

INTERNAL VS EXTERNAL DEVALUATION

The current crisis revealed the threat posed by current account imbalances on the very existence of the euro area. In the absence of a federal response, national rebalancing efforts will be needed. Two adjustment strategies seem at hand: external or internal devaluation. The Latvian and Irish experiences show that internal devaluation consists in a slow process allowing only limited adjustment to the price of persistent social costs. Argentina and Iceland, who let their currency depreciate, have undergone a radical therapy: immediate adjustment and relatively quick recovery. If more effective, external devaluation does not seem available to euro area countries as exiting the monetary union would entail dramatic costs. Internal devaluation processes must be backed by a cooperative European strategy.

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■ Current account imbalances at the heart of the Eurozone crisis

The current crisis exposed serious flaws in the design of the euro area. Economic and monetary integration has allowed unprecedented capital flows towards the peripheral countries. Meanwhile, diverging competitiveness led to vast disparities in export performances among Eurozone countries. These two processes have generated substantial current account imbalances. Such asymmetries considerably aggravate the current difficulties. With no rebalancing at the European level in sight, member states are forced to reduce their external deficit on an individual basis.

Currency devaluation being unavailable in a fixed exchange-rate regime, the Troika (IMF, ECB and European Commission) has

been advocating a deflation-led adjustment. Ireland and Latvia were branded as “role models” by the Commission for following such a strategy in tackling their own imbalances. These “internal devaluation” processes are however controversial: if some hailed Latvia for its alleged recovery¹, several authors raised serious doubts about its reach and pointed at the social costs of the implemented policies². If internal devaluation strategies are not effective in times of crisis, some countries may be forced to drop their exchange-rate regime and devalue their currency.

We analyze here the Irish and Latvian internal devaluation processes³ that we compare to currency depreciation episodes in Iceland (2008) and Argentina (2002).

1. For example A. Aslund (2011), *How Latvia Came Through the Financial Crisis*, Peterson Institute for International Economics, 207 pp. & J. Asmussen (2012), “Lessons from Latvia and the Baltics”, introductory remarks, Riga, available on the ECB's website (<http://www.ecb.int>).

2. For example D. Rodrik (2012), “What I learned in Latvia”, Dani Rodrik's weblog or P. Krugman (2012), “Latvian competitiveness”, The conscience of a liberal, <http://krugman.blogs.nytimes.com>.

3. Both countries were no longer under fixed exchange-rate regimes at the time of the adjustment. Throughout this study, we will mean by external devaluation a process of sharp currency depreciation.

■ Four tales of balance of payments crises

Latvia, Ireland and Iceland were – from 2007 – stricken by crises similar in both nature and scale (see box). They invariably originated from overheating, characterized by high growth and inflation rates (notably in wages) in the years preceding the collapse. In the same time, private agents have piled debt while public debt remained stable. The expansion of national banking systems reached dangerous proportions. Housing bubbles swelled in all three countries. This rise in imbalances resulted in widening current account deficits and the appreciation of real effective exchange rates.

Latvia is a typical case of boom and bust. In a catching up process, the GDP growth rate accelerated from 2004. The credit crunch, the housing bubble burst and the global crisis dragged the economy into recession in 2008.

Ireland is an interesting case of overdevelopment of the financial system, housing bubble and private agent excessive debt. While balanced for 15 years, the island suffered its first current account deficit in 2005, revealing more excessive domestic demand growth than a loss in export competitiveness. The 2008 global crisis quickly reached Ireland, hitting the bloated banking system (its asset represented 700% of GDP in 2007).

Iceland is also a prime example of excessive growth of the financial sector and overdevelopment of credit. The banking system's asset amounted in 2007 to 1,000% of GDP. Icelandic households set in the same year a world record with a ratio of debt to disposable income of 213%. The high inflation linked to GDP growth was accompanied by monetary inflation caused by European capital overflows.

Argentina is a special case: it enjoyed moderate inflation in the 1990s, notably thanks to its currency board. In 1995, the IMF welcomed the country's resistance to the Mexican crisis. However, worrying signs of external imbalances appeared: the current account deficit reached 5% of GDP and external debt increased. The Argentinean crisis origin remains disputed⁴: the fixed exchange rate could have contributed to the deterioration of export competitiveness. The Russian crisis and the devaluation of the Brazilian real in 1998 weakened even more the already ailing Argentinean economy.

These four countries experienced large imbalances; their real effective exchange rates provide an indication on the scale of the required adjustment. The Irish rate, undervalued in the 2000s, is slightly overvalued in 2008 (by about 5%). Meanwhile, the other countries experience massive overvaluations: by 12% in 2007 Iceland, 15% the same year in Latvia and 20% in 1999 Argentina⁵.

■ Internal and external devaluations are not equivalent

Internal devaluation: a limited adjustment

Within a monetary union or a currency board, bilateral adjustment can no longer be carried out through exchange-rate depreciation: direct action on prices is needed. Internal devaluation processes aim at pursuing this adjustment through plummeting production costs caused by deflation and the implementation of structural reforms. In practice however, governments have no influence on overall prices and must rely on the propagation of a substantial cut in civil servants' wages to the private sector's salaries, and eventually to producer prices. The process should lead to a shift in investment. Structural reforms should allow for increased productivity.

The Irish and Latvian political contexts were quite different when decisions to go for internal devaluation were taken. Membership in the euro area left the former with no other option. In the case of Latvia however, the IMF advocated a withdrawal of the lat's four-year old peg to the euro: the Latvian government refused to give up its fast-track towards euro membership and opted for internal devaluation.

Both Latvia and Ireland implemented programs combining public spending contraction, sectorial liberalization and labor market flexibility. Public servants wages were substantially cut (by 4.4% in 2010 in Ireland, by 13.2% in 2009 and 8.1% in 2010 in Latvia, see box). The Latvian government also conducted a dramatic reduction in the public service payroll (a 19% cut between 2008 and 2010). The decline in private sector wages was far from expected: 2.3% in Ireland in 2010/2011 and 2.9% in Latvia in 2009/2010. Moreover, Latvian wages growth quickly resumed, returning as early as 2011 back to their 2008 level. Prices evolution seems even less favorable: prices fell by only 2.1% in Ireland between 2008 and 2011 despite two years of deflation, while prices increased by a whopping 6% in Latvia over the same period, as the country underwent only one year of deflation (1.2% in 2010).

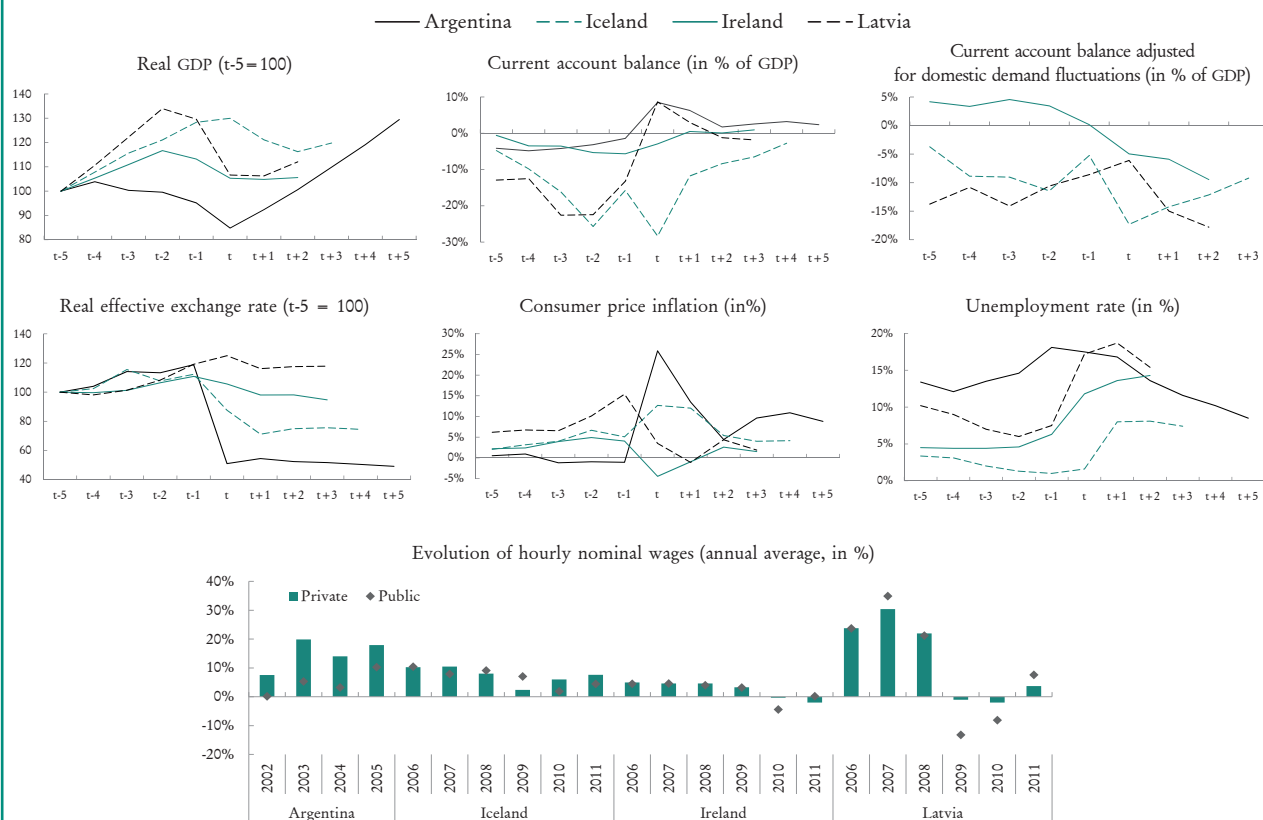
Households' impoverishment has failed to restore competitiveness as shown by the countries' real effective exchange rates that have only moderately depreciated: by 11% in Ireland and 7% in Latvia. Latvia's current account reversal in 2009 reflects a collapse in domestic demand more than a competitiveness recovery: adjusted for domestic demand fluctuations, the current account deficit⁶ would reach 6% of GDP in 2009 and 18% in 2011. Although exports were growing faster than imports between 2009 and 2011, the trade balance remains in deficit in 2011, amounting to 3.9% of GDP.

4. IMF (2003), "Lessons from the crisis in Argentina", staff report prepared by the Policy Development and Review Department, October.

5. IMF estimations for Iceland and Latvia. For Argentina and Ireland, estimations are from V. Mignon & al. (2012), "On currency misalignments within the euro area", *CEPII Working Paper*, no 2012-07, April.

6. To obtain the current account adjusted for domestic demand fluctuations, we extract from the current balance imports variations related to domestic demand changes. To calculate these variations, we adjust imports for domestic demand fluctuations using an elasticity of imports to final demand of 1.5, in line with the literature.

Box 1 – Crises and adjustments
 (t : beginning of the adjustment, 2002 for Argentina, 2008 for Iceland, 2009 for Ireland and Latvia)



Source: Authors' calculations based on data from IMF, BIS, Eurostat and national sources.

These pro-cyclical policies exacerbated an already difficult situation: Ireland and Latvia were in recession from 2008 and 2010, with GDP contracting by respectively 10.4% and 21.3%. The return to growth (5.5%) in Latvia in 2010 reflected a favorable external environment (increase in trading partners' imports). Ireland, which did not benefit from such a rebound, saw its economy stall (see box).

External devaluation: a radical solution

Argentina, who attempted to adjust through deflationary policies, saw its situation deteriorate from 1998 to 2001 (see box). The choice to default on public debt and to leave the currency board occurred in a very difficult political context. The Argentinean currency sharply depreciated: one peso was only worth 0.25 dollar in July 2002⁷. In Iceland, 2008 was marked by the gradual disintegration of the financial system. The Icelandic krona collapsed until the central bank tried to impose a peg to the euro. The latter was quickly dropped. In total, the krona lost more than 50% of its value against the euro between January 2008 and January 2009.

Such adjustments proved to be very costly in the short term as GDP contracted by 10% in Iceland between 2009 and 2010 and

also by 10% in 2002 in Argentina. Inflation reached 26% on average in 2002 in Argentina and it stabilized around 12% over the 2008/2009 period in Iceland. However these effects quickly faded and gave way to strong recovery one year after the adjustment took place: in 2003 GDP rose by 9% in Argentina and in 2011 by 3% in Iceland. Inflation slackened to reach 4% two years after the crisis erupted (2004 for Argentina and 2011 for Iceland).

Eventually, if the effects of depreciations have been to a certain extent softened by inflation, external devaluation have allowed for a sharp drop in relative prices (*pass-through*) of 54% in 2002 in Argentina and 19% in Iceland in 2008. Moreover, inflation mainly affected tradable goods⁸, allowing a transfer of resources from sheltered to exposed sectors. Real effective exchange rates adjusted instantly: by 57% in Argentina in 2002 and by 37% in Iceland in 2008/2009 (see box).

Although it is not yet possible to draw a definitive appraisal on the Icelandic case, both countries' recoveries seem sustainable. Iceland's current account deficit narrowed by 17 percentage points of GDP between 2008 and 2011 and Argentina has returned to surpluses in 2002, stabilizing around 2.5% of GDP between 2004 and 2007. In Iceland, the decline in domestic demand following the devaluation largely explains the initial

7. Under the currency board one peso was worth a dollar.

8. See A. Burstein, M. Eichenbaum & S. Rebelo (2005), "Large Devaluations and the Real Exchange Rate", *Journal of Political Economy*, vol. 113, no. 4.

current account balance improvement (see box). The subsequent reduction of the deficit was however mainly caused by rise in exports (see the current account adjusted for domestic demand fluctuations in the box).

■ Costly choices

The dramatic rise in unemployment, which amounted to 11 percentage points in Latvia and 7 percentage points in Ireland between 2008 and 2010, reflected the sharp decline in public employment but also the fall in domestic demand: firms adjusted by downsizing more than by lowering wages. The recent fall in unemployment in Latvia (by 3 percentage points in 2011) is better explained by the continued decline of labor force (around 6% between 2008 and 2011) than by employment creation (total employment rose by 3% only between 2010 and 2011). Emigration indeed played a substantial role: according to Eurostat, it has doubled in both countries while immigration dropped. These movements will induce significant costs in terms of human capital and social transfers on the long-run. As noted by the IMF, poverty and inequalities have risen in Latvia, already among the poorest countries in Europe, while in Ireland a fitter welfare system helped soften the blow.

Internal devaluation is seen by its proponents as a way to restore both competitiveness and public accounts. Yet these goals are largely contradictory in a crisis: in a context of rising public debt due to banking systems rescue, a drop in households' purchasing power mechanically reduces tax revenue and increases social transfers. Public debts sky-rocketed in Ireland and in Latvia: from 5% of GDP in 2007, the Latvian debt reached 29% in 2011 while the Irish debt rose from 11% to 102% of GDP over the same period. Both countries were forced to appeal to the IMF and their European partners, resulting in a *de facto* dependence to external public funding.

External devaluation also causes households impoverishment and widespread unemployment. The Argentinean poverty rate increased until 2003 and net migration reversed in Iceland in 2009. This impact however quickly faded: unemployment began to fall in the year following the monetary shock.

The Argentinean and Icelandic private sectors were on the eve of the crisis largely indebted in dollar or euro: both countries risked a wave of bankruptcies as a result of external devaluation. In the Argentinean case, leaving the currency board was all the more risky that the general confidence in the national currency was weak. In 2002, sustained inflation and the emergence of parallel currencies endangered the very existence of the peso. Its survival was secured by the *pesification* policy that led to partial defaults on both public and private external debt. In Iceland, external devaluation was also conducted within a strict capital control regime, preventing widespread capital flight. Thus, an important feature of external devaluation is that it entails favoring domestic debtors at the expense of foreign creditors.

■ A European crisis requires a European solution

Past experiences suggest that external devaluation is more efficient than internal devaluation in eliminating imbalances. It is however not feasible within a monetary union. The adjustment in the euro area should therefore be conducted through internal devaluation, although it is a slow and costly process. Such a strategy will be particularly difficult to implement as misalignments – in Greece and Portugal for example⁹ – are in 2011 wider than they were in Ireland and Latvia in 2008. European partners will have to direct their policies in order to support these processes. Higher inflation in surplus countries would ease relative prices adjustment. Similarly, EU investments in troubled countries' productive systems could boost their productivity and help current account deficits reduction.

Yves-Emmanuel Bara & Sophie Piton
sophie.piton@cepii.fr

9. B. Carton & K. Hervé (2012), "Euro Area real effective exchange rate misalignments", *La Lettre du CEPII*, no 319, April.

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EDITORIAL OFFICES
Centre d'études prospectives
et d'informations internationales
113, rue de Grenelle
75700 Paris SP 07
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

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DTP:
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