Impact of Currency Devaluation on Economy: A Systematic Review

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Abstract

Currency devaluation is often administered by a country's central bank as a monetary policy tool, and such practice has far-reaching implications for a nation's economy. In this paper, we conducted a systematic review of literature using the PRISMA method to assess the impact of currency devaluations on two key macroeconomic variables - Gross Domestic Product (GDP) and Export Competitiveness (EC).We also focused on the question whether policymakers in Bangladesh should use currency devaluation to boost production and exports. Along with other sources, a total of 39 peer-reviewed research publications from 2 research databases were eventually included in the review. Our findings suggest that although currency devaluation can positively influence GDP and fairly promote growth of local exports to some extent, such effects are generally short term in nature. Moreover, a significant number of devaluation attempts had additional, often overlooked but crucial implications. Moreover, devaluation often ensued negative consequences, such as decreased national exports and negative growth of GDP. After analyzing our findings, we recommend the following measures to successfully administer currency devaluation-

1. Profound degree of initial devaluation and further incremental, marginal devaluation
2. Additional government/economic policies to support the devaluation effort
3. Implementing sector specific policy solutions,rather than implementing a uniform devaluation policy on the entire export portfolio of a nation..

Keywords: Currency Devaluation, Export Competitiveness, GDP

1. Impact of Home Currency Devaluation on Economy: A Systematic Review

1.1 Currency Devaluation

Currency devaluation can be termed as a deliberate reduction in the value of a country's currency relative to other currencies on the foreign exchange market.

Another viewpoint of currency devaluation defines it as a decline in purchasing power caused by a mismatch between money demand and money supply (Sheng-yua & Ya-lian, 2013).

Currency devaluation is often administered by a country's central bank as a monetary policy tool, and such practice has far-reaching implications for a nation's economy. Currency devaluation can affect various economic factors, including trade, inflation, investment, and GDP as a whole. Bahri (2022) explains that countries may engage in currency devaluation to boost exports, reduce trade balance deficits, or alleviate debt burdens.By making domestic goods cheaper for foreign consumers and imports more expensive for domestic consumers, currency devaluation can influence a country's trade balance and its overall economic performance (Cooper, 1992). In addition, policymakers often recommend devaluation of the home currency in order to boost exports. However, such policymakers also admit that such actions lead to inflationary pressure (Kawsar, 2019).

Currency devaluation affects multiple economic factors such as trade balance, performance of the stock market,inflation, export-led growth, income redistribution, external debt, and foreign investments (Gavin,1989; Kandir, 2008). In this paper, we focused on assessing the impact of currency devaluation on two key macroeconomic variables - Gross Domestic Product (GDP) and Export Competitiveness (EC).

1.2 Gross Domestic Products (GDP)

One of the key indicators of a country's economic performance is Gross Domestic Product (GDP). GDP is the sum of all goods and services produced within the country's borders, reflecting the overall economic health and size of an economy. In other words, GDP measures the total economic output of a country within a specific time frame, and is a key indicator used to assess the economic growth and performance of a nation (Callen, 2008). Prior research has indicated that currency depreciation has both direct and indirect effects on GDP (Sing, 2013; Haughton, 2017).

1.3 Export Competitiveness (EC)

The ability of a nation or region to sell goods and services on international marketplaces is referred to as export competitiveness. It gauges how well a nation's exports perform in response to shifts in the world market for exports. (World Bank, n.d.; Kaur,2020). According to Kawsar (2019), it is often argued by policymakers

and economists that currency devaluation leads to a positive effect on export competitiveness, even though an unwanted by product of such policy is inflation. The devaluation of home currency against foreign currencies is often considered to be a robust tool to improve export competitiveness in the global arena, as it reduces the price of exports for foreigners, leading to a positive growth in a country's aggregate export (Madura, 2020).

2. Objective of the study

Currency devaluation is relevant to a country's economic performance as it brings in a multitude of changes in the local economy.Such relevance in the context of economic growth highlights the need to thoroughly examine the effects of currency devaluation on key economic indicators. It is generally considered that devaluation mostly leads to positive changes in GDP while boosting exports, and policymakers and economics, particularly those from Bangladesh seem to have a strong rationale for using devaluation in Bangladesh for enhancing national exports (Kawsar, 2019; Rahman,2022). Interestingly, our preliminary exploration hinted that there's more to this story of devaluation.

As discussed earlier, the impact of devaluation can affect multiple economic factors ranging from trade balance of a country to income redistribution, we focused on assessing the impact of currency devaluation on two key macroeconomic variables - Gross Domestic Product (GDP) and Export Competitiveness (EC). We were also interested to see if there are any negative or subtle but impactful consequences of currency devaluation. Hence, in this study we aim to answer the following questions -

1. What is the impact of currency devaluation on the economy of a country, particularly on GDP and EC?
2. Should policymakers use devaluation in Bangladesh to boost production and exports?

We believe, a review of existing, and recent research publications will help the policymakers around the world in taking better decisions, and particularly, it will help the policymakers of Bangladesh, which is struggling to stabilize the economy since the beginning of the COVID pandemic and Russian-Ukrainian war.

3. Methodology

We conducted a systematic review of literature to assess the impact of currency devaluation on GDP and EC. For conducting the review and reporting the findings, we used the widely used "Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA)"guideline (Page et al., 2021).

In the first phase, the two authors conducted independent searches on 2 databases including EMERALD and JSTOR using keywords "Currency Devaluation", "Export", "GDP". Initial search resulted in more than 22,000 scholarly sources, which was outside the manageable scope of this study. Hence, a specific Boolean search string "(currency devaluation) AND (export OR GDP)" was used in both databases. After the removal of duplicate entries, this narrowed down search returned a combined of 5,961scholarly sources. Next, we excluded 3 duplicate sources. Details of the search protocols are listed in Table 1.

Database	Scope	Search conducted on	Date range	Number of articles	Cumulative Total
EMERALD	Title, keyword and	15-Aug-23	1992-2022	1,305	4,656
JSTOR	Title, keyword and	15-Aug-23	1992-2022	4,656	5,961

Table 1- Database search protocol

During the second phase, our objective was to include only pertinent studies for this review, for which we developed an inclusion and exclusion criteria (Table 2). Based on these criteria, we assessed the titles, keywords and abstract of all 5,961 sources, and we excluded 5,379 of them. Some of these research articles appeared in the search only because the abstract had the word "GDP" or "export"; which eventually got excluded.

Inclusion	Exclusion
1. Journals with growing impact factors	**6.** No abstract or citations
2. Peer reviewed journal/research articles	**7.** Not Open Access
3. Focused on currency devaluation's direct impact on GDP or EC	**8.** Language other than English
4. Focused on impact exchange rate fluctuation on macroeconomic variables.	**9.** Articles published during 1922-2022
5. Focused on promoting national exports	**10.** Outcome variable doesn't include GDP or EC

Table 2- Inclusion and Exclusion Criteria

We then used automation tools on the remaining 582 research articles to screen out additional articles with fewer or no citations, of subpar quality and without any pertinent discussion which could be attributed to our objectives. We ended up with 112 research articles We exhaustively analyzed these articles, and eventually 39 of them were deemed to be included in the systematic review. Figure 1 exhibits the flow of the screening process.

To address the issue of bias, both authors conducted the search independently, and in case of disagreements on inclusion of a particular study, expert opinions were taken.

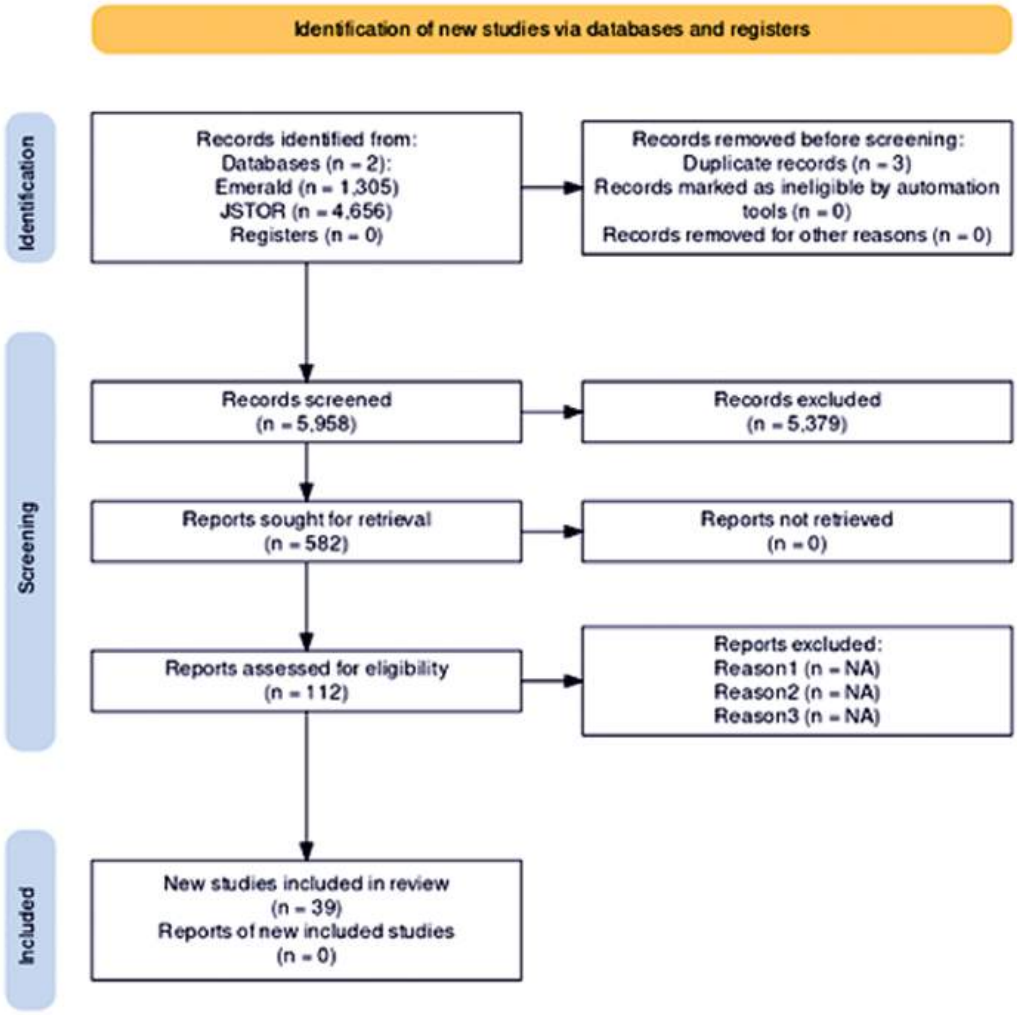

Figure 1- Overview of the systematic search process

4. Findings and Discussion

After analyzing the selected papers, we observed that both developing and developed nations use currency devaluation as a tool to bring positive economic changes. For instance, in a study conducted by Owen (2005), the findings indicated that Devaluation has a statistically significant impact on major export groups from Chile, Malaysia, and South Korea. However, the impact of such devaluations was not always positive, nor was it limited to GDP or EC. Although our analysis and

discussion focus primarily on the impact of devaluation on GDP and EC, Table 3 provides an overview of all the studies included and their outcomes on variables other than GDP and EC.

4.1 Devaluation and GDP

When focusing on devaluations' impact on GDP, our investigation revealed that devaluation can have both positive and negative consequences. According to Ribeiro (2017), devaluation can have favorable benefits on the GDP; more specifically on external balance. A devaluation carried out in Southern European countries had a strong positive effect on national output (Engler,2014). Owen (2005)observed that devaluation had a statistically significant effect on export value, while Vo (2019) found that devaluation increases manufacturing exports in the short-term.Moreover, Mariolis (2016) showed that during recession significant nominal depreciation of currency is required for recovery.

There is an opposite side of the coin too, as our analysis also revealed that devaluation also has negative or unexpected effects on domestic production and the overall economy. According to Haughton (2017), a 1% decline in the national currency might result in a 0.3% decline in GDP growth.Kamal (2015) ended with similar findings in his study which suggested that devaluation actually leads to a decrease in exports. Additionally, two of the studies revealed critical notions related to stability and growth of local economy, the findings of which were deemed to be particularly impactful for developing countries like Bangladesh. In one of those studies, Acar (2009) showed that devaluation leads to a contractionary effect on output in the first year in least developed countries (LDCs). Among the countries were India, Nepal, Sri Lanka, Gambia, Malaysia and a few more, and not surprisingly, Bangladesh as well. In the other study, Rodnyansky (2019) discussed that devaluations are shown to negatively affect exporters in terms of employment, domestic revenue, and profitability relative to non-exporting firms.

4.2 Devaluation and Export Competitiveness (EC)

In recent years, the well-known trade war between USA and China significantly changed the global economic landscape, and the USA always accused China for artificially lowering the value of the Chinese currency against the dollar to boost Chinese exports. (Itakura, 2020; Madura,2020). Not surprisingly, policymakers seem to be very keen to use this tool to remain competitive in the global market (Mántey,2013; Kawsar, 2019). In terms of Bangladesh, policymakers also argue that devaluation of Taka is essential in order to stabilize the Balance of Payments (Rahman, 2022). Although such positive impacts were reported in a number of cases, our analysis indicates there's more to that story.

To our amazement, a significant number of the reviewed researches either reported negative consequences of currency devaluation on export competitiveness, or highlighted a number subtle but crucial underlying implications. Šonje (2004) reasoned that large devaluations/depreciations in transition countries always seem to be detrimental to export growth and hence, export competitiveness. In another study by Chawla (2011), it was revealed that devaluation of local currency may have a positive effect on exports, but it also makes the imports costly, which results in a not so welcome change in net exports. Mántey (2013) observed that the negative effect on the balance sheets of export-oriented companies cancels out any possible gains in competitiveness.A study based on 30 years of panel data of exports of 67 economies around the globe, it was seen that 80% of specific export sectors devaluation has contractionary effects on real exports in 80 per cent of specific export sectors and affects a variety of industries without distinction as to whether products incorporate more added value or less added value (Cantavella-Jordá, 2012)

4.3 Devolution to boost GDP or export: Note to Policymakers

Regardless of positive or negative outcomes, policymakers should comprehend the critical datum- currency devaluation and its consequences do not happen in isolation, and devaluation alone cannot resolve issues or bring about sustainable positive economic outcomes in a country. In terms of GDP, our findings suggest that the effect of currency devaluation on GDP varies on a collection and often combination of factors, including the degree of devaluation and supporting policies. Berman (2011) provided additional insights, highlighting that the effects of currency depreciation on exports depend on factors such as firm-level debt denomination and the balance-sheet effect. In order to sustain the impact of devaluation on the real exchange rate, Khan (1996) underlines the significance of supportive policies and budgetary adjustment by the government.

In terms of EC, studies did support the generally accepted view of inflationary issues resulting from devaluation (Chawla,2011; Gao,1993). In addition, we synthesized that any attempt at devaluation needs to be relatively pronounced to make their impact on export expansion, and a devaluation can only reduce trade imbalances if it translates to a real devaluation and if trade flows respond to relative prices in a significant and predictable manner (Secretariat, 1992; Reinhart 1994). Most importantly, based on the arguments provided by Mitchell & Pentecost (2001), Kandil (2008) and Cantavella-Jordá (2012), we conclude that sector specific policy solutions are more advisable than implementing a uniform devaluation on a country's export portfolio.

Title	AUTHOR(S)/YEAR	RESULTS
Enhancing competitiveness of potential export sectors in developing countries--lessons from experience	U. Secretariat 1992	Initial devaluations need to be relatively pronounced to make their impact on export expansion.
China's foreign exchange regime and its impact on exports and growth	Xiaodan Gao 1993	The impact of devaluation on the Chinese economy is twofold.
Devaluation and monetary policy with import compression	Jørn Ratts 1994	Overvaluation and monetary expansion are likely sources of output contraction in the second regime.
Devaluation, relative prices, and international trade	Carmen M. Reinhart 1994	A devaluation can only reduce trade imbalances if it translates to a real devaluation and if trade flows respond to relative prices in a significant and predictable manner.
Are export subsidies less inflationary than devaluation	Edward F. Buffie 1997	Export subsidies are less inflationary than devaluation.

Devaluation in developing countries: expansionary or contractionary?	**M. ACAR 2009**	**DEVALUATION CREATES A CONTRACTIONARY EFFECT ON OUTPUT IN THE FIRST YEAR IN LDCS.**
Currency devaluations, product pricing and trade deficits	D. Aviel 2000	Volatile currency movements and trade deficits are not beneficial in the long run.
Exchange rate and output in the aftermath of the great depression and during the transition period in central Europe	Velimir Šonje 2004	Large devaluations/depreciations in transition countries always seem to be detrimental to growth.
The real exchange rate and the output response in four transition economies: a panel data study	Aleda Mitchell et al 2001	A devaluation can redistribute income from groups with a low marginal propensity to save to groups with a high marginal propensity to save.
Currency devaluation and emerging economy export demand	James Owen 2005	Devaluation has a statistically significant impact on major export groups from Chile, Malaysia, and South Korea.
Exchange rate fluctuations and the macro-economy: channels of interaction in developing and developed countries	Magda Kandil 2008	Currency appreciation decreases competitiveness and, therefore, export growth in many developing countries.

Debt denomination, exchange-rate variations and the margins of trade	**NICOLAS BERMAN ET AL 2011**	**A CURRENCY DEPRECIATION HAS TWO OPPOSITE EFFECTS ON EXPORTS WHEN FIRMS ARE INDEBTED IN FOREIGN CURRENCY.**
Understanding the impact of exchange rate fluctuation on the competitiveness of business	Chanan Pal Chawla 2011	Devaluation of local currency may have the positive effect on exports but also makes the imports costly.
The currency of the people's republic of China and production fragmentation	N. Yamashita 2011	The efficacy of further unilateral reform of the renminbi exchange rate regime on correcting trade imbalances is questioned.
To devalue or not to devalue	V. Popov 2011	The second type of policy response was associated with smaller loss of output than the first type (monetary contraction).
A cross-national panel study of devaluations on disaggregated export sectors: a case for sector specific policies	Manuel Cantavella-Jordá et al 2012	Current period real devaluation has contractionary effects on real exports in 80% of specific export sectors.
Currency devaluation with dual labor market: which perspectives for the euro zone ?	Barbier-Gauchard et al 2012	A devaluation of domestic currency implies a fall in production in each country.

Would a more flexible exchange rate improve competitiveness	**GUADALUPE MÁNTEY 2013**	**THE NEGATIVE EFFECT ON THE BALANCE SHEETS OF EXPORTATION COMPANIES CANCELS OUT ANY POSSIBLE GAINS IN COMPETITIVENESS.**
Export dynamics in large devaluations	George Alessandria et al 2013	Exports tend to grow gradually following a devaluation.
Export dynamics in large devaluations1		Exports tend to grow gradually following a devaluation.
The effect of exchange rate adjustment on export firms' behavior	Fu Yuli 2014	Currency appreciation or relative cost increase leads to a decrease in market share, a decrease in mark-up rate and profit.
A panel data analysis to evaluate the effect of currency devaluation on major export items	Khnd Md Mostafa Kamal 2015	Devaluation of the currencies cause export to decrease rather than to increase.
Exchange rate, capital flow and output: developed versus developing economies	Gil Kim et al 2015	Contractionary devaluation is more prevalent in developed countries.

Currency devaluation, external finance and economic growth: a note on the Greek case	**THEODORE MARIOLIS 2016**	**A RETURN TO NATIONAL CURRENCY WOULD NOT NECESSARILY DEEPEN THE RECESSION.**
Modern trends in trade and economic relations between the Eurasian economic union members and China	N. Zhanakova et al 2016	The devaluation of the Turkish lira had a very small contribution on exportable goods.
Some unpleasant currency-devaluation arithmetic in a post Keynesianmacromodel	R. Ribeiro et al 2017	Devaluation has contractionary effects on growth and positive effects on the external balance.
Importance of productivity in non-optimal currency areas	Carlos Encinas-Ferrer 2017	The devaluation risk is caused not only by domestic inflation, but by imported inflation as well.
Devaluations and growth: the role of financial development	David Perez-Reyna et al 2018	A foreign shock that results in exchange rate devaluation might translate into lower output, even if exports increase.
Exchange rate volatility and disaggregated manufacturing exports: evidence from an emerging country	D. Vo et al Journal of Risk and Financial Management 2019	A strategy that depreciates Vietnam's currency appears to enhance manufacturing exports in the short run.

(Un)competitive devaluations and firm dynamics	**ALEXANDER RODNYANSKY 2019**	**DEVALUATIONS ARE SHOWN TO NEGATIVELY AFFECT EXPORTERS IN TERMS OF EMPLOYMENT, DOMESTIC REVENUE AND PROFITABILITY RELATIVE TO NON-EXPORTING FIRMS.**
Fiscal policy and internal devaluation∗	Luisa Lambertini et al 2019	Reductions in government spending are deflationary.
Trade policies and fiscal devaluations: equivalence, neutrality, and macroeconomic effects∗	C. Erceg et al 2020	Increases in import tariffs and export subsidies boost net exports and output.

Table 1 Selected publications

5. Conclusion

Our investigation into the impact of devaluation on GDP has revealed that devaluation has two distinct characteristics. On the one hand, it can result in positive consequences like improved national output, higher export values, and even temporary increases in manufacturing exports. However, it also bears the risk of unfavorable effects, such as slower GDP growth and contractionary effects on domestic output, particularly in least developed nations. This comparison emphasizes the necessity of taking into account a wide range of variables, from the degree of devaluation to supportive policy measures, to evaluate its effects on a country's economic performance. Devaluation has often been embraced as a strategy to bolster a country's position in Export Competitiveness in the global marketplace. While devaluation may initially stimulate exports, it can also lead to increased import costs, potentially negating the positive gains. Furthermore, the detrimental effects on the balance sheets of export-oriented firms should not be underestimated.

Crucially, this analysis emphasizes that currency devaluation cannot operate in isolation. It is part of a broader economic context where complementary policies,

prudent fiscal adjustments, and sector-specific considerations play pivotal roles in determining its success.Considering these findings, policymakers must exercise caution and discretion when deploying currency devaluation as an economic instrument. A tailored and flexible approach, accounting for the unique circumstances of each nation and economic sector, may be a more prudent course of action than a one-size-fits-all devaluation strategy. Moreover, policymakers should remain attuned to the potential ripple effects on both GDP and EC and acknowledge the imperative of holistic economic strategies to accompany devaluation measures.

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