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**The 1936 Devaluation of the Lat and its Effect on Latvian Foreign Trade**

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**1. Introduction**

The international economy in the interwar period was dominated by developments in the UK, Germany, France and the USA. The Great Depression of the 1930s was the most serious economic event in this period and its effects were felt by all countries integrated into the world economy. Although today it is generally agreed that there was no single cause for the Great Depression, it is clear that monetary factors – specifically the role of the international gold exchange standard – were of particular significance.<sup>1</sup> This paper examines a small, open economy on the periphery of Europe in this turbulent time. The paper will examine the history of the introduction of the lat and its subsequent devaluation in 1936. The paper also examines how Latvia's trade balance reacted to the devaluation of the lat in 1936 and whether or not the J-curve effect could be observed.

**2. Theoretical aspects**

In the literature there three approaches to the relationship between devaluation and trade: the elasticities approach, the absorption approach and the monetary approach.

Under the absorption approach,<sup>2</sup> it is assumed that there is the existence of the Keynesian short-run world and the nominal and real effects of devaluation can be stated as follows. Devaluation reduces the relative prices of domestic goods in domestic currency and produces two effects. Firstly, there is a substitution effect that causes a shift in the composition from foreign goods towards domestic goods; that is, the exchange rate change causes an expenditure-substituting effect, and with the usual Keynesian assumption of unemployment, domestic production increases. Secondly, there is an income effect, which would increase absorption, and then reduce the trade balance. The income effect is related to both the increase in domestic output (income), which acts through the “marginal propensity to absorb” (consume) and “marginal propensity to invest,” and the change in the terms of trade. In general, this approach argues that a country's devaluation causes a deterioration in its terms of trade, and thus a deterioration in its national income. The presumption is that devaluation will result in a decrease in the price of exports measured in foreign currency.

What makes the monetary approach different from the elasticities and absorption approaches is that the role of the exchange rate is reduced to its temporary effect on the money supply. The reason being that the monetary approach assumes “a

change in the exchange rate will not systematically alter relative prices of domestic and foreign goods and it will have only a transitory effect on the balance of payments”.<sup>3</sup>

The elasticities approach is based upon the model, commonly known as the *BRM* (Bickerdike, 1920; Robinson, 1947; Metzler, 1948) *model*, which has been recognized in the literature as providing a sufficient condition (the *BRM condition*) for a trade balance improvement when exchange rates devalue. The hypothesis that devaluation can improve the trade balance has been also based upon a particular solution of the *BRM condition*, known as the *Marshall-Lerner condition* (Marshall, 1923; Lerner, 1944). This condition states that for a positive effect of devaluation on the trade balance, and implicitly for a stable exchange market, the absolute values of the sum of the demand elasticities for exports and imports must exceed unity. Accordingly, if the *Marshall-Lerner condition* holds, there is excess supply for foreign exchange when the exchange rate is above the equilibrium level and excess demand when it is below.

In a recent review of the approaches Rincon and Nelson (2001) noted that the elasticities approach incorporating the *BRM* model and the Marshall-Lerner conditions have “become the underlying framework for those who support devaluation as a means to stabilize the foreign exchange market and/or to improve the trade balance”.<sup>4</sup> They further note that the empirical evidence in support of the elasticities approach have been inconsistent and at least two theoretical explanations have been proposed for the mixed results of the approach – the *J-curve* effect and, more recently, the *S-curve*. The main explanation for the *J-curve* has been that, while exchange rates adjust instantaneously, there is lag in the time consumers and producers take to adjust to changes in relative prices (Junz and Rhomberg, 1973; Magee, 1973; Meade, 1988). In terms of elasticities, domestically, there is a large export supply elasticity and a low short-run import demand elasticity. Moreover, the most recent literature on similar settings, which has used dynamic-general equilibrium models, has found that the trade balance is negatively correlated with current and future movements in the terms of trade (which are measured by the real exchange rate), but positively correlated with past movements (Backus et al., 1994). This has been called the *S-curve* because of the asymmetric shape of the cross-correlation function for the trade balance and the real exchange rate.

In this paper I will concentrate on elasticities approach and the resultant *J-curve* effect in examining the effects of the 1936 devaluation on foreign trade in Latvia.

### **3. Introduction of the Lat**

One of the main problems for most European countries after WWI was to bring under control their internal finances – to control inflation and the often violent fluctuations in the value of their currencies. On 18 November 1918 when Latvia declared independence there was no Latvian currency. At this time a number of currencies (or currency equivalents) were in use, including Tsarist roubles, Ost-roubles, Duma roubles, Kerensky roubles and promissory notes issued by various Latvian city governments, as well as Reich marks, Polish marks, and others. On 11 December 1918 the Latvian provisional government promulgated a decree regarding the issue of Latvian independence bonds and fixing the exchange rates for the three main currencies in use: 1 Tsarist rouble = 0.8 Ost-roubles = 1.25 Duma roubles.<sup>5</sup> On 27 March 1919, Latvia proclaimed the issue of Latvian roubles and fixed the

exchange rate at 1 Latvian rouble = 1 Ost-rouble = 2 Reich marks = 1.5 Tsarist roubles.<sup>6</sup> Latvian roubles were issued by the Treasury as there was no central bank at the time. The new Bolshevik government in Russia continued to issue Tsarist roubles and Duma roubles at a rapid rate, substantial amounts of which also found their way into Latvia. This raised the possibility of an externally generated hyperinflation through the resulting increase in the money supply. On 16 February 1919, the Latvian government restricted the amount of Tsarist roubles a person could bring across the border and on 18 March 1920 decreed that the Latvian rouble was the sole legal tender in Latvia.<sup>7</sup> To hasten the withdrawal of Tsarist roubles from circulation, the Government decreed on 30 March 1920, that holders of Tsarist roubles must exchange their holdings by 20 April at the fixed exchange rate of 0.5 Latvian roubles = 1 Tsarist rouble.<sup>8</sup> Nevertheless, inflation continued, as the Government, lacking other sources of revenue continued to emit Latvian roubles in ever increasing amounts to cover the expenses of government, particularly the costs associated with pursuing the War of Independence. By March 1921 when the Constitutional Assembly gave its last authorisation for the Government to emit Latvian roubles, some 2520 million Latvian roubles had been emitted.<sup>9</sup> Effective measures to combat inflation and stabilise the currency began to be taken with the appointment of Ringolds Kalnings as Minister for Finance on 21 March 1921.

Soon after the Latvian rouble was declared as sole legal tender, the Government established a State Gold Fund to provide backing for the Treasury notes. By 25 April 1921 the value of the State Gold Fund was nearly 100% of the value Treasury banknotes in circulation. In May 1921, the Government introduced the “accounting lat” or “ideal gold frank” as the unit for the assessment of all taxes and the concluding of contracts. As this unit was tied to a currency fixed in terms of gold (e.g. gold franks), all taxes were in effect given in terms of hard currency. This enabled Latvia, without foreign aid, to halt inflation and in 1922 to introduce its own national currency, the Lat. The rate of exchange was fixed at 50 Latvian roubles = 1 gold-convertible lat. The value of the lat was fixed to the Swiss gold frank or 0.2903226 pure gold to one lat. Apart from some minor fluctuations in the balance of payments; Latvia had no problems holding this exchange rate through to 1931.

On 1 November 1922 the Bank of Latvia was established as the sole bank of issue of banknotes. The cover of issue was stipulated as follows: for an issue of less than 100 million lats, not less than 50% must be covered by gold or a stable foreign currency and the remainder by safe short-term bills; between 100 and 150 million Lats, for the sum over 100 million must be covered to the extent of 75% by gold or a stable foreign currency and 25% by safe short-term bills; and for the amount exceeding 150 million, 100% must be covered by gold and a stable foreign currency. Nevertheless, the Bank of Latvia pursued a policy of that 100% of all issued banknotes shall be covered by gold or a stable foreign currency. However, the Bank of Latvia was never a “central bank” as is commonly accepted. It was neither a lender of last resort, nor could it engage in open market operations. In fact it operated also as a commercial bank. Many of the “normal” central bank functions were in fact performed by the Treasury. The only central bank function the Bank of Latvia had, was the emission of banknotes. However, at the same time, the Treasury was given the right to continue to issue Treasury banknotes now converted to denominations of lats. Thus, Latvia was firmly enmeshed within the gold exchange standard of the interwar period.

When in 1931, Latvia’s biggest export partner – Great Britain, abandoned the gold exchange standard and devalued by about 40%, it was quickly followed by the

Scandinavian countries and Finland, who pegged their national currencies to the Pound Sterling. Latvia was faced with the choice of abandoning the gold exchange standard or introducing exchange controls to curb the outflow of capital. The Latvian government did not abandon the gold exchange standard at this time, but on 8 October 1931 suspended the free exchange of the lat for gold while at the same time maintaining its gold parity exchange value.<sup>10</sup> All transactions in foreign currencies were made the prerogative of the Bank of Latvia. A Currency Board at the Ministry of Finance was established to “manage” the currency and to distribute the proceeds from the export of goods and services. At the same time an Import Regulation Commission was established, which issued import licences. Thus, an importer had to firstly obtain an import licence from the Import Regulation Commission and then turn to the Currency Board to obtain the necessary foreign currency to make the transaction. With the availability of foreign currency being restricted and only at the official exchange rate, of course a black market developed with up to a 35% premium on foreign currency. In 1932, Latvia signed the so-called bilateral “clearing” agreements with Germany and France. The bilateral clearing system was an arrangement between the central banking institutions of two countries for carrying out trade transactions between them, including the balancing of credits and debits on a national level. The basic idea behind bilateral clearing agreements was to even out or “balance” trade between two countries, while at the same time conserving scarce foreign currency and gold reserves. By 1937, Latvia had signed clearing agreements with seven European countries – Germany, France, Sweden, Estonia, Lithuania, Italy and the USSR.

The Government used two arguments for managing the currency at the gold parity exchange value. First, an actual devaluation would not help matters and would only lead to inflation. That is, exchange controls were seen as preferable to devaluation, as the latter was associated with hyperinflation. Memories of the inflation and currency crises post-war were still powerful. Second, devaluation would be a breach of trust and faith in the lat. Although Latvia was not officially a member of the “gold bloc” group of countries, by maintaining the gold exchange parity as the official exchange rate it felt that it could look to this group of countries, especially France for leadership in terms of currency stabilisation.

Similarly to other central banks in Eastern Europe, the Bank of Latvia held most of its reserves in foreign currency (averaging 80% during the period 1925-1931).<sup>11</sup> In 1928, with banknote issue running at about 40-45 million lats, Bank of Latvia reserves reached some 95 million lats in gold and foreign currency, thus covering the currency issue by some 200%.<sup>12</sup> On 20 December 1930, the Bank of Latvia took a decision to restrict credit in an attempt to halt the outflow of foreign exchange reserves due principally to an increased negative balance of trade. However, the sudden devaluation of sterling in 1931 caused a capital loss of some 2.1 million lats in respect of its sterling reserves and the Bank of Latvia started to sell its foreign currency and buy gold.<sup>13</sup> By 1934, the proportion of foreign currency holdings in the Bank’s reserves had fallen to 10.5%. During the same time period there was a decrease in the money supply – the amount of banknotes in circulation fell by 26%.<sup>14</sup> The wholesale price index fell by 37 points from 120 in 1929 (1913 = 100) to 83 in 1934.<sup>15</sup> This meant that the real value of the lat had in fact depreciated during the period by some 31%. At the same time the export price index fell by 89 points from 168 in 1929 (1913 = 100) to 79 in 1934.<sup>16</sup> This meant that exporters received only 47% of the value in lats that they would have received in 1929 for the same amount of exported goods. The high official value of the lat meant that Latvia’s exports were dearer and could not compete with those of her neighbours, which had devalued

earlier (Norway, Sweden, Denmark and Finland in 1931, Estonia in 1933). Unemployment in Latvia peaked in 1932 at 31 027 from 14 580 in 1930 and had declined to 10 789 by 1934.<sup>17</sup>

After the *coup d'état* of 15 May 1934, the new authoritarian regime promised to maintain the gold parity exchange rate and passed laws which in theory tightened up the distribution of foreign currency for imports. They abolished the Import Regulation Commission and transferred its functions to the Currency Board, as well as providing for the possibility of paying for the imports from a particular country with Latvia's exports to that country – the so-called export clause. On the basis of the export clause, which was applied extensively by the Currency Board, a quasi-legal black market in foreign currency flourished as importers purchased foreign currency direct from exporters by paying a premium on the foreign currency so purchased. By 1936, the premium had reached some 40% of the amount purchased (that is, a real depreciation in the market value of the lat by 40%). Nurske called this the 'gradual extension the free market': "The extension of free-market transactions [i.e. payment of premiums] as a method of exchange adjustment has the advantage of allowing the "correct" rate to be gauged as a result of the free operation of demand and supply."<sup>18</sup> Nevertheless, difficulties in obtaining sufficient foreign currency to purchase necessary imports due to the high official value of the lat continued. The Government even took a decision to temporarily ban the creation of new industrial sectors and the extension of existing industries in order to dampen demand for foreign currency for imported raw materials and energy resources. The new regime also encouraged autarky by restricting imports and subsidising import-replacement, as well as creating commodity boards to make the control of the administration of trade easier.

Thus, the reasons behind the refusal of devaluation and the insistence on official gold parity were first of all fear of inflation and adherence to the principles of the politics of stabilization. The cost of the decision was the introduction of foreign exchange restrictions, and the sacrifice of the convertibility of the currency. The artificial maintenance of the fictitious exchange rate was a serious disadvantage for the export sector and rendered the surmounting of the crisis difficult. The Latvian government and the leaders of the Bank of Latvia, however, continued opposing the devaluation of the lat.<sup>19</sup>

#### **4. Devaluation of the Lat**

By 1936 the Latvian economy found itself in paradoxical position. On the one hand it was obvious that the currency was overvalued, that exports were extremely depressed, and that the price level was under strong pressure as a result of low prices on the world market. The real economy stagnated. On the other hand, from a strictly monetarist point of view, the situation was basically sound: gold reserves were ample, interest rates low, and despite a trade balance deficit for most previous years (except 1932) the balance of payments was now moving towards a surplus. The Government believed that this low-level equilibrium could have persisted for a number of years after 1936, had not the "gold bloc" collapsed in that year.<sup>20</sup>

When France devalued on 26 September 1936, thus effectively liquidating the "gold bloc", Latvia decided to follow. In a radio broadcast on 28 September<sup>21</sup>, the Finance Minister, Ludvigs Ēķis, emphasised several times that Latvia could not remain isolated and disengage the economic and financial relations of Latvia from the rest of the world.

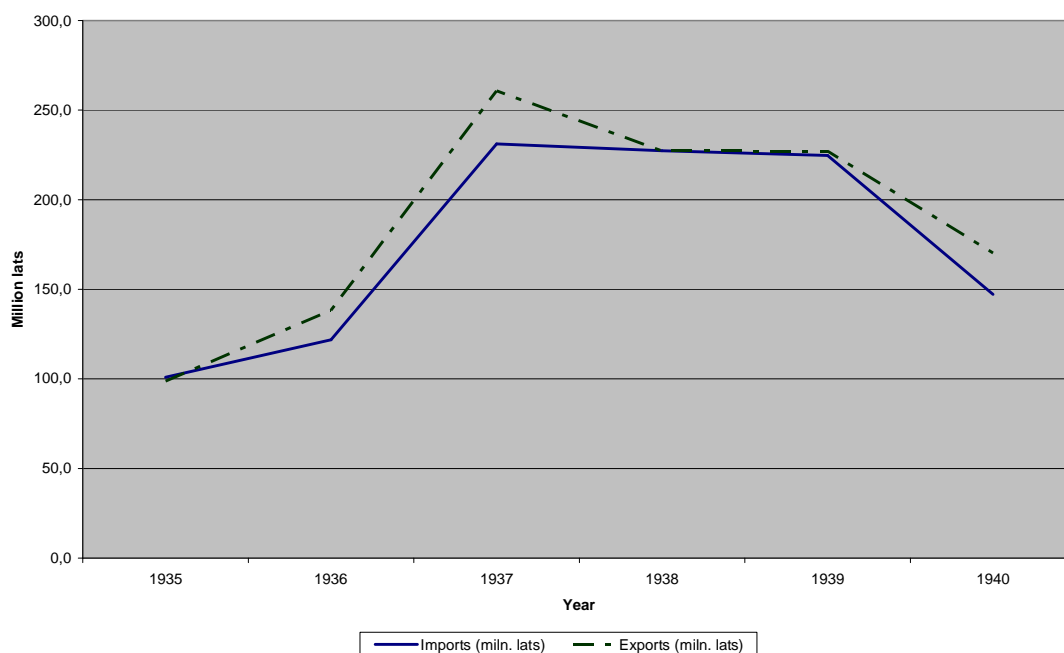
Thus, on 28 September 1936 Latvia devalued the lat by some 40% and aligned it with sterling.<sup>22</sup> The exchange rate was fixed at £1 = Ls 25.22. This was the gold parity rate to sterling which had obtained up to September 1931 when Britain left the gold standard.<sup>23</sup> Thus, Latvia had in fact devalued to the level that had been established in the ‘free market’ of the export clause. The devaluation and the pegging to sterling was justified in economic terms (Britain was the main export trading partner, neighbouring countries were also in the “sterling bloc”, etc.) and in the hope that the Tripartite Agreement between the USA, Britain and France held out the prospect of a new stable exchange rate system in which further competitive devaluations would be avoided.<sup>24</sup>

In 1936, the Government also changed the rules regarding the issue of banknotes by the Bank of Latvia. The cover of issue was now stipulated as follows: for an issue of less than 100 million lats, not less than 30% must be covered by gold or a stable foreign currency and the remainder by safe short-term bills, but if the amount of issue exceeds 100 million lats, the cover by gold or a stable foreign currency must be at least 50%.<sup>25</sup> The money supply as a result of the devaluation the gold and foreign currency holdings of the Bank of Latvia was re-valued in terms of lats and showed a huge increase in nominal terms (from 56.8 million lats on 1 September 1936 to 103.1 million lats on 1 January 1937).<sup>26</sup> However, recalculating the increase taking into account the devaluation, the gold and foreign currency holdings increase is only 61.9 million lats – an increase of some 8%. The wholesale price index rose by 28 points from 89 in September 1936 (1913 = 100) to 117 in September 1937.<sup>27</sup> Thus, taking into account the devaluation of 40% the lat had appreciated some 24%

Concurrently with the devaluation, the Government took a number steps to stabilise internal prices. Firstly, the volume of lats in circulation was not increased to avoid inflation. The price of most imports did not increase very much because it was already high due to the operation of the ‘export clause’ noted above. With the devaluation all premiums on foreign currency were abolished. The possibility of a rise in the price of imports was further reduced by the liberalisation of the import regime in relation to a large range of consumer goods. The currency regime was also liberalised to a degree, allowing importers greater access to both import licences and foreign currency. Finally, price controls, which had been in place previously were tightened up and provided for harsh penalties for those who wished to increase prices without the permission of the price control authority. As a result, whereas the consumer price index for 1936 was 73 (1930 = 100), in 1937 it had risen only by 6 points to 79 – an increase of some 8%.

The devaluation of the lat also signalled the end of attempts by the regime to implement economic autarky *à la* Germany and Italy. However, in order to reduce the windfall profits of timber exporters, especially those who had bought stocks cheaply (i.e. for “dear” lats), the Government introduced an export surcharge, which amounted to some 44% of the value of the timber FOB Latvian ports. From 1936 the Latvian balance of trade and the current account was in surplus.

**Fig. 1**                    **Latvian Foreign Trade 1935-1940**



Source: Author's calculations

As can be seen in Fig. 1, overall, the immediate effect was a sharp rise in both exports and imports especially in 1937, with a slight decline in the following years (the figures for 1940 are for the first eight months).

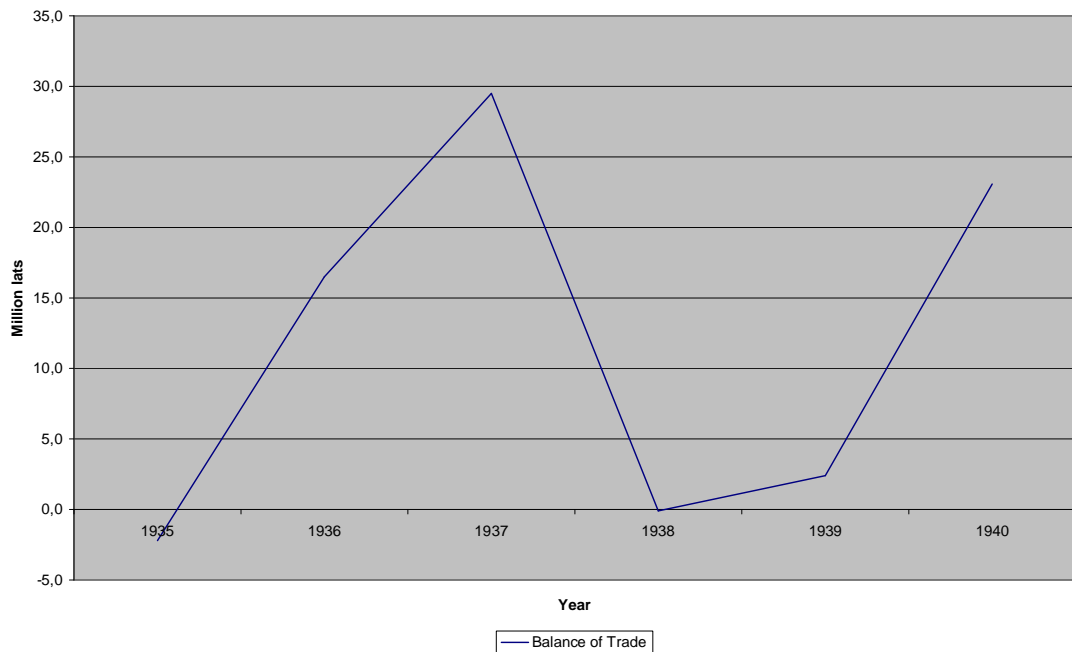
## 5. *J*-curve Effect

In terms of the elasticities approach, an interesting relationship exists between the exchange rate for a nation's currency and its balance of trade. In principle, the drop in a nation's exchange rate, or price of currency, makes the currency less expensive to "buy." With "cheaper" currency the price of domestic production is less and the price of foreign stuff is more, causing an increase in exports to other countries and drop in imports coming in from foreign producers. The economy thus moves in the direction away from a trade deficit and toward a trade surplus. However, the first few months after a drop in the exchange rate the balance of trade goes in the other direction, with any existing trade deficit increasing or any trade surplus shrinking. This occurs because the quantities imported and exported don't change in the short run, but the prices do. Because more is paid for the same amount of imported goods and receive less for the same amount of exports, total spending on imports increases, total revenue received from exports declines and the movement is in the trade deficit direction. Once those quantities start adjusting in the long run, then we see a movement in the direction of a trade surplus. Thus, devaluation has two effects on trade flows – a price effect and a volume effect. The combined effect when plotted over time with trade balance on the y-axis results in the *J*-curve.

The Latvian trade flows were examined after the devaluation of the lat to see if the *J*-curve phenomenon held for Latvia. Utilising a somewhat primitive analysis

technique based on monthly and/or yearly data it was found that there appeared to be no *J*-curve effect for the Latvian trade balance as a whole (Fig. 2). In fact, the balance of trade deteriorated markedly in 1938 before improving again in 1939-1940.

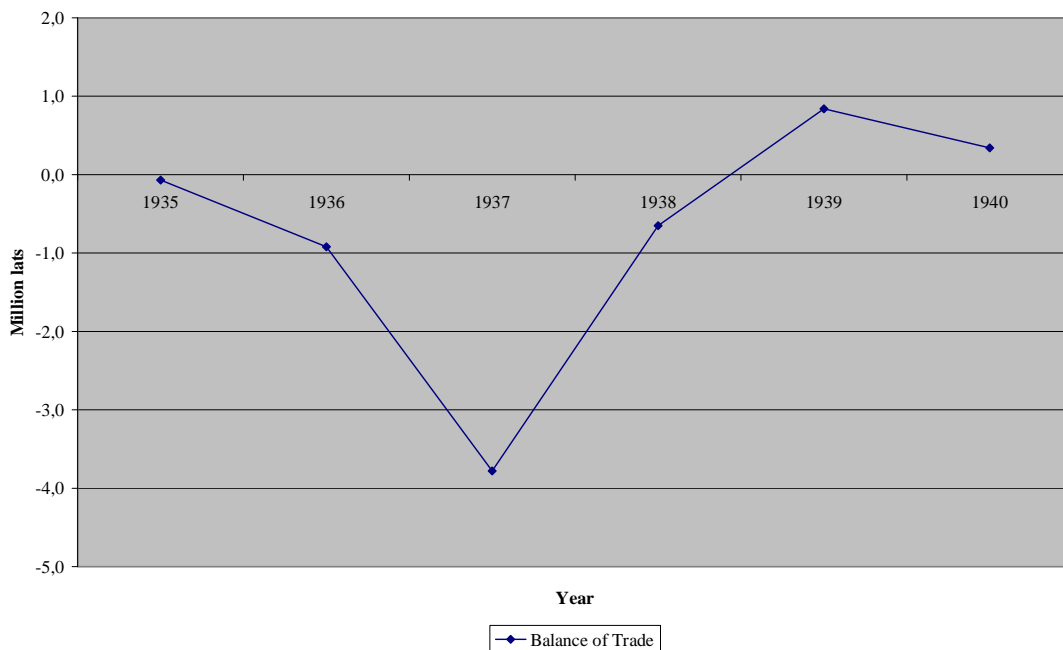
**Fig. 2** Latvian Balance of Trade 1935-1940



Source: Author's calculations

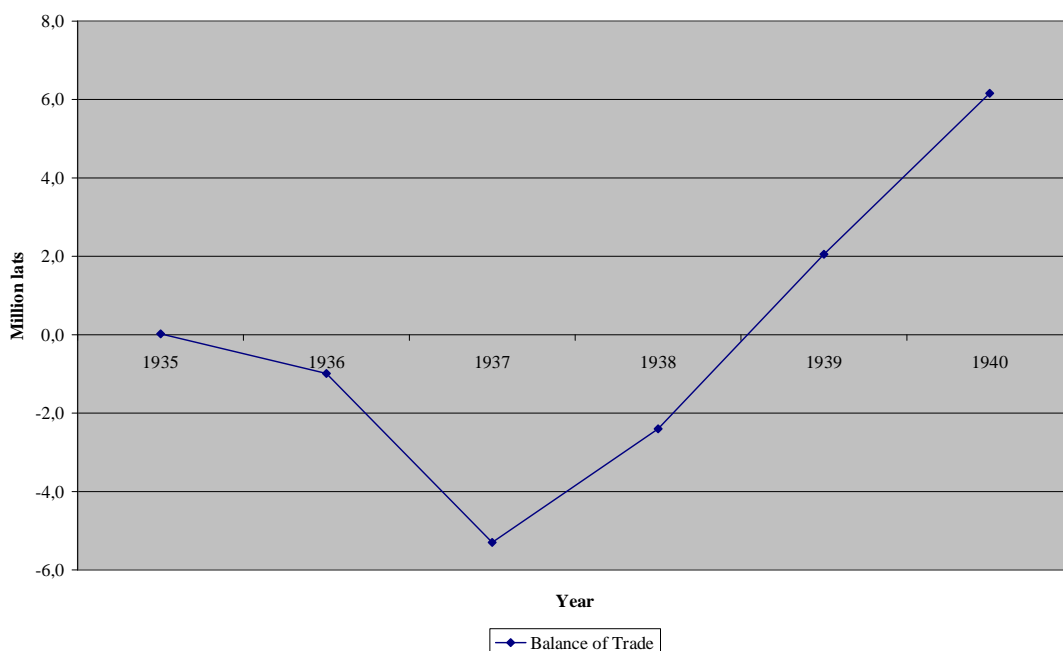
However, when trade balances were examined for selected trading partners an effect similar to the *J*-curve could be observed, for example, for Denmark and Sweden (Figs. 3 and 4).

**Fig. 3** Latvian Balance of Trade with Denmark



Source: Author's calculations

**Fig. 4** Latvian Balance of Trade with Sweden



Source: Author's calculations

As can be seen from Figs. 3 and 4, it took approximately two years for the beneficial effects of the devaluation to show up as an improvement in the current account trade balance with Sweden and Denmark.

There appear to a number of reasons for this observed lag in the volume adjustment in response to the devaluation. Firstly, in an effort to dampen a possible domestic price increases, the Government reduced tariffs on the importation of consumer goods. Thus, those countries which mainly supplied such goods there was increase in the importation of these goods. However, the corresponding lower prices for Latvian exports pushed up the volume of exports especially in 1937. Where exports rose much faster than imports (as for Sweden and Denmark) the *J*-curve effect could be observed. It should be noted however, that these Scandinavian countries belonged to the so-called “Oslo Group”, which included also Norway, Finland, Holland and Belgium. At the Oslo Group conference in Copenhagen on 5-6 April 1936, the issue of mutual economic assistance in the event of a possible international crisis or war blockade was discussed.<sup>28</sup> Clearly however, Latvian export goods were of value for adding to prudent stockpiles, which would probably explain the sudden rise in exports to these Scandinavian countries in 1939 (exports to Denmark nearly tripled and to Sweden they doubled).

It would seem that the lag times for Latvia’s trade balance a whole may be longer than for individual states, as well as possibly being associated with the volume of trade of both the nation as a whole and with each state separately.

## 6. Conclusions

The effects of a devaluation can be complex and far-reaching. In theory, a weaker currency means that exports from the affected country will be cheaper relative to prices in other countries, and that imports will be more costly. These conditions may provide a boost to an economy that has undergone a devaluation, but typically there are negative consequences as well, both internally and externally. And depending on the nature of a country’s trading structure, the benefits may never materialize at all.

It is clear that the Latvian 1936 devaluation had a differentiated effect on Latvia’s foreign trade with the Scandinavian countries and rest of the world. The general effect was dampened through the total control by the authoritarian regime over Latvian foreign trade, the clearing agreements with several states, including Sweden and the favourable world economic situation in 1937 (high timber prices) after devaluation. Latvia’s low, but definite foreign trade turnover with Sweden and Denmark prior to devaluation and the purchasing policies of the Oslo group which also were introduced in 1936 could be the reason the *J*-curve phenomenon in relation to the export trade balances of Latvia with these countries. On the other hand, Latvia’s import trade balances could be related to the needs of the Ķegums Hydro-electric power station and more freely available foreign currency for importers.

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<sup>1</sup> See for example, the classic study by Barry Eichengreen – "Golden Fetters"

<sup>2</sup> The following discussion is based upon Straughn, R. (2003), p. 70-75

<sup>3</sup> Whitman, M. V. (1975), p. 494.

<sup>4</sup> Rincon, H and Nelson, G.C. (2001), p. 3

<sup>5</sup> Aizilnieks (1968), p. 112

<sup>6</sup> Ibid. p.114

<sup>7</sup> Ibid. p.165

<sup>8</sup> Ibid. p. 166

<sup>9</sup> Ibid. p. 169

<sup>10</sup> *Ekonomists*, 1931, No. 20, p. 727

<sup>11</sup> Ibid. pp. 292, 459

<sup>12</sup> *Ekonomists*, 1931, No. 20, p. 725

<sup>13</sup> Ibid. p. 459

<sup>14</sup> Ibid. p. 460

<sup>15</sup> *Ekonomists*, 1937, No. 4, p. 139

<sup>16</sup> Ibid. p. 139

<sup>17</sup> Latvijas Statistikas gada grāmata 1939, Rīga: Valsts statistiskā pārvalde, 1939, p. 295

<sup>18</sup> Nurske (1944), p. 169

<sup>19</sup> In fact, in the radio broadcast announcing the devaluation on 28 September, the Finance Minister asserted that „the government had sufficient reserves to hold the lat at any level”.

<sup>20</sup> *Ekonomists*, 1936, No. 19, p. 658

<sup>21</sup> Reported in the newspaper „Valdības Vēstnesis” [official Gazette of the Government of Latvia], 29 September 1936, pp. 1-2

<sup>22</sup> *Ekonomists*. 1937, No. 6, p. 201

<sup>23</sup> Finanču un kredīta statistika 1937, V izdev., Rīga: Valsts statistiskā pārvalde, 1937., p. 224

<sup>24</sup> *Ekonomists*, 1936, No. 19, p. 658

<sup>25</sup> Finanču un kredīta statistika 1937, V izdev., Rīga: Valsts statistiskā pārvalde, 1937., p. 223

<sup>26</sup> *Ekonomists*. 1937, No. 6, p. 201

<sup>27</sup> *Ekonomists*. 1937, No. 23, p. 961

<sup>28</sup> LVVA, 2575.f., 8.apr., 79.l. – p. 164.