Dossier: The Mediterranean in Times of Multi-level Crisis: Pandemics, Mobilizations and Hopes for Change

Runaway Public Debt in Mediterranean Countries: Is It Manageable?

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Introduction and Literature Review

The Mediterranean (MED) countries of Tunisia, Jordan and Lebanon stand at a crossroad in history, with negative exogenous and endogenous shocks sweeping through them. The COVID-19 pandemic, social and political unrests and earlier series of financial and debt crises[1] have exposed the weaknesses of the adopted macroeconomic models and raised questions about the sustainability and manageability of MED countries' sovereign debt and deficits. The neoliberal economic model of the International Monetary Fund (IMF) implemented in MED countries since the late 1980s, which centred on fiscal and monetary stabilization and economic liberalization has yielded a relatively acceptable level of economic growth and, in general, has managed to meet the goals of economic and financial stability. Moreover, monetary, fiscal and inflationary pressures have, overall, been smoothed. However, and in light of the recent financial and debt crises and the more recent pandemic and its devastating consequences on the world economy, the impact of such macroeconomic policy choices has not led to the desired outcomes in terms of debt reductions and containment. Indeed, in certain cases, exogenous shocks, the COVID-19 pandemic and the fast financial liberalization have in fact aggravated the macroeconomic imbalances. In light of a critical reassessment of the achievements and failures of MED economic policies, a new macroeconomic approach should emerge, one which is more holistic, integrating the macroeconomic and social spheres in combination with strong institutions and democratization to ensure fiscal consolidation. The new macroeconomic model will reconsider macroeconomic policies that incorporate fiscal discipline in order to achieve a structural macroeconomic change. Moreover, and in light of the COVID-19 pandemic, fiscal and monetary policies will have to be reshaped to achieve not only macroeconomic stabilization, but also fiscal discipline in order to render sovereign debt more manageable. Within this context, such macroeconomic stabilization policies will have to be reassessed for the purpose of proposing new fiscal policies that are sustainable and that will be conducive to growth, development and debt and budget deficit reductions.

In this article we will try to answer the following questions. How can the MED countries in health, financial and debt crises curb macroeconomic imbalances (debt, budget and current account deficits) at a time of low economic growth, high unemployment rates, rising inflation and sudden stops in capital inflows? 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 health, financial and debt crises, but also prevent future ones from developing? What about the introduction of macroeconomic stabilization programmes, is there

[1] For a detailed discussion of the recent debt and financial crises and their impact on the MENA region see Neaime (2012a&b, and 2016).

still room to use both monetary and fiscal policies in tandem to curb those macroeconomic imbalances? MED 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 debt tend to reinforce each other.

Empirical studies on macroeconomic and debt sustainability are numerous and have gained extreme importance after the latest financial and debt crises worldwide. A major strand of the empirical literature looks at the time series properties of the fiscal variables. This approach has proven to be elegant and robust as it uses actual fiscal and macroeconomic variables and shies away from calibration empirical modelling. Two empirical frameworks have been used to test for fiscal sustainability. The first rests mainly on testing the stationarity of the various macroeconomic variables, while the second employs cointegration and granger causality time series techniques and explores the existence of a long- and short-run equilibrium relationship between the macroeconomic variables of interest.

Under the first framework, if the budget or current account deficit series are non-stationary, then it means that they are growing without bound over time, which means that subsequent debt will also grow without bound, rendering fiscal policy unsustainable (Hakkio & Rush, 1991). A stationary deficit means that the series is reverting to a certain mean over time, being in general close to zero. If that were the case, then obviously fiscal policy and debt would be sustainable, since deficits will be under control. The second framework explores whether there is a long-run relationship between government revenues and expenditures, and exports and imports. If such a relationship exists, this means that the respective government is not spending without bound and is taking into account the amount of revenues it is generating (Haug, 1995). Subsequently, it will not have to resort to deficit financing to cover its expenses, and debt would be sustainable and will not grow without bound.

Under the above strand of the literature, Neaime (2008, 2010, 2012a, 2015a&b) analysed the conduct of fiscal and financial policies and studied the sustainability of public debt and macroeconomic policies in the Middle East and North Africa (MENA) in the post United States financial crisis period. Using time series econometric tests and the Present Value Constraint model for the period that ends in 2015, the empirical results show strong evidence of sustainability of fiscal policies in Tunisia, given the country's fiscal discipline. The weak sustainability in Egypt is explained by the successful privatization plan introduced during the 1990s. Morocco's mixed results are explained by the recently introduced fiscal recovery reforms. The unsustainable debt and fiscal policies for Jordan and Turkey are explained by the size of the government causing major fiscal imbalances for Jordan's economy, and by the weakness of the financial and banking sectors in Turkey. With the above in mind, and in this chapter, we will not dive into any empirical exercise, but will only overview the latest macroeconomic fundamentals of some selected MED countries for the purpose of establishing the current sovereign debt situation in those countries, its sustainability and how manageable it is in light of the consequences of the COVID-19 pandemic.

The macroeconomic improvements observed since 2015 in Tunisia's key macroeconomic fundamentals have been largely offset by the ongoing COVID-19 pandemic

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Tunisia

The macroeconomic improvements observed since 2015 in Tunisia's key macroeconomic fundamentals have been largely offset by the ongoing COVID-19 pandemic. Tunisia's national currency, the dinar, has lost about 65% of its value since 2014 and Tunisia's economy shrank by 4.3% in 2020 (see Table 7). The severe depreciation of the local currency led to a further deterioration of living standards. The country is now running a twin deficit. The budget and fiscal deficit and the current account deficit are widening rapidly and are expected to reach 10% of GDP respectively by the end of 2021. As those deficits widen, there is growing concern of increased public debt accumulation. 80% of Tunisia's public debt is exter-

TABLE 7 **Selected Macro-Economic Indicators for Tunisia: 2014-2020**

Indicator /Year	2014	2015	2016	2017	2018	2019	2020
Real GDP Growth, %	2.9	1.2	1.2	1.9	2.7	1	-4.3
Inflation rate, % at end of period	4.8	4.1	4.2	6.2	7.5	6	5.5
Interest rate, % at end of period	4.75	4.25	4.25	5	6.75	7.75	7.98
Unemployment rate, %	15.0	15.4	15.5	15.5	15.5	14.9	16.7
Budget Deficit, % of GDP	-3.3	-5.2	-6.2	-6.0	-4.5	-3.9	-10.6
Gross Public Debt, % of GDP	51.5	55.4	62.3	70.9	77.5	71.8	87.6
Current Account Balance, % of GDP	-9.8	-9.7	-9.3	-10.3	-11.1	-8.4	-6.8
International Reserves, USD billion	7.7	7.4	6.0	5.6	5.3	7.4	6.5
International Reserves in Months of Imports	3.1	3.8	3.2	3.1	2.6	3.8	3.3
Gross External Public Debt, % of GDP	63.7	68.4	75.2	86.2	99.4	97.3	100.7
Foreign Direct Investment, % of GDP	2.2	2.3	1.5	2	2.5	2	0.4
Exchange Rate, per One USD	1.7	1.96	2.15	2.42	2.65	2.93	2.81

Source: IMF & World Development Indicators (2020). Tunisia's Central Bank & Ministry of Finance.

nal and is being serviced in foreign currency thereby contributing to the rapid depletion of Tunisia's foreign exchange reserves. Foreign public debt now stands at more than 100% of GDP. The bottom line is that Tunisia's sovereign debt is becoming unsustainable. There have been renewed talks in early 2021 between the Tunisian authorities and the IMF, in view of a new assistance programme to help support economic reforms and bridge the financing gaps.[2]

In the absence of such financial support from international donors, there would be a further depreciation of the dinar, making debt servicing in foreign currency even more expensive. More recently and in early 2021, Tunisia's public debt ratings were also downgraded by the international credit rating agencies, making it more difficult for Tunisia to borrow from domestic and international financial markets at low interest rates.

It should also be noted that the 2017-2020 was a period of considerable economic hardship and uncertainty in Tunisia. Economic difficulties were amplified by the 2015 terrorist attacks, which produced low GDP growth rates (below 2%) and high inflation rates (close to 8%), as well as a decline in Foreign Direct Investments (FDI) to a low of 0.4% of GDP in 2020 (Table 7). The aftermath of the attacks was characterized by a crumbling tourism industry and a rapid deterioration in tourism receipts which constituted a major source of badly needed foreign currency, with international reserves declining to the extent that they were worth just three months of imports in 2020. Despite the relatively small size of the international financial assistance, Tunisia's economic situation would have been far worse and would have further deteriorated without the IMF disbursements in 2017. During the same period, there were also serious structural problems, such as difficulties paying civil servants' wages and acute social instability.

During the same period, rising social unrest and tensions between workers' unions and the government meant that the authorities could not adopt various fiscal and social measures as stipulated in the IMF and World Bank assistance programmes, respectively. The IMF, for instance, had recommended a pay freeze in the public sector. This conditionality could not be met, owing to the prevailing unfavourable social climate at the time. Note though that wages were increased in nominal terms during the period under consideration – but not in real terms given the prevailing high inflation rates. Furthermore, Tunisia's government did not have much fiscal space, owing to a large share of the budget being allocated to reinforcing national security (especially after the 2015 attacks). The restructuring of subsidies and improvements in targeting social safety nets in Tunisia was ongoing.

Government revenues increased rapidly over the period 2017-2020. Fiscal reforms have been introduced to increase tax revenues (Value Added Tax (VAT) rates increased by one percentage point as of January 2018) and efforts were devoted to fight tax evasion. Government revenue growth was, however, hampered by the low growth environment. Subsequently, Tunisia had to borrow from the international financial

[2] See e.g. www.bloomberg.com/news/articles/2021-04-25/tunisia-requests-new-imf-program-to-back-reforms-letter-shows.

market through several Eurobond issues over the 2017-2020 period. However, borrowing on local and international financial markets became increasingly difficult from 2019 onwards. The persistent depreciation of the dinar, rampant inflation, sustained macroeconomic imbalances and eight consecutive downgrades in sovereign bond ratings have limited Tunisia's access to international financial markets.

Jordan

Jordan's main macroeconomic problems lie in its past accumulated sovereign debt (forecast at 116% of GDP in 2021). The presence of such huge debt has restricted Jordan's access to domestic and international financial markets. In the past, the IMF and European Union's financing programmes have secured Jordan's continued access to international financial markets. However, and despite the presence of these programmes, trends in the debt-to-GDP ratio appear to be unsustainable. In addition, Jordan does not have the needed fiscal space to finance its current account and budget deficits. The Jordanian government is also hosting half a million Syrian refugees which is even further exacerbating the government budget, the accumulation of sovereign debt, as well as Jordan's infrastructure. It should also be noted that 2015-2020 was a period of considerable economic hardship and uncertainty in Jordan. Economic difficulties were exacerbated by the COVID-19 pandemic, which produced low GDP growth rates (below 2%) and a contraction in the Jordanian economy in the order of 2% in 2020, as well as a decline in FDI to a low of 1.3% of GDP in 2020 (Table 8).

Another issue is Jordan's ineffective monetary policy. In the presence of fixed exchange rates and an open capital account, monetary policy is impotent. These combined factors are also draining the Central Bank's foreign exchange reserves which had fallen by 3% in April 2021. International reserves were already being depleted and the import coverage of reserves decreased considerably from eight months in 2015 to five months' worth of imports in 2020. Furthermore, it should be stressed that the huge burden on Jordan's macro economy is public debt, which is expected to climb to 116% of GDP in 2021. While Jordan is currently in a critical financial position, monetary policy continues to be ineffective, with no direct impact on the macro economy and GDP growth rate. The current situation could be attributed to the impossible trinity, discussed above.[3] Therefore, more credit rating downgrades are to be expected from the international rating agencies, which could render servicing of Jordan's public debt even more expensive.

Since 2018, Jordan has been experiencing public debt manageability issues coupled with limited access to financial markets. Between 2015 and 2018, Jordan still managed to borrow from the international financial markets through a Eurobond issue, only at relatively high interest rates. Therefore, based on the current situation, it seems quite unlikely that Jordan will be able

TABLE 8 **Selected Macro-Economic Indicators for Jordan: 2014-2020**

Indicator /Year	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Real GDP change, %	3.4	2.5	2	2.1	1.9	2	-2
Inflation rate, % at end of period	1.6	-1.7	1.2	3.5	3.8	0.7	-0.3
Interest rate, % at end of period	4	3.8	3.8	5	5.8	5	3.5
Unemployment rate, %	11.9	13.1	15.3	15.78	16.29	16.85	18.5
Budget Deficit, % of GDP	-2.3	-3.5	-3.2	-2.6	-2.4	-3.4	-5
Gross public Debt, % of GDP	75.0	78.4	77.4	76.0	75.1	78.0	88.5
Current Account Balance, % of GDP	-7.1	-9	-9.7	-10.6	-6.9	-2.25	
International Reserves, USD billion	14.7	15.7	14.8	15	12.9	14.3	16.9
International Reserves per Months of Imports	7.3	8.3	8.1	7.8	6.8	7.7	5
Gross External Public Debt, % of GDP	31.6	34.9	37	41.1	37.2	35.3	39.5
Foreign Direct Investment, % of GDP	5.8	4.2	3.9	5	2.3	2.1	1.3
Exchange rate, JOD per USD	1.41	1.41	1.41	1.41	1.41	1.41	1.41

Source: IMF & World Development Indicators (2020). Jordan's Central Bank & Ministry of Finance.

[3] That is, Jordan cannot maintain a fixed exchange rate and an open capital account and have in place an effective monetary policy.

to issue new Eurobonds in 2021, i.e., tap into the international financial markets again. While Jordan may not have the ability/capacity to do so, it should perhaps resort to the domestic financial market, through the local issuance of government bonds. The development of the domestic financial market (local primary and secondary bond markets) was among the conditions specified under the IMF programme. The importance of developing the domestic financial market should also be emphasized at a time when access to international markets is becoming more and more difficult.

While Jordan is currently in a critical financial position, monetary policy continues to be ineffective, with no direct impact on the macro economy and GDP growth rate

Easy access to international financial markets (with favourable terms) may well have been the case between 2015 and 2018, but this has now been severely challenged and jeopardized as a result of the COVID-19 pandemic. While the use of fiscal policy to deal with macroeconomic imbalances is usually preferred in less developed economies, given Jordan's socioeconomic context (limited fiscal space, social unrest, fixed exchange rates, etc.) it is becoming impossible to introduce and implement fiscal adjustment measures or fiscal stimulus packages. In this context, there were limited options in terms of spending cuts and revenue increases. Tax evasion reform, however, was successfully implemented, subsequently raising tax revenues. More recently, while income tax evasion has been significantly reduced, the evasion of other revenue sources, such as sales and profit taxes, has not. While the presence of a fixed exchange rate regime[4] has been used in the past to attract foreign investments, today this system, which is still in use, is now draining foreign exchange reserves and rendering debt unsustainable and monetary policy ineffective. The Jordanian dinar is overvalued – which is why Jordan is losing foreign exchange reserves, putting pressure on Jordan's exports and producing current account deficits. If Jordan does not move as soon as possible to a flexible exchange rate regime, the threat of a currency and debt crisis will start to loom on the horizon.

Lebanon

An economic, financial, banking, political and social crisis of significant magnitude has been rapidly unfolding in Lebanon since October 2019. Unlike other recent crises in both emerging and mature economies, the current crisis is embedded in Lebanon's corrupt political system and in the financial and economic system. The essence of the problem goes back to ill-guided decisions made by the Lebanese authorities since 1990, coupled with unsustainable government borrowing and its Ponzi scheme, widespread corruption and cronyism, which have all benefited Lebanon's political elite and produced today's perfect storm. The WhatsApp tax, which ignited the protests in October 2019, became an emblem of the need to stop corruption. The domino effect of such a crisis, which is now translating into a sovereign debt, banking and currency crisis is affecting all sectors of society and has already wiped out the middle class, with poverty rates climbing to 60% of the total population.

Lebanon's macroeconomic fundamentals are the worst among the MED countries reviewed above. Lebanon is the third most indebted country in the world, after Japan and Greece, with a debt-to-GDP ratio currently at 190%, and a gross public debt of USD100 billion. Lebanon's debt and its service are becoming clearly unsustainable (Neaime, 2015b; Neaime & Gaysset, 2017). Lebanon's fiscal policies have produced a large-scale debt, inequality and chronic twin deficits inflated by rampant corruption. The country imports vastly more goods and services than it exports. While the current account deficit was over 25% of GDP in 2019, the budget deficit was estimated at 15% of GDP by the end of 2019 (see Table 9 below). Finally, GDP growth has been near 1% since the start of the Syrian crisis in 2011, with a severe 25% contraction in 2020.

Lebanon's current macroeconomic fundamentals can be summarized as follows. The country's exchange rate has been fixed since the mid-1990s at Lebanese

[4] Foreign investors would therefore know that under a fixed exchange rate system, the value of their investment will not depreciate as a result of exchange rate volatility/depreciation.

TABLE 9	Selected Macroeconomic Indicators for Lebanon: 2014-2020						
Indicator /Year	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Real GDP change, %	2.5	0.2	1.5	0.9	-1.9	-6.7	-25
Inflation rate, % at end of period	-0.7	-3.4	3.1	5	5.6	7	150.4
Interest rate, % at end of period	10	10	10	10	10		
Unemployment rate, %	6.35	6.31	6.26	6.18	6.1	6.04	-
Budget Deficit, % of GDP	-6.2	-7.5	-8.9	-8.6	-11.3	-10.5	-15.1
Gross Public Debt, % of GDP	138.3	140.8	146.2	149.7	154.9	174.3	154.4
Current account balance, % of GDP	-28.8	-19.9	-23.5	-26.3	-28.2	-26.5	-14.3
International Reserves, USD billion	39.5	38.7	43.3	43.5	40.6	38.2	17.4
International Reserves in Months of Imports	16.8	17.2	18.9	18.8	17.1	17.7	-
Foreign direct investment, % of GDP	5.9	4.3	5.0	4.7	4.8	4.3	-
Exchange rate, LBP per One USD	1,500	1,500	1,500	1,500	1,500	1,500	9,000

Source: IMF & World Development Indicators (2020). Jordan's Central Bank & Ministry of Finance.

Pounds (LBP) 1,507 to the USD and depreciated to 9,000 LBP to the USD in 2020. By the end of 2019, Lebanon's GDP was estimated at USD 53 billion with an estimated growth rate in 2020 of -34%. The current account deficit stands at USD 15 billion per year and has been on average 25% of GDP between 2015 and 2019; the highest among all MED countries during the last three decades. The total government budget in 2019 stood at USD 13.8 billion with government revenues at USD 11.6 billion (or 21% of GDP) and government expenditures at about USD 17.8 billion (or 160% of government revenues). Therefore, the government budget deficit in 2019 amounted to USD 6.2 billion or 11% of GDP and to USD 8.5 billion in 2019 or 15% of GDP. Government revenues decreased by about 20% in 2019, expanding the budget deficit even further.

Before the government debt default in 2020, the government's foreign currency debt (Eurobonds) stood at USD 32.6 billion in 2020 (or 37% of total debt) and was held by local banks (USD 20 billion) and international investors (USD 12.6 billion), while government debt denominated in LBP amounted to USD 54.5 billion (or 63% of total debt) and was mostly held by the Banque du Liban (BdL) (USD 30 billion) and local commercial banks (USD 18 billion). The gross central bank foreign reserves are currently estimated at USD 15 billion. They include USD 15 billion in commercial banks' reserve requirements. This means that today, the Central Bank is no longer able to pay for the country's strategic imports (oil, wheat and medicine). More importantly, commercial banks' total exposure to the BdL and the government is estimated at USD 125 billion or about 71% of total bank assets. This significant exposure to the government led

Lebanon's fiscal policies have produced a large-scale debt, inequality and chronic twin deficits inflated by rampant corruption

to the downgrading of BankMed, Bank Audi and Blom Bank to the selective default category by several rating agencies, including Standard and Poor's. The recent government debt default will lead to the bankruptcy or mergers of several commercial banks, depending on their relative exposure to the government debt, with a significant loss of the banking sector's deposits, estimated at USD 80 billion.

The government's recent default on its external debt and the exposure of Lebanon's commercial banks to the country's sovereign debt – with an estimated 70% of total assets invested in either treasury bills or bonds or certificates of deposit – have caused a severe banking crisis coupled with bank panics. For the past few decades, a dysfunctional electricity system, poor tap water quality and solid waste mismanagement constitute examples of an inefficient service delivery by the authorities to the people of Lebanon. Finally, the estimated 1.5 million Syrian refugees in Lebanon have only exacerbated Lebanon's fiscal problems, the cost of which was recently estimated by the IMF at around USD 25 billion since 2012.

Concluding Remarks

In short, over the past few years, increased financial support from multilateral donors (the IMF, EU and

World Bank) has remained difficult and unlikely, making it harder for Tunisia to continue managing its debt. Such assistance, whenever possible, will help Tunisia approach bilateral donors, and would also help open the door to the international financial markets, thereby allowing Tunisia to bridge its financing gaps and better manage its public debt. In the absence of international funding, the servicing of the public debt would become rather costly owing to rising interest rates and the depreciation of the domestic currency – which would further exacerbate the current macroeconomic imbalances.

Lebanon shares similar macroeconomic fundamentals with Jordan (e.g., a huge number of Syrian refugees, in the order of 1.5 million, a fixed exchange rate regime and the accumulation of a huge public debt). However, Lebanon has yet to benefit from financing from international donors. Lebanon's current economic situation (currency, debt and banking crises) is exactly what could have happened in Jordan if the IMF and EU funding programmes were not introduced back in 2015-2020. Finally, it should be noted that Jordan is entirely under the influence of external shocks from neighbouring countries. Short of an IMF programme, the debt situation would not have been manageable. Without support from the EU and IMF, Jordan would have already defaulted on its debt; not to mention the problem of the Syrian refugees, and the subsequent pressure on Jordan's infrastructure, and budget deficits from the past.

Unlike other recent financial and debt crises in both emerging and mature economies, Lebanon's accumulation of the interrelated political, social and economic crises, mutually feeding on each other, can best be described as a perfect-storm scenario rooted in Lebanon's past failed economic policies and corruption. The consequences of these crises individually, and even more so combined, for Lebanon and all stakeholders involved (people, government, universities, civil society, private sector, NGOs, etc.) could be devastating unless urgent policies are implemented. It is critical that Lebanon begins, under the umbrella of the IMF, a process of significant fiscal and monetary consolidation and structural reform to curb corruption, restructure public debt, stabilize and capitalize the banking system and increase economic growth (Neaime, 2015b). Structural, fiscal, monetary and social adjustment and reform measures are the only way out of Lebanon's current situation.

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