DEVALUATION AND REVALUATION IMPACT ON EXPORT AND IMPORT COMPETITIVENESS: THEORY AND EU EXPERIENCE

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Abstract: *The impact of currency devaluation and revaluation on the state of trade balance is considered in the article. In particular, the directions and nature of the exchange rate policy impact on the competitiveness of export and import operations are investigated. The degree of exports and imports exchange rate elasticity is defined. The influence of revaluations and devaluations in one country on the state of the trade balance of other countries is characterized. The comparison of the benefits and risks of single European currency devaluation is conducted. The impact of euro devaluation on competitiveness of European exporters and importers is examined.*

Global markets' functioning under modern conditions is characterized by competition tightening that entails necessity to develop products', companies' and countries' competitiveness. Among the tools used by the state to regulate the level of national products competitiveness on domestic and foreign markets, the use of devaluation and revaluation as the instruments of exchange rate policy is quite spread. The most general level of the national economy external competitiveness is reflected by the state of trade balance and balance of payments.

Devaluations and revaluations are often used as tools for trade balance regulation due to the impact that changes in the exchange rate can make on the dynamics of exports and imports of goods and services. While managing the exchange rate, the central bank can influence the demand and supply of currency, dynamics of transactions with foreign countries and therefore the state of the balance of payments.

Impact of exchange rate policy on the overall value of exports of goods and services is done through the change of price competitiveness of exports. Revaluations or devaluations worsen (improve) price competitiveness of national products abroad, the demand for them increases or decreases accordingly and export value increases or decreases, respectively. This effect of exchange rate changes on export dynamics is characteristic for the short term. As far as floating exchange rates are subject to significant fluctuations their impact on exports of goods and services is characterized by mainly short and medium effect. If the exchange rate is fixed by the central bank, it has the ability to effect the export during a long period of time. In regard threats appear in the national economy associated with a significant overestimation or underestimation of the exchange rate.

If the exchange rate is overvalued relative to foreign currencies, the position of domestic producers on domestic and foreign markets worsens, and the position of foreign producers on the domestic market improves. If overvaluation of the exchange rate continues for a long time, foreign producers consolidate on the domestic market, and even depreciation of national currency will not help to restore the positions of the domestic producers.

In case of long-term underestimation of the exchange rate favorable conditions for exports are created, and even industries whose goods are not really competitive start exporting their products. Hence, unreasonable and excessive export orientation of the economy can occur. Thus, in the long run exchange rate changes cause changes in the structure of exports, affecting regional and sectoral proportions in the economy.[1]

Impact of exchange rate policy on the import of goods and services through the exchange rate regulation is made in three areas:

1) the impact on prices of imported goods in national currency;
2) the impact on the physical volume of imports;
3) the overall impact on the value of imports.

[1] Белінська Я.В. Валютний курс та інфляція у трансформаційній економіці. [Монографія] / Я.В. Белінська. – К: Інститут економіки НАН України, 2002. – 183 с. – С.92.

There is a direct relation between the prices of imported goods in national currency and the exchange rate: revaluation of the currency reduces the prices of imported goods and the devaluation leads to higher prices.[1]

Reaction of physical volume of imports to changes in the exchange rate is considered to be insignificant, since this figure is largely influenced by other factors, the most determinant among which are the dynamics of domestic demand.

Effect of exchange rate changes on the overall value of imports is more complex. If the currency is revaluating, the value of imported goods in foreign currency will increase, and supply of goods will also grow. Price of imported goods in national currency decreases and volume of imports increases.[2] Similarly, in case of decrease in the national currency rate of exchange price of imported goods in national currency grows and volume of imports decreases. In this situation, it is impossible to make a definite conclusion about the overall changes in the value of imports in domestic currency as a result of exchange rate raising or lowering without proper mathematical calculations.

When using exchange rate policy as a tool for regulating trade balance one must take into account that exports and imports react asymmetrically in time to the change of the exchange rate. If theoretically devaluation leads to activation of current account balance, in practice a situation is often observed when after depreciation net balance, calculated in national currency, first tends to decrease (the J curve effect or the effect of stick).

This effect is caused by the more rapid growth of import prices (i.e. as a result of the devaluation the domestic price for imports in national currency grows faster than price for exports in foreign currency decreases). Initially import is characterized by low price elasticity, and exports and imports volumes remain almost unchanged, so the value of imports rises. The cost of more expensive imports is not compensated by increase in revenues connected with quantitative growth of exports, and in the short run a tendency to passive current balance can occur. But over time, the elasticity of exports and imports grows and demand switches to domestic goods. As a result, in the long run exports increase, imports decrease, and net trade balance becomes active accordingly. Consequently, the current account balance reacts differently to change of the exchange rate in the short and long run.

Through impact on export and import operations, devaluation and revaluation of currencies accordingly determine changes in the value of net exports, which in turn affects the national production performance. In particular, devaluation of the national currency causes the growth of exports of goods and services and reduces imports. As a result of the increase in net exports aggregate demand and aggregate supply increase. Eventually, decrease in the exchange rate leads to an increase in real output and prices. Thus, the impact of the exchange rate on the dynamics of national production indicators is made through the value of net exports, which depends on the following variables: GDP, income of other countries that determine the demand in these countries for national goods, real exchange rate.

For a developed economic system, this situation is normal. However, in the short term values of exports and imports may become inelastic. Therefore, after decrease in the exchange rate net exports cannot increase or remain unchanged, but even decrease for a while. Consequently, the discrepancy between the reaction time of aggregate demand and aggregate supply for changes of the exchange rate (i.e. if the effect of supply shock is felt by economic system earlier than a similar impact on aggregate demand), the immediate response of the economic system is raising prices and low growth or even decline of real output.[3] Similarly, revaluation leads to a decrease in the general level of prices and a corresponding decrease in real output.

Taking into account the overall impact of exchange rate changes on the export and import of goods and services, one can conclude that growing rate of the national currency (revaluation) entails net trade balance decreasing, while depreciation (devaluation) results in its increasing. This reaction of current balance on exchange rate changes is considered to be normal. But in some cases, the change of the exchange rate can not affect the trade balance.

The reaction of the current balance on the exchange rate changes depends on the elasticity of country's demand for the import and foreign demand for export from the country. For instance, high elasticity of country's demand for imports allows changing the volume of imports significantly by

[1] Белінська Я.В. Валютний курс та інфляція у трансформаційній економіці. [Монографія] / Я.В. Белінська. – К: Інститут економіки НАН України, 2002. – 183 с. – С.94.
[2] Савельєв Є.В. Міжнародна економіка: теорія міжнародної торгівлі і фінансів / Є.В. Савельєв. – Тернопіль: Економічна думка, 2001. – 504 с. – С.349.
[3] Лютий І.О. Валютна політика та перспективи входження України в міжнародне економічне співтовариство / І.О. Лютий. – К.: Курс, 2000. – 58 с. – С.8-9.

means of insignificant exchange rate change. If the country's demand for import or foreign demand for export is inelastic, the net trade balance does not respond to changes in exchange rates. In this case, use of the exchange rate as an instrument of influence on the competitiveness of external trade and regulation of the current account balance becomes impossible.

Using the exchange rate as an instrument of influence on the competitiveness of the national economy one should take into account other possible consequences of regulatory action. These effects include changes in domestic prices, the growth or reduction of foreign exchange reserves of the central bank, activation or slowing foreign investment processes. That is why one of the central problems of the exchange rate regulation is balancing between maintaining national economy competitiveness (export promotion) and decreasing additional inflationary pressure that can be caused by the currency devaluation.

In addition, the devaluation in one country can influence the production and employment in other countries and also their competitiveness on external markets. The official devaluation of the national currency leads to increased competitiveness of national products, increased domestic production and employment. Simultaneously, in other countries appreciation of national currencies is observed, their products become uncompetitive, resulting in reduced national output and employment. This policy is called "beggar thy neighbor". Beggar-thy-neighbor policy is an economic policy through which one country attempts to remedy its economic problems by means that tend to worsen the economic problems of other countries. This can force other countries also start devaluating their national currencies to boost their competitiveness. Thus, a circle of successive devaluations can occur worldwide.

For the relatively short time of its existence the single European currency experienced both periods of significant rises, and noticeable reductions in price. These periods of devaluation and revaluation are quite differently estimated by economists from the position of their impact on the state of the European economy and the foreign trade positions of the EU countries.

Current situation of the euro depreciation is not an exception. In March 2014 the euro exchange rate was 1.39 US dollars, in September 2014 – 1.29, in March 2015 – just 1.09 dollars.[1] In recent months the single European currency lost in value rapidly against the US dollar. Nowadays the euro rate against the dollar is the lowest since 2006. For the financiers this was not a surprise: while the US Federal Reserve has the intention to raise interest rates again, the European Central Bank will continue to favor further softening of monetary policy. In 2014 the US Federal Reserve interest rate remained unchanged at 0.25%, while the European Central Bank lowered it several times. In early 2014 it was 0.25%, like in the USA, but by the end of the year European interest rate reduced to 0.05%.

Deutsche Bank analysts expect the decline of the euro against the US dollar until 2017 to the level of 85 cents. The main cause of this situation is considered to be a large-scale capital outflow from Europe. However it is possible that the euro devaluation will occur rather on the background of US economic growth than European economy weakening.

The euro devaluation on a reasonable level will not affect the Eurozone countries, but will make European exports more competitive. Rather cheap euro makes purchasing goods in Europe attractive and export-oriented countries as Germany will only benefit. European companies are also expected to become more competitive with regard to companies from Japan, whose currency depreciated in recent years significantly. Euro devaluation is also beneficial for the heavily indebted Southern European countries (Portugal, Italy, Greece and Spain). Thus, the tendency of euro devaluation complies with the European Central Bank policy that aims to reduce the price of the euro to make a positive impact on the national economies of the Eurozone countries, especially the week countries of Southern Europe.

Alongside it, the euro devaluation has a lot of risks. In particular, imports cost will rise, and it will concern imports not only from the USA but also from Asia, including computers and other electronics. Euro devaluation will also affect the European population, whose savings will continue to decline. Depreciation of the euro can cause a sharp decline of investors' confidence in this currency, which ultimately will lead to an outflow of investments. Thus, taking into account the significant risks of losing confidence and worsening of imports competitiveness the European Central Bank is unlikely to allow a long-term devaluation of the euro.

[1] Euro foreign exchange reference rates: European Central Bank Statistics. [Electronic resource]. – Access mode: http://www.ecb.europa.eu/stats/exchange/eurofxref/html/index.en.html

Summarizing the impact of devaluation and revaluation on the competitiveness of exports and imports, one can conclude the following. First, changes in the exchange rate have different effects on external trade in the short and long run. Second, the impact of exchange rate on export and import activities largely depends on the exchange rate regime (fixing or floating). Third, the benefits received by the country from increase in competitiveness of exporters through devaluation, often have a short-term effect, as far as other countries can use the same instrument of exchange rate policy. As a result, the tendency of the total depreciation of national currencies can occur in the world economy. The comparison of the benefits and risks of euro devaluation, which has been observed in recent months, gives reason to conclude that the European Central Bank should not allow prolongation of this trend, as far as the losses caused by significant devaluation can be unjustified, even compared to its expected positive impact on European exporters.