The Effects of European Austerity Measures on the South and East Mediterranean Countries

Simon Neaime
Professor of Economics, Department of Economics
Director, Institute of Financial Economics, American University of Beirut

Following the 2008 United States (US) financial crisis and the European Union (EU) debt crisis, European countries have been experiencing a deep recession, and consequently a dramatic and fundamental shift in their expenditure and taxation policies. Accumulated public European debts have soared, balanced budgets have virtually disappeared, and government deficit financing through the issue of treasury bonds has prevailed. This resulted in the Greek debt crises of 2011 with potential fiscal insolvency in the remaining countries of Italy, Spain, and Portugal. Subsequently, all EU countries started implementing fiscal austerity measures in order to address their fiscal imbalances, curb their budget deficits and contain their accumulated public debts.¹

Despite genuine fears that the newly introduced austerity measures in several EU countries could prolong the recession in the EU, collapse aggregate demand, worsen already high unemployment rates, and further lower prices, European countries had no choice but to introduce swift austerity measures to address their fiscal imbalances in order to avoid a debt default and a fully-fledged banking and debt crisis. While these fiscal policy measures may improve the external deficits of Greece, Portugal, Spain and Italy, they are expected to lead to painful domestic adjustment measures, as a significant number of domestic firms will likely shut down further worsening the EU’s unemployment rates. Furthermore, deflation would also worsen the real burden of the EU’s national debt (Neaime 2015a).

The timing of the introduction of the various austerity measures in most European countries remains a concern for the Mediterranean Partner Countries² (MPCs), given the recessionary environment that the EU has been experiencing since the 2008 US financial crisis. It is believed that the newly introduced fiscal adjustment measures would keep EU countries in recession thereby worsening the existing debt burden and hampering any future effort to grow out of the accumulated public debt through higher real Gross Domestic Product (GDP) growth rates. Moreover, these austerity measures are expected to lower the EU’s demand for Mediterranean imports, lower capital outflows to the region and adversely affect remittances and tourism from the EU to the South and East Mediterranean countries.

In the wake of the signing of the Euro-Mediterranean Free Trade Agreements, the recent debt and financial crises and their respective negative spillover effects on several emerging economies including the South and East Mediterranean countries, have brought forward the potential damage to the Mediterranean Economies emanating from the EU’s weak financial sector and poor public sector finances. Moreover, there are recent fears that the EU’s fiscal and monetary imbalances and the newly introduced austerity measures could even endanger the recent trade and economic integration efforts between Europe and its Mediterranean partners.³

With the above in mind, and in light of the various austerity programmes that have been recently intro-

¹ For a more detailed discussion of the European Union’s debt crisis, see Neaime 2015.
² In this study the eight MPCs are: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria and Tunisia.
duced in the EU, this paper will attempt to assess the macroeconomic and financial implications of those measures on the Mediterranean Partner Countries.

**Impact of the European Union's Austerity Measures on MPCs**

The recent European debt and financial crises and the newly introduced austerity measures have put pressure on the MPCs' economies, contributing to declines in their real GDP growth rates, commodity exports, Foreign Direct Investment (FDI) inflows, tourism revenues, workers' remittances, and stock market performance. The EU’s adverse macroeconomic implications on the MPCs have not yet fully unfolded. It is possible that the negative economic and social consequences of the EU crisis, for example on Mediterranean employment, will be felt for some time to come – especially given the ongoing double-dip recession in the EU’s economies.

Weaknesses in the public sector finances of some MPCs made the transmission of the EU's recession into the region a source of concern, and have undermined the recent integration efforts of those countries with the EU. Moreover, lower growth prospects in the EU as a result of the various austerity measures introduced are leading to soaring current account and budget deficits, and are a source of concern for the sustainability of the current exchange rate regimes in several MPCs. Although trade and globalisation issues and the financial and economic integration of the MPCs with the EU’s financial and goods markets were among the main reasons why the EU’s austerity measures are affecting the Mediterranean region, it was accentuated by domestic macroeconomic, political, fiscal, monetary and financial issues, notably the existence of fixed exchange rates, weak domestic

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4 See also Colton and Neaime 2002.
stock and bond markets, high real interest rates and limited fiscal space in some of those partner countries. The EU’s austerity measures coupled with the recent political and military turmoil in the Mediterranean region have lowered the MPCs' real GDP growth prospects, through the trade and exchange rate channels, and through declines in GDP growth rates of the region’s main trading partners (Chart 9). Even during the financial crisis of 2008, the MPCs’ real GDP growth rates were much higher than the growth rates observed since 2011.

Chart 10 indicates that the MPCs' real GDP growth prospects for 2014 were negatively affected because of weak growth prospects (1.4% in the EU, and 2.4% in the US) in their major trading partners, mainly the EU which accounts for about 40% of the MPCs’ total trade, followed by the US, accounting for about 10% of the region’s total trade. Chart 11 shows the specific MPCs’ total export destinations in millions of dollars between 2009 and 2014. It is clear that the South Mediterranean countries’ major trading partners are the EU-28 countries. It is through this trade channel that Israel, Morocco, Tunisia, Algeria and Egypt have been affected by the recent austerity measures in the EU.

Weak growth prospects are affecting the EU’s demand for MPC exports. The most affected MPCs are the South Mediterranean countries of Israel, Algeria, Tunisia, Morocco, and to a lesser extent Egypt. The ensuing EU recession has not only dried up liquidity but also reduced financial inflows and export revenues, threatening the fiscal and current account balances and, subsequently, the macroeconomic stability of several MPCs. Some partner countries have been facing liquidity challenges since the beginning of the Arab uprisings, which may evolve into solvency problems for a number of them. For MPCs with weak financial linkages with the EU, the multiple external shocks have started to reveal gaps between revenues and spending, and capital outflows have put downward pressure...
on their exchange rates coupled with a decline in foreign exchange reserves. Lower export earnings and an inability to impose counter-cyclical taxation measures will worsen their budget deficits and further widen their gap of foreign exchange needs.

Similar to the export of commodities, tourism and remittance revenues constitute an important source of foreign exchange and contribute to economic growth for the MPCs of Egypt, Morocco, Tunisia, Jordan and Lebanon. However, the European austerity measures have had a profound knock-on effect on remittances in all MPCs with the exception of perhaps, Egypt and Lebanon. Remittances provide valuable foreign exchange for the MPCs that are used to financing current account deficits and foreign debt service payments, not to mention meeting consumption demands of the domestic market. In Egypt for instance, remittances have averaged $18 billion since 2012, followed by Morocco where they have averaged $6 billion. Therefore, any further decrease in remittances, resulting from the EU’s austerity measures, is expected to have a detrimental effect on the above two countries’ growth rate of real GDP (Chart 12), and on their ability to service their foreign public debt.

The spillover effects of the recent recession and the EU’s austerity measures on MPCs and their effects on the MPCs’ financial markets varied according to their degree of financial integration with the EU’s capital markets (Neaime 2012). Jordan, Israel, Egypt and Morocco with large exposure to EU banks, bonds and equity markets, were the first to suffer (Chart 13). These countries are facing a four-edged sword, i.e. plunging asset prices, higher borrowing costs, capital outflows and a decrease in exports. Other MPCs, namely Tunisia and Lebanon have become more resilient with respect to past crises, owing to the build-up of adequate foreign exchange reserves and a robust fiscal stance. The current financial crisis has also reversed the gains made in the past decade in reducing the debt burdens of some MPCs, and might also carry the risk of new debt/exchange rate crises because of a dangerous combination of fixed exchange rates, internal and external shocks, the higher cost of debt servicing, and the pressing need for increasing new external and domestic borrowing.

Conclusion

Given the current recessionary environment in the EU, it is difficult to design a credible fiscal consolidation scheme for growth and development on the one hand,

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5 See also Neaime (2015b) for a more detailed discussion of the implications of the financial crisis on Lebanon’s macroeconomic fundamentals.
and for debt and deficit reduction on the other, that could be implemented swiftly and effectively without harming the EU’s Mediterranean Partners, and perhaps endangering the EU-Mediterranean Partnership agreements across the board. No doubt, the various stabilisation programmes will help EU countries over time to grow out of debt and modernise; with an efficient and fiscally responsible public sector, a credible tax system, more competitive labour markets and an internationally competitive economy.

Some MPCs have been hit by the worst exogenous financial/economic/political shock in decades, while others were ill-equipped to fight the economic and social consequences of the crisis given their poor macroeconomic and fiscal policies. Therefore, alleviating the macroeconomic imbalances of those countries, and providing them with the fiscal space needed to combat the economic and macroeconomic implications of the European debt and fiscal crisis would also help stabilise European demand, and should thus be regarded as an integral component of EU countries' stimulus packages.

Bibliography


