

THE MIRAGE OF A WEAK CURRENCY

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One of the most common misunderstandings among those studying economic development theory has been the idea that a weak currency is beneficial for economic development. This old fallacy has regularly been resurrected by practitioners, usually found in ailing industries or unions, or policy makers in search of a quick fix.

The underlying idea is quite simple. If we take the basic economic model and presuppose a lack of interdependence across economic actors of the globe, the exchange rate seems to be a powerful and efficient instrument. By manipulating it authorities may influence macroeconomic processes. Output produced at a given cost level can become competitive relative to similar products in other countries at the mere stroke of a pen. Prudent central bankers can therefore exert leverage over the real economy, allowing domestic producers to become more vigorous and successful on external markets than they would be if left to a *laissez-faire* arrangement. In a more sophisticated version, planners can pick winners, and those happy recipients of largesse receive indirect subsidies or pushes from the far-sighted planner, who knows already in advance which horse will win the Olympic race.

This idea tended to be a commonplace when the old developmental paradigm reigned supreme in the 1950–1990 period, but has since largely evaporated from developmental studies. During this period, proactive exchange rate policy gained respectability, partly a reflection, partly an ideological justification of state interventionism as an emulation of adhoc Soviet-type planning. Traces of the idea resurface every now and then even in post-transition Hungary. It is remarkable how often authors on both the left and right of the political spectrum advocate the application of this old-style medicine as a remedy for Hungary’s growth ailments.

It should be noted though that the “competitive devaluation” tool of export promotion has never been a mainstream instrument of economic development. Indeed it arguably played a central role in the disintegration of the world economy after its first application in the 1930s. One of the fundamental insights of Lord Keynes, when conceiving the post-war global financial system was the need to

constrain in an institutional fashion, via binding international agreements, the resort to devaluation as a means of economic policy making. Keynes succeeded in fact for a quarter of a century until capital flows finally became unstoppable and eventually undermined the fixed exchange rate regime based on capital controls.

Adherents of the weak currency idea point to South Korea and Japan who employed the tool during their period of industrialisation, and indeed this held true to an extent in the 1950s and 1960s, but, crucially, not for any period since. It is regularly forgotten that the Bretton Woods international financial system was built on precisely the opposite principles. As long as the major powers – including the United States, Germany and Britain – adhered to the rules of the game, the international fixed exchange rate system would survive. And by the same token it could even tolerate deviators, as long as they were on the margins, exceptions to the general rule.

When the Bretton Woods system collapsed following the crises of 1973 and 1979 and was replaced by what Robert Triffin called a “global non-system” the rules of the game changed. With financial flows growing several hundred times faster than physical or trade flows, the freedom of central banks to choose and impose exchange rate regimes diminished. By the late 1980s a so-called “bipolar” view had become entrenched. In this approach, only floating or finally fixed exchange rates are sustainable in the long run. Intermediate regimes, neither fixed nor floating, as well as arbitrarily set exchange rates, tend to be swept away by financial arbitrage and capital flight.

This insight has been proven valid in the past two decades. Despite arguments by people like Nobel laureate Paul Krugman in favour of the creation of global currency bands, currency zones have typically evolved as regional creatures. In short, while intra-EU or intra-NAFTA trade and payments require exchange rate pegging, transatlantic and transpacific flows require flexibility across the major currencies.

It is worth mentioning here that the successful completion of Hungary’s transition to a market economy as well as its accession to the European Union have also fundamentally changed the *modus operandi* of its economy.

At the level of the real or physical trade flows a fundamental change in the pattern of production and employment can be observed. While during the communist period an obsolete pattern of exports, focused on primary commodities and industrial semi-products such as steel survived, the situation fundamentally changed soon after the transition began. Owing to a large extent to massive inward foreign direct investment, the pattern of production, employment and exports all underwent a sea change. About two thirds of Hungarian exports are

now composed of machinery, engineering products, equipments and spare parts. This trade is typically intra-firm trade, part and parcel of a global value chain.

Unlike the sale of simple products – the process used for illustrative purposes in economic textbooks – trade in sophisticated commodities is not particularly or primarily price sensitive. Instead it is sensitive to myriad factors such as quality, timing, services related to the product, after-sale supplies and monitoring, and many other aspects simply disregarded in basic economic modelling. Therefore what seems straightforward on paper or on a computer screen may be plainly wrong on the ground, in actual or real business practice.

To illustrate, let us look at an important element of Hungarian exports like pharmaceuticals. Should the price of aspirin go down, would that lead to its increased consumption? Perhaps during a flu epidemic, but even then not automatically, given the spread of homeopathic medicine and many other modifying factors, such as the human inclination to avoid medication right up to the last possible minute.

If we then consider a more sophisticated pharmaceutical product, can we expect medical doctors to prescribe significantly more of it if prices of Hungarian suppliers go down? Not necessarily, especially if we talk of individual and innovative products rather than generic, old and worn-down ones. This is simply not the grain market of the 19th century, supply and demand dynamics involve more complex considerations these days than their basic predecessors did.

Another important feature of transition in Hungary and elsewhere has been the opening up of the economy. This happened at least on two levels. In the real economy exports plus imports account for over 160 per cent of GDP, on a par say with Belgium and the Netherlands. And in the financial sector new money and much of the banking sector originate from abroad. In turn, perceptions and expectations in the capital market have gained in relevance against traditional considerations, such as simple price-quantity relationships on which most textbook models are still being built.

If we look at the 2009–2012 period, the forint exchange rate fluctuated between 270 and 323 forints per euro without any actual changes in the underlying Hungarian economic fundamentals. These fluctuations were instead largely a result of psychological factors, such as the coming and going of the IMF, the assessment of governmental policies, or the latest developments in the efforts of the EU to deal with the Greek and Spanish crises.

It follows that the actual leverage any central bank or fiscal authority can exert on an exchange rate is in reality quite limited. While technically speaking the interest rate is set by the monetary policy council, its room for manoeuvre is

severely restricted by the financial markets and their expectations, especially in terms of returns and spreads against the Bund. Should a central bank not follow suit, the derailment of say, Cyprus, appears quite feasible. Indeed Cyprus has proven unable to dissipate fears over the fragility of its financial assets in the wake of the Spanish and Greek crises.

From our short survey it follows that even talking in public about weakening a currency or a weak currency can be harmful. First it reflects a large dose of ignorance, both of contemporary economic phenomena and economic thinking. Second, it disregards those changes that have taken place in how modern financial markets work. Third, it sends the wrong signal to financial market players who are bigger and often more powerful than the central bank of a small country, especially if that country is not part of the single currency zone, and thus is not under the umbrella of an authority and mechanism like the European Central Bank and the European Stability Mechanism.

In other words, technically speaking, verbal interventions can weaken a currency just as lavish fiscal easing can, as we have repeatedly seen in the case of the United States. However, in a country struggling with relatively high inflation even during a period of recession – as has been the case with Hungary between 2009 and 2012 – the intentional weakening of an already weak currency would not seem to be a wise idea. If turned into policy, it runs the risk of causing a return to inflationary practices and self-imposed exclusion from the stability club of Europe, as represented by the single-currency zone.

The latter argument is only an add-on, however, to our fundamental case: *the road to sustainable growth, in both theory and practice, is paved by a strong currency*, not a weak one, and sound, not lax, public finances. High inflation is unlikely to be conducive to a higher savings rate, and without a sufficient amount of domestic savings and investment, foreign investment is unlikely to be enough to sustain lasting economic growth and rising employment. On the contrary: the incentives for capital flight and to run down savings would be likely to increase, due to the uncertainty caused by high inflation rates and volatile exchange rates in a small open economy like Hungary.

If we suppose that one way or another the Hungarian economy will get back on the track of sustainable growth with 2.5 to 3.0 per cent growth per annum and a slow but steady convergence to the EU-15 in terms of per capita income, this will inevitably translate into a strengthening, rather than a weakening, of the exchange rate. The historical experience of catch-up economies, from Germany to Japan to Spain all testify to this. On the micro-level, productivity gains are also bound to translate into a strengthening of the currency. In the same vein, if the

eurozone crisis is eventually overcome, that is also likely to strengthen confidence among the EU members. Furthermore, if or when Hungary's accession to the EMU becomes a reality, as would follow from the logic of trade and financial integration in the eurozone, it would trigger a virtuous convergence game, implying lower rates of interest, lower inflation and a stronger currency. No central bank can stop the ebb of the sea.

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