Assessment: "The Effects of Competitiveness on Trade Balance: The Case of Southern Europe"

This paper is focused on a relevant empirical topic with important economic policy implications: the significance of real effective exchange rates for the determination of trade balances in the "peripheral" countries belonging to the European Monetary Union (EMU). These countries (Spain, Portugal and Greece, and at much less extent Italy) accumulated persistent and increasing current account deficits since the onset of the EMU to the financial and economic crisis of 2008-2009, and the orthodox interpretation is that this is due to a loss of price-competitiveness, measured by an increase in relative unit labour costs (ULC). This narrative has been embraced by the European authorities, and their economic policy recommendation is that these countries require some sort of internal devaluation –a slower ULC growth than in the rest of the members of the EMU- in order to restore competitiveness.

It is important to point out that the European and national authorities have not only considered internal devaluation as a necessary tool to correct external deficits, but also argue that it will help restore economic growth. The impulse to external demand due to a higher competitiveness should offset the decline in domestic demand, which the internal devaluation policy itself exacerbates. The authors of this paper underlines this when state in page 2 that "all these measures should allow the trade balance to improve, and hence to recover the previous levels of employment and growth". However, this is only true if lower ULC are passed on to export prices, if lower export prices influences significantly the trade balance, and if this positive effect is strong enough, because, as they also write in the same page 2, trade balance "is only a share of total aggregate demand".

The authors estimate trade balance equations for Greece, Italy, Portugal and Spain, both for total trade and for trade performed within the EU. The explicative variables considered are domestic and foreign GDP, and the real effective exchange rate (REER).

Three different deflators (CPI, export prices and ULC) are used to obtain the REER:

- ✓ This is an adequate decision, because the exclusive use of relative ULC as a measure of competitiveness gives for granted that changes in aggregate costs are reflected by the same extent in the prices of tradable prices, which is not necessarily true. Wood (2014) provides a critical assessment of the use of relative ULC as an indicator of external competitiveness in the context of current internal devaluation policies.
- ✓ Indeed, the results obtained by the authors show that the estimated coefficients associated to different measures of the REER are not equivalent, because the fall in ULC has mostly meant higher profit margins and not lower relative export prices –the ultimate aim of internal devaluation-.
- ✓ Nevertheless, I think that using the GDP deflator instead of CPI would be better, because the former computes the evolution of final prices of all the goods and services produced inside each country.

Although I am not an specialist in econometric techniques, the empirical exercise seems rigorous, using appropriate standard techniques, and the results are important and they are in line with the literature: the estimated coefficients for domestic and foreign GDP are always significant and have the expected signs; on the contrary, this is not true for the alternative measures of REER, and trade balance is not clearly related to changes in the REER in these countries. Moreover, when the estimated coefficients related to some measure of the exchange rate are significant, the estimated elasticities are clearly lower than those associated to domestic and foreign demand. In my opinion, this conclusion ("demand dominates prices") must be underlined, because it contradicts the orthodox explanation of the origin of the crisis inside the Eurozone and, above all, queries the idea that internal devaluation may trigger an export-led resumption of growth in the periphery, thanks to the dynamism of its exports.

Section 2 of the paper provides the theoretical framework of the paper, consisting in a simple version of the imperfect substitutes model of international trade. Although there is nothing wrong, I do not find it too much value-adding for the aims of the paper. Alternatively, I would suggest a more in-depth discussion of the results in the context of some other relevant literature for the current debate on the Eurozone crisis and the adequate answer in the peripheral countries. For example:

- ✓ Constantine, Reissl and Stockhammer (2016) discuss competing explanations for European current account imbalances, and they show that there exist opposing views on the relative importance of cost developments and of demand developments in explaining current account imbalances. Consequently, there is also a remarkable variability of policy conclusions. The paper by Bajo-Rubio, Berke and Esteve could be an important empirical contribution to this debate.
- ✓ Bhaduri and Marglin (1990) established two possible demand regimes in different economies: wage-led economies are those in which an increase in the wage share on total income have a positive impact on aggregate demand; on the contrary, if a shift towards profits has favourable repercussions on the economy, then we shall say that this economy is in a profit-led economic regime. Internal devaluation policies would only have the expected expansive effects if the economy is profit-led, and the recent empirical literature (for example, Onaran and Obst, 2015) has shown that: 1) most European economies, and particularly Spain, Italy, Portugal and Greece, are wage-led economies; 2) those economies which are profit-led are characterized by an important effect of ULC on external competitiveness, and a high degree of external openness. The empirical conclusions obtained in this paper, then, reinforces the idea that peripheral Eurozone economies belong to the wage-led regime.
- ✓ The authors state that demand is more relevant than prices to determine the evolution of the trade balance, and they conclude that "an improvement of domestic demand might jeopardise any favourable developments of the trade balance" (page 9). This sentence can be related to the concept of Balance-of-Payments-Constrained Growth Rate (BPCGR), whose relevance in the context of the intra-Eurozone imbalances has been highlighted by Hein and Detzer (2015). When national growth is constrained by the rate of growth of foreign GDP, provoking for example a slower economic growth than that necessary to eliminate existing unemployment or to avoid its increase, the appropriate economic policy should be improve competitiveness in order to lift the BPCGR. Nevertheless, according to this paper, the focus should be on non-price or structural competitiveness.

Concluding, I think this is a very good research paper which provides relevant empirical results which can be adequately used in the context of current debates regarding both the causes and the possible solutions of the Eurozone crisis. These results cast important doubts on the internal devaluation strategy supported by the European and national authorities in the peripheral European countries.

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