Latvia's Options—Internal versus External Devaluation

By Torbjörn Becker[1]

A key policy choice for Latvia has been between a so-called internal devaluation where domestic wages and prices are adjusted and a regular devaluation of the nominal exchange rate (or external devaluation). I have argued before, as have the IMF and others, that the option of external devaluation would be the most efficient way for Latvia to deal with both internal and external imbalances and reduce the economic pains of this adjustment process. Pain there will be regardless of this choice—we all understand this—so the issue is really how to minimize pain or protect the downside. The following note goes through some of the arguments for and against internal and external devaluation.

To summarize the arguments that follow for the impatient reader, a regular, external, devaluation in combination with a unilateral adoption of the euro would be the most desirable solution. Under current circumstances, the main reason for this is to remove all the uncertainty that surrounds the current exchange rate regime and get the economy moving again. In addition, a devaluation will provide an across the board adjustment of relative prices for both exports and imports that is immediate and economy-wide and reduce the need for individual companies to undertake costly wage and input price negotiations. The wage cuts that have already been made will make the necessary devaluation smaller than it would otherwise have been, so this adjustment has not been done in vain if the country now chose to devalue and adopt the euro.

Before going through the pros and cons of internal and external devaluation it is useful to understand what brought Latvia here. Basically the fixed exchange rate in combination with an overenthusiastic private sector and lax fiscal policy created a situation where there were large inflation differentials between Latvia and euro countries and thus interest rate differentials between lats and euro denominated loans. In real terms, anyone who borrowed in euro and invested in real lats assets got paid to do so (see example in Box 1). This fueled a bubble that for as long as it lasted made lats returns on euro borrowing even more irresistible. A rapid build up of foreign debt resulted (figure below). It should be noted that this was rational from a borrowers perspective as long as the exchange rate was fixed and banks supplied credit.

Box 1. Cheap euro loans—an example

Assumptions:

- 1 Lats = 0.7 euro fixed exchange rate
- Latvia's inflation15%, euro inflation 2%
- Loan in lats 20% interest (households)
- Loans in euro 7%,
- Borrow 100,000 lats for apartment

The cost of loans:

- Interest payment on lats loan: 20,000 lats
- Interest payment on euro loan: 7,000 lats
- Inflation reduces real value of loan by 15,000 lats
- Real cost of lats loan 20,000-15,000=5,000 lats
- Real cost of euro loan 7,000-15,000= -8,000 lats

Conclusion: Households and firms get paid to borrow in euro

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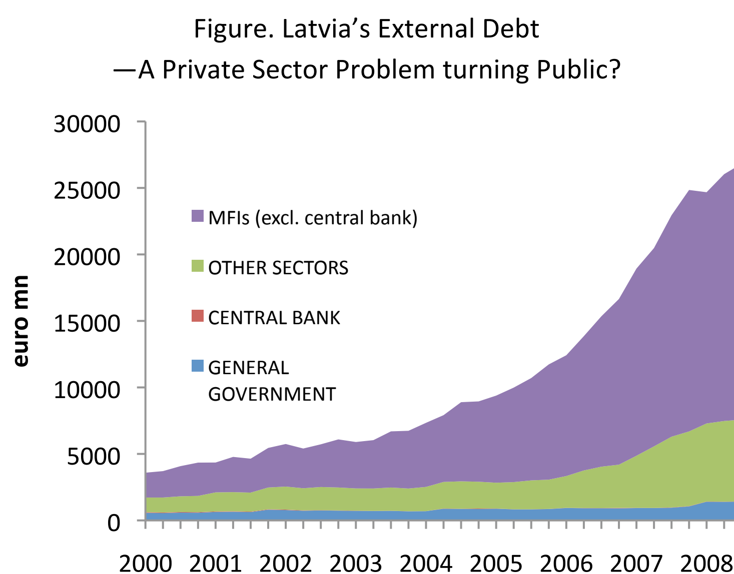
Mussa et al (2000), IMF Occasional paper no 193, p. 36 on exchange rates

> ”…no single exchange rate regime may be prescribed for all countries. However, it is crucial that the chosen exchange rate regime be credibly supported by a set of policies, in particular monetary and fiscal policy, that is fully consistent with the logic of that regime.”

Although there is no one-size fits all solution to exchange rates, to maintain a peg, fiscal policy need to be both willing and able to support the exchange rate. However, in Latvia the private sector flows were so large—the current account deficit peaked at around 25 percent of GDP—they were well beyond what fiscal surpluses could have undone. In other words, this was beyond the ability of fiscal policy and consequently, the exchange rate should have been adjusted already in the boom (unless administrative measures could have been used to limit credit expansion, which at the time was not a fashionable thing to do.)



The main arguments for Latvia to devalue its nominal exchange rate today are:

- When relative prices are incorrect a devaluation produces an immediate, coordinated and economy-wide correction
- An overvalued exchange rate adds to uncertainty for investors (”how long will it hold”, ”when will they devalue”)
- The exchange rate is an extremely important relative price not only for exports but also imports and capital flows and the lat is not close to an equilibrium today
- A devaluation will allow focus on private sector debt clean up
- Almost all other countries in the region with an independent currency have adjusted
- ALL IMF programs in the region have included adjusting the exchange rate, why?
    - Get economies going

- Don’t waste money on overvalued exchange rate

Problems with “internal devaluation”:

- To restore competitiveness Latvia’s inflation has to be below competitors by 20-30 percent =>DEFLATION. This is an economic nightmare in all other countries.
- This is a private sector problem but policies focus on public sector:
    - Foreign debt is almost exclusively private sector debt
    - Competitiveness is not a public sector issue and lowering wages in the public sector is very indirect, inefficient and uncertain way to make Latvia competitive

Many arguments can be made against a regular devaluation, but are they good reasons?

- ”We have loans in foreign currency”
    - It is a symptom of interest rate and inflation differences that arise with a fixed exchange rate and inconsistent policies
    - Internal devaluation has the exact same effect on debt service capacity but hits everyone rather than just the ones with loans, thus reducing consumption much more
    - Why should a majority of the population carry the cost of a small minority with fx loans?

Box 2. Internal vs external devaluation with fx loans =>same debt service

Internal devaluation of 20% vs equivalent external devaluation

	Starting point	Internal	External
Exchange rate	0,70	0,70	0,88
Income in lats	200	160	200
Income in euro	286	229	229
Foreign debt in euro	150	150	150
Foreign debt in lats	105	105	131
Assets in lats	80	80	80
Euro interest rate (%)	7	7	7
Interest payment in euro	10,5	10,5	10,5
Interest payment in lats	7,4	7,4	9,2
Debt service/Income (%)	3,7	4,6	4,6
Debt/Income (%)	52,5	65,6	65,6
Debt/Assets (%)	131	131	164

- ”But we don’t have an export sector and export markets contract”
    - Exactly! Latvia will never have an export sector with an exchange rate like this
    - Import substitution even more important
    - Investments will not take off with overvalued exchange rate
    - All in all, massive decline in GDP without devaluation
- ”It will create uncertainty, panic, collapse”
    - It can be problematic for a while, but it is not the case that keeping the currency overvalued is not costly
    - Other countries devalue, and with supporting domestic policies and external financial support Latvia would do better than most countries
    - THE SOLUTION IS TO TAKE THE EURO UNILATERALLY!
- ”But we want to join the euro properly”
    - That would be great but takes too long and unfortunately the EU is very rigid
    - Current developments will make it hard to meet deficit targets anyway

In the build up to the crisis we heard many times “Latvia is different!” as an argument for why current accounts, credit expansion and debt would not be a problem. Now we hear it again with regard to the exchange rate and internal devaluation. Unfortunately, when it comes to exchange rates and macroeconomic policy, Latvia is NOT different. For some reason the exchange rate is almost sacred in Latvia, but the exchange rate is a tool, not a goal in itself. The real goals are welfare, economic prosperity and stability for as many Latvians as possible, not only the minority with loans in foreign currency. What is stability when the only thing stable is the exchange rate?