies, a new macroeconomic approach is being shaped, one which is more holistic, integrating the macroeconomic and social spheres in combination with strong institutions and democratization, ensuring full participation in the decision-making process. It is vital that policymaking should expand to accommodate these spheres and place them on an equal footing in the service of a long-term rights-based developmental vision.

5. Implications and Recommendations

The new macroeconomic model should reconsider macroeconomic policies that incorporate developmental priorities and would thus achieve structural macroeconomic change. Fiscal and monetary policies will be reshaped to achieve not only stabilization, adjustment and economic growth, but will also trigger the transformation required to generate growth that is broad-based, inclusive and sustainable. Within this context, and in this policy brief, such macroeconomic stabilization policies have been reassessed for the purpose of proposing new policies that are sustainable and that will be conducive to growth, development, and debt and budget deficit reductions. At the same time, macroeconomic policies should not shy away from meeting the same objectives as social policy under this new development paradigm, in which the interests and welfare of every person in society are the target. It is also of central importance to ensure that social policy goes hand-in-hand with macroeconomic policy to bring about the required transformation and ensure inclusive economic growth. While the social and economic spheres interconnect to create synergies, this new macroeconomic model will not achieve its goals if political and institutional reforms remain as they are. The objective is to reinstitute democratic values and have strong developmental political systems.

Monetary Policy will remain ineffective as long as expectations of the private sector are not adjusted positively, and banks remain in poor shape, mainly Italian and Greek banks. The Greek Debt crisis is nega-

tively affecting the behavior and expectations of businesses and consumers, and austerity measures are negatively affecting aggregate demand and the growth rate of GDP. In particular, stagnant wages and high unemployment rates are adversely affecting domestic demand, especially in the absence of fiscal space in most MED and EU countries due to the accumulation of large public debts and recurrent budget and current account deficits.

In the MED region, the ineffectiveness of monetary policy is due to the presence of fixed exchange rates and free capital movements. This boils down to no role for government policies (fiscal and monetary) to deal with the current macroeconomic imbalances paving the way for future fiscal and currency crises. Thus, the various EU and MED governments will need to: (1) reduce the public sector in favor of the private sector; (2) channel liquidity to the private sector through loans and encourage investments in productive ventures; and (3) reduce government spending and increase supply side taxes.

Finally, given the ineffectiveness of both monetary and fiscal policies, the private sector needs to take a leading role in addressing macroeconomic imbalances by first improving its expectations in both the EU and MED. This would increase the growth rate of GDP and would render debt more sustainable. Once the above is achieved, introduce austerity and structural adjustment measures. This will insure sustainable economic growth and will reduce the likelihood of a future debt and currency crisis.

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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.*



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