THE EFFECTIVENESS OF INTERNAL DEVALUATION IN LITHUANIA AND LATVIA

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Abstract. *In the face of economic crisis, Baltic governments had to choose between internal and actual devaluation. Eventually, the first path was chosen to tackle the external and domestic macroeconomic instability. The aim of this study was to evaluate the effectiveness of the internal devaluation policy in the Baltic economies. Using qualitative research methods and graphical analysis, we have evaluated whether the choice of internal devaluation or deflation was appropriate in the exceptional recession period and whether it helped to eliminate the imbalances of the boom period. Obviously, fiscal consolidation helped to ease the tensions and restore confidence in the markets. However, we believe that the internal devaluation policy was efficient only temporarily in Latvia and Lithuania. This policy was hampered by the sectorial mismatches between labour demand and supply, which resulted from a strong surge in unemployment. A. detailed cos–benefit analysis of the internal devaluation policy option requires a more formal econometric analysis which will be implemented in the future research.*

Key words: *deficit, internal devaluation, unit labour cost, productivity, cyclically adjusted budget*

Introduction

Since joining the European Union in 2004, the Baltic economies have switched to a higher gear of growth. The underlying vast economic potential has encouraged Nordic lenders to pursue very proactive lending processes. This has fed domestic demand, housing market and fostered growth; unfortunately, it led to significant economic imbalances, e.g., the collapse of "Lehman brothers" in 2008, which kick-started the global recession and resulted in a severe risk aversion undermining the shaky fundamentals of the Baltic economies. The halt in the export markets and internal devaluation led to the largest GDP fall in the Baltic States and on the global scale in 2009.

Given the circumstances of 2009, the Lithuanian and Latvian governments had only two options to tackle the external repercussion. As borrowing from financial markets was virtually impossible, one choice was to cut spending, the other being to abandon the currency pegs and thereby to meet nominal obligations with less valuable banknotes.

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