

# ICABE-‘21

## TWIN DEFICITS HYPOTHESIS REVISITED: ECONOMIC POLICY LESSONS FOR THE FRAGILITY OF EMU.

### Abstract

**Purpose:** The main aim of the study is to re-examine the twin deficits hypothesis (TDH) for the South-West Euro Area Periphery (SWEAP, i.e., Greece, Portugal, Ireland, Spain and Italy) during the period 1992-2020. The European economic and monetary union's (EMU) institutional framework, in continuous adjustment to meet global challenges provides an interesting basis for re-considering economic policy issues.

**Design/Methodology/Approach:** The article contributes the relevant literature in restoring its incomplete and therefore fragile architecture, through in depth theoretical and extensive empirical analysis we have done. It develops research questions derived from respective versions of the TDH relevant theory, within the context of optimum currency areas' (OCA) theory and EMU's institutions. The empirical study has been started with the analysis of panel data impulse response functions and Granger causality tests, while, the heterogeneity, the variable non-stationarity and the cross-sectional dependence, that it was found in the yearly sample data, were treated properly with the common correlated effects mean group (CCEMG) estimators and relevant error correction models (ECM).

**Findings:** The findings from the preliminary estimations of the panel vector autoregressive (PVAR) analysis were consistent with both the TDH and the intertemporal approach (ItACA) to the current account balance (CA). However, their robustness tests, made through modern panel time series (PTS) econometric methods, have shown that neither the government budget (TDH), nor the temporary government expenditures (ItACA), nor any other deficit net of these temporary expenses (nested models), could affect the CA because they were found statistically insignificant. A logical economic interpretation of this impressive evidence, should be searched to the "rigid rules logic" of the incomplete EMU architecture, such as the straitjacket of the Stability and Growth Pact (SGP) as it stands today, causing the aforementioned statistical properties of the sample.

**Practical implications:** Important policy lessons can be derived towards centralizing a significant part of the national budgets to the European level. This can lead to restore the sustainability of the EMU by erasing its incompleteness and inherent fragility, every time it is appeared an asymmetric shock, provoking lack of confidence in financial markets considering that the governments cannot serve their debts. The latter in its turn, can in a self-fulfilling way, foster member countries to a default. As modern OCA theory predicts, and the post Covid-19 era requires more political and institutional unification, the paper's evidence refuted the validity of austerity measures with balanced government budgets imposed by policy makers who invoked erroneously the international competitiveness of SWEAP member countries.

**Keywords:** Eurozone; Government Budget; Current Account; Fundamental Current Account Equation; Panel Data Econometrics.

**JEL codes:** F32, F41, F45, H62.

**Paper Type :** Research Article.