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Choice of Devaluation

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To devalue or not to devalue

That is the question which confronts countries once in a while, if their currencies are under fixed exchange rate regimes.

Two countries are now facing the painful choice. One is Greece, a member of the 17-member Eurozone. The other is Samoa in our region.

Greexit

Greece's problem is more severe. It is similar to the unpleasant choice faced by legendary Greek hero Odysseus and his men, who had to pass through a strait where they were caught between *Scylla and Charybdis*.

Greece has to decide: "To be in or not to be in?" If not in, the answer is easy. It has to go back to its previous currency and it will have to be devalued.

Exiting eurozone, nicknamed *Grexit*, is now a real possibility.

Government debt of Greece in 2011 is 165% of gross domestic product (GDP), more than double the eurozone limit of 60%. Its budget deficit in 2011 was 13%, more than 4 times the allowed. Since fiscal tightening: cutting public and private spending, all aimed to slim down and emerge stronger in next five to seven years is not feasible, the "ship-out" solution is politically more acceptable than painful "shape-up" remedy.

Returning to *drachmas* the previous currency, the "prodigal son" will see a "fatted euro" rather than a "fatted calf ready". The euro would cost more in terms of drachmas. It would be

1000 to 1500 drachmas as against 340 drachmas in 2001, when Greece joined the club. Thus, devaluation would be by 200% or more.

The consequences would be summed up in one word: catastrophic.

Aside from inflation, external debt, when re-valued in drachmas, will rise in absolute terms as well as a percentage of national output; private debtors owing moneys to banks outside Greece will have to set apart higher proportion of their incomes for servicing debt. Foreign investment inflows will dry up. Unemployment will shoot up. The list of woes lengthens.

The other option is: stick to euro and suffer the consequences of fiscal austerity.

Turning to Samoa

The IMF Article IV Staff Report is not yet officially released. It is not clear whether IMF wants a devaluation of the *tala*. The IMF Public Information Notice says the "realignment of the exchange rate" is needed for two reasons: (i) for preventing further foreign exchange reserve losses; and (ii) for "strengthening export competitiveness.

"Re-aligning" is euphemism for the invasive surgical procedure: devaluation.

Radio New Zealand International has just reported the reaction of Governor of Samoa's Central Bank that devaluing the currency is not the answer to the country's poor export performance. So we go by Governor's word and take it IMF wants devaluation.

Should tala be devalued?

IMF says as the *tala* has appreciated in real effective terms over the past decade, it must be hurting exports. Real exchange rate (RER) is determined by actual nominal exchange rate (NER), units of foreign currency per unit of tala, and domestic price level relative to foreign price level. RER is thus product of actual NER and ratio of domestic price level to foreign price levels.

Nominal rate is influenced by net capital inflows. In Samoa, the major component of capital inflows is remittance inflows, which forms 25% of GDP. Despite the recession, the ADB July issue of *Pacific Monitor* says, there has been a 10% growth in remittances during the eight months of fiscal year 2012 from Samoan migrants in New Zealand, United States, Australia and American Samoa.

Rise in RER would render exports less attractive. Given NER, rise in domestic price level relative to foreign price level, RER rises; and if the relative price level remains the same, rise in NER also leads to rise in RER.

There are advantages if NER rises. The stronger the *tala,* cheaper would be the imports. With world food prices predicted to be rising due to shortages in the grain growing countries, government's preference for a stronger *tala* is obvious.

According to ADB, Samoa's foreign reserves would cover 5 months of imports and it is not unhealthy. The external debt has been brought down from 54% of GDP in 2009-10 to 49% in 2010 -11. The projections for the coming years show the debt would rise if budget deficits rise. Since most of the post-tsunami expenditures are winding down, budget deficits are likely to fall.

Dissenting Views

The dissenting views expressed in the IMF Board are worth noting. They cautioned that due consideration be given to the potential impact on external debt and inflation. Immediate impact would be inflation as prices of imported items in *tala* would rise, aside from re-valuation of external debt in *tala*, which will be up in percentage of GDP.

Thus, net gains are more likely to be negative. Costs would far exceed likely benefits of devaluation. Structural weaknesses in the economy rather than mere price advantages offered by devaluation to foreign buyers deserve attention. Samoa's exports, being mainly agricultural, compete with similar but cheaper exports from Malaysia and Thailand.

Long term programmes of exports diversification are needed rather than short term remedy such as devaluation.

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