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Latvia's Recession: The Cost of Adjustment With An "Internal Devaluation"

Executive Summary

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The Latvian recession, which is now more than two years old, has seen a world-historical drop in GDP of more than 25 percent. The IMF projects another 4 percent drop this year, and predicts that the total loss of output from peak to bottom will reach 30 percent. This would make Latvia's loss more than that of the U.S. Great Depression downturn of 1929-1933.

This paper argues that the depth of the recession and the difficulty of recovery are attributable in large part to the decision to maintain the country's overvalued fixed exchange rate. With the nominal exchange rate fixed, the adjustment in the real exchange rate takes place through pushing down prices and wages. The IMF, which has a current loan agreement with Latvia, acknowledges this, referring to "the original program strategy of internal devaluation through wage and price declines."

But even after two years of recession, with unemployment hitting 22 percent, the real effective exchange rate has only dropped 5.8 percent from its peak.

The overvalued exchange rate hurts Latvia's tradable goods industries by making the country's exports more expensive, and its imports artificially cheap. It also harms the investment climate generally, causes spikes in interest rates when investors fear that the peg will collapse, as well as capital flight. The IMF projects that 2009 will see a total capital and financial account deficit of 4.2 billion euros, and that an additional 1.5 billion euros, or 9 percent of GDP, will leave the country in 2010.

An even bigger problem is fiscal policy, which the government has stated is pro-cyclical. An expansionary fiscal policy runs the risk of undermining confidence in the peg; it would also go against the effort to lower wages and prices for purposes of internal devaluation. The current IMF program, which the government has signed on to, calls for a fiscal tightening of 6.5 percent of GDP for 2010. This would be accomplished through a combination of spending cuts and tax increases. The IMF acknowledges that this fiscal tightening "will likely cause continued demand weakness through early 2010." [1]

Expansionary monetary policy also runs counter to the need to maintain the fixed exchange rate. Since the IMF is expecting "significant deflationary pressures for the next year or two," the inability to pursue expansionary monetary policy – and even tightening it, as happened various times last year – is another serious obstacle to recovery.[2]

The end result is that the economy is trapped in a deep recession in which all of the major macroeconomic policy variables – the exchange rate, fiscal policy, and monetary policy – are either pro-cyclical or cannot be utilized to help stimulate the economy. This makes it very difficult to get out of the recession.

In addition, as a result of the recession, the Latvian government is rapidly accumulating debt. From just 7.9 percent of GDP in 2007, Latvia's debt is projected at 74 percent of GDP for this year, stabilizing at 89 percent of GDP in 2014. This would put Latvia far outside the Maastricht debt/GDP limit of 60 percent of GDP for adopting the euro. The goal of adopting the euro has been one of the main arguments for making the sacrifices necessary to keep the peg.

Latvia's experience has been similar to that of Argentina from 1999-2002, which also suffered a deep recession as it tried unsuccessfully to adjust its economy under a fixed exchange rate regime. The government tried to maintain confidence in the peg through contractionary fiscal and monetary policies, and borrowing for interventions to support the currency. But with rising interest rates and

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1 IMF (2009b, 20).

2 Ibid. (4).

a rising public debt burden, this proved impossible. At the end of 2001, the government defaulted on its debt and by January 2002 it abandoned the peg. It is worth noting that, despite widespread consensus that the Argentine economy would experience prolonged economic problems after its default and devaluation, and the collapse of its banking system, the economy contracted for just one quarter before beginning a robust recovery in which it grew by 66 percent over six years.

In comparison, the IMF's projected recovery for the Latvian economy is weak, just 13.9 percent for the four years 2010-2014.

A devaluation would have significant negative balance sheet effects, because about 89 percent of Latvian residents' debt is in foreign currency (mostly euros). However, there is much that the government could do to mitigate the damage from a devaluation. It could allow households who borrowed in foreign currency for their mortgages to redenominate these debts into local currency at the pre-devaluation fixed rate, as was done in Argentina. In the housing sector, this redenomination could be limited to owner-occupied housing, and the amount of coverage could be limited to the price of the median home, or some additional fraction above that. Of course such a plan would imply losses for the banks holding these mortgages; however the government could subsidize these losses as necessary to share some of the burden.

If a devaluation is done in a planned way, rather than holding the peg until it collapses under a speculative attack, a better outcome is likely. It is important to note that there are also serious balance sheet effects of continuing along the present course, as indicated by the rise in non-performing loans – as the recession continues, increasing numbers of borrowers cannot pay off their loans due to falling incomes and unemployment. Despite the problems associated with devaluation, the risks of continuing indefinitely along the present course would appear to be greater.

The complete report can be accessed online at:
http://www.cepr.net/documents/publications/latvia-recession-2010-02.pdf

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