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Macroeconomic adjustment under regime change: From social contract to Arab Spring

João Ricardo Faria [a], Peter McAdam [b,*]

[a] University of Texas at El Paso, United States
[b] University of Surrey, United Kingdom

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ABSTRACT

Against the backdrop of the Arab–Spring protests, we examine macroeconomic stabilization under regime shift. We model this as a dynamic interaction between a government and a profit-maximizing firm. The former imposes the state of technology, some value of rent extraction, labor-market rigidities and time preference. The firm, conditional on these factors and the optimally-determined inflation rate, sets labor demand. Given its extractive nature, there is a continuous probability of a political regime shift, characterized by a hazard function (we compare state and non state contingent forms). The model is able to rationalize the early growth and developmental gains of many Arab economies and their subsequent reversal, as well as the later stalling of economic reforms. The model provides a novel analysis of the evolution of the Arab economies, the shifting time preferences of policy makers and their interaction with economic reforms.

1. Introduction

In the post-war period many countries underwent radical regime shifts: e.g., consider the transition from dictatorships to democracies in Southern Europe, Latin America and Eastern Europe in the 1970s, 80s, and 90s, respectively. Such transitions were rarely smooth. Latin America, for example, experienced hyperinflation and high unemployment in the 1970s and 80s. Though challenges remain,

* Corresponding author.
E-mail addresses: rfaria2@utep.edu (J.R. Faria), pmcadamp@googlemail.com (P. McAdam).

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macroeconomic stabilization patterns are converging to G7 averages in all three regions. With the uprising against autocratic governments in the Middle East and North Africa (MENA)[1] from late 2010, however, we again face the question of how economies, undergoing dramatic regime shift, can manage the transition. The transition represents a profound source of uncertainty that is likely to impact negatively on macroeconomic stability, IMF (2012).

Accordingly, against the backdrop of the Arab–Spring protests, we examine macroeconomic stabilization under regime shift. As far as we aware, ours is the first to address it. Our model comprises two agents (government and representative firm) and two political economy regimes (before and after the "Spring"). We assume that the government has preferences over inflation and employment.[2]

In addition to policy management, the government is assumed to extract rents from the firm. We further assume that the transition between regimes (pre and post–Spring) is determined by a hazard rate. This can be formulated in different ways. For instance, regime change might happen dramatically and with no apparent forewarning. Or, more likely, it may be an *endogenous* reaction to some underlying polity failure. One consequence of the latter is that a policy maker, mindful his actions could trigger (unwanted) regime shift, may tailor policy to contain revolutionary pressures.

Armed with this framework (calibrated to the MENA region), we ask how such a model economy would evolve, how would regimes survive or fail? Would the model mimic outcomes that broadly match that witnessed in the MENA in recent decades? The contribution of this paper is therefore to provide a unified framework for analyzing the economic and policy evolution of Arab economies over time. To that end, we consider the MENA block as having passed through the following phases:

Regime 1 (expansion, then crisis): the rapid "Expansion" of their economy and welfare system after colonial independent (the so-called Arab "Social Contract"). "Crisis", their protracted slump in the 1980s, and attempted structural reforms.

Regime 2 (full regime change): the current post–Spring phase of economic uncertainty and regime shift.

Our approach moreover makes a very distinct series of contributions to the literature. We merge hazard and regime-shift analysis with the literature on macroeconomic stabilization, and are able to relate the regime's survival prospects with unemployment and various rent-seeking activities. We also corroborate the importance of institutions, on both the traditional growth focus as well as on macro stabilization.

Our findings are the following:

1. We rationalize the Arab world's early developmental gains as a demand-based "stability premium" (i.e., low unemployment) needed to build political support. The stronger the forces of internal rebellion and the weaker the dynamism of the economy, the greater the required premium.
2. This initially low unemployment level rapidly escalates as we move from this early demand expansion to a crisis period. Quadratic curvature of the unemployment rate to regime-dependence factors is also confirmed empirically.
3. Given the hazard treatment of regime change, the policy makers's preferences become naturally time varying. The certainty of eventual regime change endogenizes and shifts the rate of time preference; in effect, the incentive to run the regime well diminishes over time.
4. The policy response following this crisis was a variety of structural reforms. We demonstrate however that governments at the more extractive end of the political spectrum can ensure that reforms generate worse outcomes than no reforms.
5. The most stable political regimes can be the most "extractive".

[1] This block, as defined by the IMF, comprises 20 countries: Algeria, Bahrain, Djibouti, (Arab Republic of) Egypt, (Islamic Republic of) Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates, Yemen.

[2] For background on policy stabilization in emerging and/or politically strained economies, see Blanchard (2004), Hachicha and Bates (2009), Aktas et al. (2010), IMF (2012).