Ilmārs Rimšēvičs: Standing firm against manipulations with Lats' exchange rate

Article by Mr Ilmārs Rimšēvičs, Governor of the Bank of Latvia, published in the daily Diena on 16 February 2007.

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Economists are currently discussing ways to improve the ability to compete of the Latvian economy and they are right to do so because it is being undermined by high inflation. Morten Hansen from the Riga School of Economics has also devoted this issue a great deal of thought, sharing some of his insights with the readers of the newspaper Diena (10 February).

The Latvian economy is still the fastest growing economy in the European Union and that should make us happy because our standard of living is raised. The downside, from the macroeconomic perspective, is that the speed at which we are traveling can be compared to driving at 200 kilometers an hour, because it is accompanied by high inflation, record high prevalence of imports over exports (current account deficit), decreased ability to compete, a fast growing foreign debt. For quite a while now, the main problem of the Latvian economy has been the overly high domestic demand that exceeds supply; the economists call it "overheating" of the economy. The budget deficit is also too high for this juncture in our economic development: we are not saving for the moment when the pace of the economy will abate. Estonia, where the situation is very similar, last year recorded a budget surplus of 3% of GDP.) If we fail to have a firm grip on the steering wheel and we dismiss the danger of driving too fast, our breakneck speed can land us in a ditch!

We can only regret that Mr. Hansen has not applied his theoretician's savvy to come to the aid of the Latvian economic policy makers: to specify the list of tasks that would allow the excessively rapid development to slow down so that Latvia would continue to develop in the long term with a yearly growth of 6-7% instead of running the danger of overheating as is obvious from the estimates of the last quarter of last year. It would have been wonderful if Mr. Hansen had made use of his teaching skills, which involve the ability to get things across with ease, to remind us that in the marathon distances – in our case, approximating the level of European standard of living – sprinter's tactics are of no use.

In such a list, there would be tasks that produce immediate results along with ones where the results would be seen after several years. As a Scandinavian, Mr. Hansen could have reminded us, inter alia of the unpleasant consequences – price adjustments – after the real estate bubble burst in the Nordic countries at the beginning of the 1990s He could have reasonably suggested that the government agenda should include a surplus budget sooner than is currently planned and a balanced budget as early as 2008 instead of 2009-2010. By way of illustration, he could have shown the real possibilities for slowing down the growth rate of lending, one of the drivers of high inflation, as they have been used in other EU member states, including Ireland. Mr. Hansen could surely have talked about the promotion of exports and strengthening of domestic competition, including increasing the number of small and medium businesses and augmenting their efficiency as essential for the stability of the economy and currency. Finally, he could have discussed restructuring Latvian exports to the advantage of goods and services with a higher value added, which would have a strong beneficial impact on the ability to compete.

Instead, the economist has regrettably chosen another route: to play with fire in the pages of Diena and to frighten the population of Latvia. As a solution for the loss of ability to compete he offers devaluing the lats, i.e. reducing its value. His pronouncements have not gone unnoticed in the public space and for that reason I will henceforth outline the central bank's position on this issue. The loss of ability to compete is a factor that is unequivocally detrimental to the Latvian economy: we are in full agreement here, yet I categorically oppose his suggestion that devaluation would be the right medicine here. It would be poison!

What consequences would devaluing the lats produce? Reducing the value of the lats would drive the prices up even more and everybody would be affected. Imported goods, raw materials, energy would all become more expensive. The potential relief to entrepreneurs would thus be short lived or nonexistent. The rise in the standard of living would become more remote because the value of savings in lats would decrease accordingly. In addition – and this is of crucial importance – confidence in the lats as a payment and savings instrument, which has taken years to build, would disastrously diminish both in Latvia and abroad.

About 75% of the loans granted to Latvian households are in euro whereas the income is in lats. Should the lats be devalued, the burden on those loan recipients whose liabilities are in euro but income in lats would increase dramatically: it would take more money to buy a euro. Anyone who speculates, albeit theoretically, about devaluation of the lats, should be aware that it would lead to a dead-end.

Whereas foreign experts keep devaluation in mind as an instrument that can be applied if necessary to restore the ability to compete, my opponent goes much further than that: he claims that devaluing the lats is unavoidable under the conditions of excessive inflation and loss of ability to compete. On the contrary: a stable and unchangeable lats exchange rate in under such conditions serves and will continue to serve as an automatic stabilizing and inflation-suppressing factor. I would also like to remind any hotheads that only the Bank of Latvia can make the decision to devalue: not the government. During my tenure as the chief officer of the Bank of Latvia it will not happen. On 31 January, the foreign currency reserves of the Bank of Latvia amounted to 2.4 billion lats. The Bank's foreign reserves exceed the amount of lats in circulation and thus we would be quite ready and able to exchange even the entire amount of lats in circulation for foreign currency in accordance with the exchange rate as set by the Bank. Mr. Hansen is fully aware of this.

In conclusion, I would like to express confidence that the discussion about balanced development of the Latvian economy in the long term will continue and that the set of measures that will be undertaken in March under the auspices of the minister of finance and aimed slowing down inflation will prove successful.