Structural reforms and external rebalancing in the euro area: a model-based analysis

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The external imbalances inside the euro area during the past decade reflect mainly higher consumption and low saving rates in the deficit countries rather than exceptionally high investment. The growing disparity of current account positions and foreign indebtedness has been facilitated by financial market integration and the decline of borrowing costs in the periphery of the euro zone. While part of the disparity in external positions inside the euro area can be justified by economic fundamentals, other parts have been unsustainable, fuelled by housing and consumption booms, and finally have to unwind.

The present paper focuses on the external adjustment when smooth rebalancing cannot be taken for granted. It analyses the potential of structural reforms to support adjustment along two dimensions, namely the resilience of external positions to non-fundamental exogenous shocks, i.e. imbalance prevention, and the correction of existing imbalances.

The paper builds on a three-region version (small EMU member country, other euro area, rest of the world) of the QUEST model to assess the transitory and permanent effects of (credible) structural reforms on external positions and external rebalancing in the euro area. The analysis focuses on the small EMU country as example for euro-area members with adjustment needs.

The simulations suggest that enhanced flexibility of prices and wages has limited quantitative impact on the adjustment path. Higher price flexibility dampens the deterioration of external balances in reaction to housing bubbles and demand shocks, whereas higher wage flexibility amplifies the reaction of net imports and borrowing from abroad. Prudent lending that avoids over-borrowing in response to house-price booms limits housing investment, current account deficit and debt accumulation compared to a baseline in which collateral constraints soften when house prices rise.

Price mark-up reduction, wage moderation and fiscal consolidation improve trade and current account balances in the short and medium run (here, over periods of 5-6 years), based on the competitiveness gain and the demand-dampening effects of temporary increases in the real interest rate and fiscal consolidation. Despite the fact that the competitiveness gain (terms-of-trade adjustment, real effective depreciation) is permanent, the positive impact of structural reforms on trade and current account balances declines in the longer term and external positions return (close to) initial levels. The decline of reform-related trade and current account surpluses in the longer term derives from the positive income effect of successful reforms. Reforms that increase domestic activity, employment and income also increase the domestic import demand and net capital inflows in the longer term.
The contribution of structural reforms to external rebalancing does not depend to a significant degree on the initial imbalances' size. Structural reforms that lead to real devaluation initially increase the foreign debt burden in real domestic terms, but also strengthen the subsequent current account adjustment. Area-wide reforms affect external balances with the rest of the world, but do not reduce disparities across EMU member states.