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Is currency devaluation by exiting the euro wise?

By AMITRAJEET A. BATABYAL - 1/6/2012

Many observers have argued that it is perhaps time for some heavily indebted nations in Europe to exit the euro, the common currency used by 17 of the 27 nations of the European Union. There are many indebted nations in Europe, but for concreteness I shall focus on Greece. The basic idea behind the above line of reasoning is that because Greece uses the euro as its official currency, when faced with mounting public debt, it is unable to devalue its currency and reap the benefits.

There are two ways in which a currency devaluation can help an indebted nation like Greece with its debt. First, when a nation's debt is denominated in its own currency, a devaluation lowers the real value of the debt owed externally. However, Greece's debt is denominated in euros and not in its own currency. Hence, there is no way for Greece to enjoy the benefit of a reduction in the real value of its debt because it cannot devalue a currency that is not its own. This is why many have suggested that it may now make sense for Greece to exit the euro, default on its debt, re-denominate its debt in its local currency-presumably the drachma-and enjoy a fruit of currency devaluation.

The second way in which a currency devaluation could help Greece is through a positive terms-of-trade adjustment. What this means is that the devaluation will lower the price of Greek exports and raise the price of Greek imports, and this salubrious effect will result in the generation of fiscal surpluses for the Greek government. This positive terms-of-trade effect is now well-known, and it is widely cited by commentators as a key benefit of currency devaluation.

Although this second benefit of currency devaluation is real, what is less well-known is that there exist "fiscal devaluations" that can deliver the same effects as a currency devaluation. This is convincingly demonstrated in interesting recent research by the economists Emmanuel Farhi, Gita Gopinath and Oleg Itskhoki. These researchers show that there are two types of fiscal policies that are equivalent to a currency devaluation.

One of the two policies they study involves raising value-added taxes in the economy and accompanying this increase with a uniform payroll tax reduction. Raising VATs will increase the price of imported goods because foreign firms now face a higher tax and, at the same time, it will lower the price of exports because exports are exempt from VATs. The net effect of this is a lowering of the terms of trade that is equivalent to that achievable with a currency devaluation. The only caveat is that the government needs to ensure that firms that alter their prices do so similarly across fiscal and currency devaluations. To ensure this, the VAT increase needs to be accompanied with a reduction in payroll taxes. This equivalence result holds in a broad range of economic circumstances.

The key policy implication for a nation such as Greece is that the lack of exchange rate flexibility does not preclude it from obtaining the same outcome by undertaking apposite domestic policy measures that have positive (lowering payroll taxes) and negative (raising VATs) effects for the citizenry. Put differently, of the two benefits of a currency devaluation, one also can be achieved with domestic fiscal instruments. This state of affairs calls for a rethinking of previous calls for nations like Greece to devalue their currency by first exiting the euro.

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