Foreign Exchange Rate Policies in Baltic States: Current and Future Challenges

Abstract

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Summary

In the last decade Baltic countries have fixed their national currencies against anchor currency or basket of currencies at a significantly undervalued exchange rate. This was intentional and justified policy, as real exchange rate was expected to appreciate (because of relatively higher inflation cause by Balassa-Samuelson effect and other factors). Recently there have been a lot of talks (both in world famous papers, like The Economist, and local tabloids) about significant overvaluation of Baltic currencies and imminent devaluation. Large spreads between interbank offered rates in euros and national currencies indicated a severe pressure in Baltic foreign exchange markets. This study aims to estimate whether Baltic currencies are fundamentally overvalued and what implications this has for prospective Euro adoption.

Lithuania, Latvia and Estonia are about to join Economic Monetary Union (EMU) and adopt Euro. Determining appropriate parities between Litas, Lats, Kroon and Euro bears long term significance not only for countries' economic policy, but also corporate sector and financial markets. Upon joining Euro zone, Baltic countries will no longer be able to alter their exchange rates and use it as macroeconomic adjustment tool. If a country adopts Euro at an overvalued exchange rate, its competitiveness within Euro zone would be seriously restricted. On the other hand, choosing parity where national currency is undervalued, price convergence with other EMU members would put a strong pressure on short and long term inflation. Not surprisingly, finding the equilibrium exchange rate is not an easy task. By allowing their currencies to float, governments would enable market forces to
determine this equilibrium, however this is not possible, since Lithuania, Latvia and Estonia are already members of Exchange Rate Mechanism II (ERM-II) and have to keep their currencies fixed at least two years prior to Euro adoption. It could have been useful to float the currencies before joining ERM-II and allow the exchange rate self-adjust towards equilibrium, but all the Baltic currencies have their exchange rates fixed for more than a decade and this policy was very successful in curbing inflation and attracting foreign investments. Other Central and Eastern European countries (Poland, Hungary, Slovakia and Czech Republic) have taken this path and liberalized their exchange rate policies to a lesser or greater extent, but still face the prospective decision regarding the parity with Euro.

A few years ago numerous studies (e.g. Schularick and Bialluch [2005]) have suggested, that most of the Central and Eastern Europe (CEE) currencies are fundamentally undervalued. This was confirmed by speculative revaluation attack (coordinated attempt by market participants to force revaluation of currency) against Hungarian forint in 2003.

There are many ways to estimate equilibrium exchange rate, however none of them are too reliable. The simplest approach to estimate this rate is based on purchasing power parity (PPP) theory, which suggests that exchange rate of two countries should equalize their purchasing power. The issue of appreciating real exchange rates in CEE was addressed by Coudert and Couharde (2003). Based on PPP theory, they estimated that Latvian and Lithuanian currencies in 2001 were overvalued (by 0.8% and 12% respectively), whereas Estonian currency was undervalued by 4.7%. However, the numerous studies on purchasing power parity (e.g. Macdonald, 2000) indicate that on its own PPP is not a good vehicle for defining an equilibrium exchange rate.

Another simplistic approach towards determining equilibrium exchange rates is based on uncovered interest parity (UIP) theory, which assumes that the ex-ante risk-adjusted nominal rate of return on domestic and foreign assets should be equal. In other words, the nominal exchange rate is likely to move based on the interest rate differential. However the UIP condition does not provide the fundamentals which determine the real exchange rate equilibrium in longer term, but rather is suitable for ‘explaining the adjustment path of the exchange rate back to it equilibrium’ (Driver
and Westaway, 2005). In addition, the UIP condition seems to have difficulties to be proved empirically.

Other popular approaches include fundamental equilibrium exchange rate (FEER) and behavioral equilibrium exchange rate (BEER); however they are of limited use. Both models define real equilibrium exchange rate as the exchange rate yielding country’s internal and external balance simultaneously. Internal equilibrium is conceived to be non-inflationary growth at full employment in line with the growth potential. External balance (equilibrium) is achieved if the exchange rate brings the current account in line with long-term capital account. Schularick and Bialluch (2005) point out, that these equilibrium models depend on three critical assumptions: (1) current account model with the corresponding exchange rate elasticities can be specified; (2) potential growth can be estimated with sufficient accuracy; (3) the optimal capital account position can be identified. However, emerging and transition countries (such as CEE, including, of course, the Baltics) do not meet these preconditions. These countries have only short time series available, which are further complicated by structural breaks. Estimating the real exchange rate elasticity of individual current account positions is only achievable on a long time series, thus the results derived using such models depend strongly on underlying assumptions.

This paper takes different approach of estimating over- or undervaluation of Baltic currencies. Competitive position of Lithuania, Latvia and Estonia in EU Single Market is examined on the basis of Euro wage levels in manufacturing. If wage costs are higher than permitted by the level of productivity in the Baltic economies, this suggests that the national currency is overvalued. In this case unpopular and painful political decision of either currency devaluation or wage cuts would be required.

References