The Euro area is suffering from substantial internal trade imbalances. These are widely recognised as important contributing factors to the crisis of the Euro system because persistent current account deficits come with increasing external liabilities. The present economic policy regime essentially aims at rebalancing the Euro area by means of internal devaluation and/or by fiscal contraction in the deficit countries; in short, by a deflationary adjustment.

The paper estimates the costs of rebalancing via internal devaluation. This strategy tries to achieve the necessary adjustment via reduction of unit labour costs in the deficit countries. To identify these effects quantitatively the paper takes an old Keynesian approach. The model uses annual data for the panel of Euro area member states for the Euro period (1999-2011). First, we estimate a current account equation as a function of domestic demand and of unit labour costs (ULC). Second, we estimate a traditional wage Phillips curve, where ULCs are explained by unemployment, import prices and lagged ULCs. Third, we estimate an Okun’s Law relation, where changes in unemployment are explained by changes in growth.

Combining the effects of these equations allows us to identify the direct as well as the indirect effects of demand on the current account balance. The direct effect is that a decrease in demand will reduce imports and thereby improve the current account. The indirect effect is that the decrease in demand will lead to an increase in unemployment, which reduces wage inflation and thus price inflation. This will affect the current account via changes in competitiveness.

The econometric results are used to calculate the output loss necessary to eliminate the average current account deficit for the GIIPS (Greece, Ireland, Italy, Portugal and Spain) countries (8.4% of GDP in 2008). We find that in order to eliminate the average current account deficit of the GIIPS group, a GDP reduction of 47% is needed. We also report alternative results based on different samples that are somewhat lower, but of similar order of magnitude. The rebalancing of trade flows is a necessary part of stabilising; however, there are other issues, such as dealing with unsustainable debt levels that are not subject of this paper.

These results should not be considered as forecasts, but as ‘what if’ exercises. They indicate the output loss required to eliminate the GIIPS’ current account deficits if the basic macroeconomic behavioural equations were to hold, on average, as in the recent past. There are reasons to think that we overestimate as well as underestimate actual adjustment costs. First, economic relations may differ during recessions from those of normal times. Second, there may not be a need to eliminate current account imbalances completely. Third, ‘structural reforms’ may work and dramatically improve productivity (and thus competitiveness) of the GIIPS. However, there are also several reasons to think that we underestimate actual adjustment costs. First, we do not account for the negative effects from the uncertainty over the future of the Euro. Second, we do not model the negative effects that deflation has on real debt burdens and thus on aggregate demand. Third, we do not consider the spillovers of demand between European countries.

The results have to be interpreted with care, but they clearly indicate staggering amounts for the adjustment costs of the internal devaluation strategy. Our results indicate that the economic costs of this adjustment to the GIIPS countries are equivalent to or larger than the output loss of the Great Depression. These costs are so large that there is only one conclusion: deflationary adjustment in the deficit countries will have devastating economic and social effects. Indeed we think that such a reduction of GDP should not be imposed in the GIIPS group; moreover, we doubt whether it would be politically feasible.

If the Euro area is to survive it has to rebalance. If this is to be done without strangling the deficit countries, the surplus countries will have to do a much larger part of the adjustment. There are two ways of rebalancing: a deflationary and an inflationary one. Inflationary adjustment involves higher wage growth and expansionary policies in the surplus countries. An adjustment of the surplus countries would increase growth and it would come with higher inflation, but it would allow rebalancing without a Great Depression in parts of Europe. Europe desperately needs inflationary adjustment.