Tamás Bánfi

A Few Notes on the Study by László Csaba

In 2013 Akadémiai Kiadó published a volume of studies entitled *Minden Egész eltörött, Útteremtés és Útfüggőség válságos környezetben (Every Whole is Broken Now, Path Creation and Path Dependence in a Crisis-Ridden Environment). József Móczár* published an argumentative critique on the matter in the Dispute column of the *Public Finance Quarterly* (2013/3). The article can be downloaded from the following link: http://www.asz.hu/en/public-finance-quarterly-articles/2013/my-old-horse-carts-running-slow-1. Just reading the argumentative article directed my attention to *László Csaba's* study (*Theoretical Lessons Learnt from the Euro Area Crisis*). I agree with all of László Csaba's material statements, yet I still think that the questions raised and the answers provided are of extraordinary significance, and must be written and talked about either in agreement, or partially amended or complemented. My comments on the various topics are as follows.

1 There are two concise statements back to back on page 261 of the study. The first is the following: *"We should take note: if the national currencies of a group of countries exchange hands at an identical rate for a long period of time, the difference between them also becomes nominal. The substantial difference in the currency union is that the fixed exchange rate cannot be retracted..."* We can also phrase this another way. The currency union can be established in two forms. One of these is the practice of the European Union, where Member States gave up their former national currencies and introduced a single (i.e. one) common currency, the euro for the whole country group. Fully equivalent to this is the solution, where the exchange rates of the original currencies of the country group are fixed between one another so that the bands of movement of market exchange rates on the currency market (FX market) is 0 per cent (in other words, market exchange rates cannot deviate from declared currency parity), and the unchangeability of currency parities is stipulated. The weak and strong point of this solution is one and the same. Its weakness: ensuring the unchangeability of currency parity (devaluation or appreciation) through power of government can only be laid down in statutes, which

E-mail address: tamas.banfi@uni-corvinus.hu

the government of a nation state can easily "sweep aside". Its strength: in a given critical situation, if the government of a country struggling with economic and financial crisis is unable or does not have the courage to drastically reduce public employee wages or state transfer payments, currency depreciation may be a viable alternative. Though its consequences are similar, they are slower and more opaque. Furthermore, we must not rule out the possibility either that if due to special innovation abilities or newly discovered natural resources, one of the nation states of the country group were to gain a considerable competitive advantage, the appreciation of its currency may be suggested and implemented in the interest of currency integration.

The necessity of possible devaluation or appreciation within the currency union may potentially also arise if the exchange rate determined then fixed at the start of the currency union was determined as a compromise of opposing interests. If, for instance, at any given time the interest enforcing ability of exporters is stronger, they may introduce a weaker exchange rate, while if those with considerable, mostly liquid wealth are allowed to dictate, they may introduce a stronger exchange rate. The possible devaluation of an excessively strong exchange rate or the possible appreciation of an overly weak exchange rate could facilitate the harmonic functioning of the given currency union.

It is a consequence of the fixed exchange rate need of the currency union that if a country group strives to achieve this, it is expedient to gradually reduce the bands of movement between the currencies of nations states that make up the country group, and it would be particularly advised to limit the expansion of these bands of movement.

It is a specific fact of economic history that at the end of the 1970s, in the interest of saving the Bretton-Woods system, an attempt was made to maintain the fixed exchange rate system by increasing the bands of movement of currency exchange rates against the dollar to ±2.25 per cent. Since in the case of cross rates, the band of movement was double compared to the band allowed against the dollar, within the country group of the European Community the change would have represented a band of ±4.5 per cent, which would have contradicted currency union measures. In the interest of accomplishing the goals set, the band against the dollar within the European Community was reduced to ±1.125 per cent, which meant that the maximum band of movement here dropped to the allowed rate against the dollar (±2.25 per cent).

2 The statement on page 261 continues as follows: "*…the banks creating the single currency—the ECB and commercial banks alike—may and do create credit and money independently of national borders or the state of national budgets. In other words, the discipline of budget policy becomes a boundary condition of general financial stability—which does not just affect the price level.*"

From the aspect of national financial stability, the discipline of budget policy is not the only criterion, so is the behaviour of the private economy and households (population). I will mention two examples. The weakest point of Hungarian foreign currency-denominated lending was that customers who were not creditworthy in HUF were made seemingly creditworthy in foreign currency. If customers are uncreditworthy in the domestic currency they receive their income in, there is no magic wand that would make them creditworthy. This particular miracle was only made possible by the aggressiveness of loan intermediaries, the outdated nature of the creditworthiness criteria of banks, the mistakes committed by bank decision-makers, the market gaining interests of banks, the absence of self-criticism and erroneous perception of load-bearing capacity of customers taking on debts. In other words, banks have "over-lended" to the population, which corroded financial stability. Another problem, of opposite direction, is when banks "underlend" to the private economy (the real sector), which weakens and gradually deconstructs the operation of the real economy. Domestic banks, the Hungarian subsidiaries of foreign parent banks in particular, are not very keen on lending to the micro and small-enterprises (MSEs) sector, which may be due to the operating risks of the MSE sector, but the resentment of banks cannot be ruled out either.

Common monetary policy may also have a negative effect. Given the single nature of the monetary policy within the currency union, interest conditions are in essence identical, which means that Greek customers in Greece can take out loans from Greek banks with conditions similar to those of loans taken out by German customers in Germany from German banks. The Greek consequences are well-known (this of course cannot be attributed exclusively to the single monetary policy); if, however, the monetary policy of the European Central Bank (ECB) were to adapt to Greece, it would limit the German economy and in the end ruin it completely.

3 *"Is the model of monetary integration erroneous?"* asks László Csaba (p. 263). His answer is clear: *"…the problem lies not in the structure and architecture of the euro, but in how it operates."* (p. 267). We can also phrase the question another way: do the countries belonging to the currency union meet the criteria set out in the theory of optimum currency areas? (Mundell, 1961; Tower – Willett, 1976) When formulating a reply, it would be expedient to distinguish "mini" countries from "normal-size" countries. The Baltic countries, Cyprus, Malta, Slovenia, perhaps even Slovakia are capital city-size countries, and in addition, the Baltic countries and Slovenia are fragmented parts of a larger state, while Slovakia was recently still half of a larger country. Their economic structure is simpler, therefore their adaptability is greater.

The extent of the connection between the markets of "normal-size countries" can be evaluated in a number of ways, but it cannot be disputed that though the 1973 expansion of the European Economic Community (Denmark, Ireland, United Kingdom) did not represent such an insignificant impact, the subsequent Greek, Portuguese and Spanish accession weakened the cohesion between the initial six to an extent that could not be overlooked and also impacted adaptability to the common market. We must also not forget the fact that the strong impact arising from the unique German-French relationship could have changed with the increasing of the number of Member States and with the passing of time. Just to mention one example: in the case of the six, the agricultural subsidy system could still have been built on this unique German-French relationship, but the expansions necessarily continuously distanced it.

In essence, László Csaba – though in a different context – writes the same thing: *"… it is a fact that at the time of the introduction of the euro as legal tender, the area of the common currency had already existed for nearly two decades in the majority of Member States in the form of a fixed exchange rate."* (p. 264) Furthermore, if it is true (and of course it is) that the expansions were political decisions, then *"…they were built on the reform momentum expected of newly acceding states (something they promised), as well as commitment and the thesis of the self-strengthening nature of reforms."* (p. 264)

Political decision based on political promises. The goal is to "herd in" all the countries in Europe (with the exception of Russia and maybe Turkey, though – we could argue – that the two are not really European countries, with most of their territory located in Asia), and who could prove that all European countries meet the needs of the currency union from an economic, social and political aspect? The decisions, as always, may continue to be political in nature with all the consequences this may entail. Our hopes may strongly be based on illusions. The question is can the current and expanding monetary integration be operated well at all?

4 *"Who fell into crisis and why?"* (p. 268) I 'almost' agree with the reply given to the question. *"Should we not blame the exclusion of the entire private sector from the common system of regulations, the regulatory framework that unilaterally narrowed to discipline executive power?"* (p. 271) I think we should. However, in my reading, László Csaba does not find the response arising from the question satisfactory, because *"…under and over-regulation or relationships that are too close to decision-making are no imaginary threats, particularly when established within the framework of the increasingly politicised European Central Bank (which also participates in budgetary matters), with powers over nations."* (p. 271)

If the expansions until now have been political decisions (and will presumably continue to be in the future), we cannot expect anything else from operational mechanisms. We must, however, admit that in the case of a non-ideal country composition – regardless of under or over-regulation – a country should not fall into crisis. Crises – or at least crises similar to the last crisis – are, and will be in the future, the result of incorrect political and economic policy steps taken by national governments (not necessarily those currently in power). The murky operation of the currency union will at the most cause insufficient participation by Member States, which is not necessarily a regulatory problem.

5 The study's closing point is entitled *The economy-theory role of psychological factors*. Though the conclusions resulting from László Csaba's approach outlined here do relate to the analyses of the euro area crisis, their significance is much more general and can be applied to the whole of economics: *"…what is the point of elaborating 'iron laws' that apply to paper or computer models only? Perhaps the assumption – greatly significant with respect to our topic – represented by both the theory of efficient markets and the mainstream, that the market reacts to all distortions rationally and without delay. In economic policy terms, this means – as the creators of the EMU also thought – that those who breach the rules of the game, are – in essence – 'immediately' punished and forced out by the global markets, suffocated with arbitrage measures before they get comfortable doing so. In addition to Greece, the example of the other crisis countries also shows that this was a false argument, no matter how good it looked on the computer screen or in the model published in a high-impact paper with the strict assumptions applied there."* (p. 278) I agree. Regardless of whether anyone agrees or disagrees with the above quote, I recommend reading The Black Swan (2013), a lengthy economic essay (?) that due to its readability can be finished quickly, which should make everyone think even further.

There is slight discomposure in László Csaba's tone when he writes about the establishment of the banking union, which in essence represents the end of individual banking supervision and the linking of said supervision to the ECB. He is certainly correct on a theoretical plane; the principal-agent problem of bureaucratic systems is an irresolvable task, but in spite of all this, I think the change is not that bad compared to the current system. The remarks of László Csaba on Spanish and Irish supervisory agencies do not support the status quo either. What would be an appropriately efficient, acceptable and good solution? According to the author *"…first the industry then the social agreement should be established,* *and only then the institutions."* (p. 281) We are in agreement. However, until the industry and social agreement are established – which will not happen in a short time or perhaps will not happen at all – we must undertake and accept a solution that is less bad.

6 The thoughts and statements on "easy money" only touch upon the topic of the study very briefly. In the case of these issues, our opinions are not always the same, but as elaborating on the matter would far exceed the confines of this argumentative article, I am simply indicating the existence of differences in opinion by mentioning these. Why would there have been stagflation in Japan in the past two decades? How can we prove that price stability is equal to the rate nearing the 2 per cent inflation rate from below? What level of public debt would no longer be alarming? Do households truly have no voluntary savings? Should companies (corporations) save in money? In most parts of the world, the government, companies and households can be indebted at the same time? The questions give away my responses, but the discussion on these individual topics would require separate studies.

* * *

I have enjoyed László Csaba's study on the crisis of the euro area as the best published on the subject in Hungary. It is a concise, to-the-point and clearly phrased piece. If needed, he gives specific practical answers based on theoretical assertions to provocative questions; if, however, he considers theoretical reasoning superfluous, he describes, explains and assesses the given event. In summary: the whole of the article makes the reader think and form an opinion.

Literature

Móczár, J. (2013): „Fut velem egy rossz szekér"? Gondolatok az EU-ról a Minden Egész eltörött című könyv tanulmányozása közben ("My Old Horse-Cart's Running Slow"? Thoughts about the EU While Reading the Book *Every Whole is Broken Now* (Minden Egész eltörött)). *Public Finance Quarterly. Issue 3*

Mundell, R. A. (1961): The Theory of Optimum Currency Areas. *American Economic Review.* 51., September, pp. 717–728

Taleb, N. N. (2012): *A fekete hattyú, avagy a legváratlanabb hatás (The Black Swan: The Impact of the Highly Improbable).* Gondolat Kiadó. Budapest

Tower, E.–Willett, T. D. (1970): Theory of Optimal Currency Areas and Exchange Rate Flexibility. *Princeton Special Papers in International Economics.* 11. Princeton University