Summary for non-specialists
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The impact of structural policies on external accounts ininfinite-horizon and finite-horizon models

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The impact of structural reforms, notably in labour and product markets, on current account and net foreign asset (NFA) positions has received particular attention in the context of the large and persistent external imbalances inside the euro area. The value of model simulations for policy analysis in this context depends on the robustness of results especially with respect to elements not easily tested empirically. In this spirit, the paper investigates the robustness of the impact of structural policies on external accounts with respect to the planning horizon of agents as one important model dimension in otherwise identical small open economy versions of the QUEST III model with tradable and non-tradable sectors.

The paper analyses the impact of product market reform in the form of price mark-up reduction, labour market reform in the form of wage moderation and fiscal devaluation as tax shift from labour to consumption on the economy's external position. It also discusses second-round effects of budgetary policy and the impact of initial foreign indebtedness on the effects of structural reforms on external positions.

The comparison between the infinite-horizon and finite-horizon specifications across the policy scenarios suggests the following conclusions:

Both model versions imply qualitatively similar responses of domestic activity to structural reforms, but differ in the qualitative and quantitative response of external positions. Structural policies tend to have stronger and more persistent effects on external positions in the finite-horizon model.

The wealth channel suggests at the same time a more differentiated assessment of the impact of structural policies on external positions in the finite-horizon model compared to the infinite-horizon framework as different reforms affect financial wealth in different ways.

The improvement of external accounts and the NFA positions tends to be stronger if structural policies are accompanied by fiscal consolidation, i.e. potential budgetary savings are used to decrease the level of government debt, and if the economy starts with high pre-reform levels of net foreign debt, so that the growth of the denominator improves the NFA-to-GDP position. The second-round budgetary effects of structural policies are particularly relevant in the OLG

framework where government debt is part of the household wealth.

The effects of structural policies on the NFA-to-GDP position in infinite-horizon and finite-horizon models become more similar if the economy faces high levels of net foreign debt. The greater similarity between INF and OLG results with higher foreign debt is due to importance of the denominator effect. Output gains associated with structural reforms reduce foreign debt to GDP in both models in the medium and longer term.