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Twin deficits and the sustainability of public debt and exchange rate policies in Lebanon☆

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ABSTRACT

This paper examines empirically using time series econometric models the sustainability of public debt and exchange rate policies, as well as, the relationship between current account and budget deficits in the emerging small open economy of Lebanon. The empirical results point to unsustainable debt and exchange rate policies. Other empirical results support the existence of a unidirectional causal relationship, in the short run, between the budget and current account deficits, indicating that rising fiscal deficits have started to put even more strain on the current account deficits and on the national public debt. To avoid a future depreciation of the exchange rate and perhaps a fiscal and currency crises, the government will have to timely introduce austerity measures to curb the negative implications of its rising budget and current account deficits and debt on Lebanon's economy.

1. Introduction

The conduct of exchange rate and fiscal policies in the emerging economy of Lebanon has recently become critical in determining the country's future economic and fiscal position, due to the

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accumulation, since the early 1990s, of sizable levels of internal and external debts, and the pursuit of a fixed exchange rate regime since the mid-1990s. Lebanon has been running permanent current account deficits for the past three decades and budget deficits since the early 1990s, resulting in a total public debt estimated at 145 per cent of GDP in 2013. With the more recent accumulation of a sizeable foreign debt, the pursuit of a fixed exchange rate regime became a must in order not only to keep debt service costs under control, but also to insure a steady inflow of foreign capital. Subsequently, monetary policy became subordinated to preserving the exchange rate peg to the United Satets Dollar (US$), and Banque Du Liban (BDL) lost an effective monetary policy tool that constituted an effective mechanism to absorb and neutralize fiscal and macroeconomic imbalances, as well as external/political shocks on the domestic economy.[1]

Moreover, there is substantial evidence in the literature stipulating that foreign debt and exchange rate crises are strongly linked in emerging economies. Reinhart (2002), for example, finds that 84 per cent of all default episodes in her 59-country sample over the period 1970–1999 were followed within 24 months by currency crises, while 66 per cent of all currency crises in her developing-country subgroup were followed within 24 months by debt defaults. It remains to understand why the link between the two phenomena should be so strong empirically, as well as why in some cases the two types of crises tend to occur together while in others they do not.

On the other hand, the relationship between budget deficits, current account deficits, public debt and exchange rates policies has attracted a great deal of attention from academics and policy-makers. There exists numerous papers in the macroeconomic literature dealing with the issue of debt sustainability and its implications on exchange rates (see for instance Neaime, 2009, 2010; Chalk, 2000; Mendoza and Ostry, 2008; Ghosh et al., 2013; Bohn, 2005; Hamilton and Flavin, 1986; Trehan and Walsh, 1988, 1991; Smith and Zin, 1991; Buiter and Patel, 1992; Baglioni and Cherubini, 1993; Caporale, 1995; Haug, 1995; Quintos, 1995).

Moreover, the theoretical and empirical literature that has examined the relationship between current account and budget deficits may be divided into two strands. The Keynesian view argues that budget deficits have a statistically significant impact on current account deficits. For example studies by Mundell (1963), and Haug (1996) have argued that government deficits cause trade deficits through the interest and exchange rate channels. In a small open economy IS-LM framework, an increase in the budget deficit would induce upward pressure on interest rates, thus, causing capital inflows. This will lead to an appreciation of the exchange rate through the high demand on domestic financial assets, leading to an increase in the trade deficit. The second strand of the literature falling under the Ricardian Equivalence Hypothesis (Barro, 1989) argues that there is no relationship between the two deficits. In other words, budget deficits do not result in current account deficits. It is shown that changes in government revenues or expenditures have no real effects on the real interest rate, investment, or the current account balance.

Since the early 1990s, Lebanon has emerged to be a major debtor country. A heavy debt service burden, inadequate collection of taxes coupled with heavy government expenditures on infrastructure led subsequently to the emergence of recurrent budget deficits. Increases in the budget deficit have induced upward pressure on domestic interest rates, thus, causing capital inflows seeking investment in Lebanese Treasury Bills (TBs). This had led to the appreciation of the nominal exchange rate in between 1993 and 1995, and an appreciation of the real exchange rate since the mid-1990s, further deteriorating the trade deficit. On the other hand, Lebanon has always been characterized by an inefficient export sector and high levels of imports. Lebanon imports about 80 per cent of the goods consumed locally. The byproduct has been a huge gap between exports and imports and recurrent trade and current account deficits.

Against this backdrop, this paper aims to achieve two broad objectives. The first is to determine whether Lebanon's fiscal policy has become unsustainable, and subsequently, whether the current

[1] With a fixed exchange rate regime and an open capital account, monetary policy becomes ineffective, as the central bank of a small open economy will be subordinated to keep the interest rate under the control and close to the foreign interest rate to which the currency is pegged. This phenomenon is known as the impossible trinity in the literature. That is a fixed exchange rate, an open capital account and an effective monetary policy cannot coexist.