GROWTH, FINANCE AND REGULATION

2008: THE GREAT CRISIS LESSONS FOR HUNGARIAN ECONOMIC POLICY

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Abstract: The trigger for the worldwide crisis that erupted in 2008 was the poorly conceived tax cutting scheme of US President George W. Bush between 2001 and 2003. These tax cuts which then totalled the equivalent of 15% of the USA's GNP (USD 1.5 trillion) did not result in investments - as expected - but instead chose the 'easier' route of speculative capital. They manipulated the oil market, created significant capacities in the production of biofuels with low efficiency and substantial amounts of government funding, but most of all they exerted an influence on the mortgage loan market. The outcome of it all was irresponsible monetary expansion that generated severe fluctuations in the real economy, and it is this fluctuation that we are now experiencing as the current crisis. This chain of events contains important lessons for Hungarian economic policy that are well worth taking into consideration.

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Introduction

Unexpected developments took place in the United States in September 2008: suddenly, and quite spectacularly, the mortgage loan market collapsed. families purchasing or even building their apartments or houses from mortgage loans became insolvent, one after the other. In principle this should not have caused any great difficulty since the essence of mortgage loans is that if the borrower is unable to pay then the lender takes possession of the property, thus acquiring the house, apartment, etc. But this insolvency also meant the housing market itself, the market for building homes, got clogged up, and therefore the homes repossessed from defaulting borrowers could not be sold. This applied especially to houses and apartments still under construction, which the banks were saddled with. Since the banks regularly lend to each other this led to a payment gridlock in the banking system, and suddenly, in general terms, the credit market stopped functioning. We should not forget that money is the commodity of bankers, which they have to sell on the market in the same way as car manufacturers sell cars or shoe factories sell shoes.

The US economy revolved around credit mechanisms anyway, and never followed the European approach of only lending what had previously been saved. This got to the point that the average American no longer saved from his income, and at most invested older savings or rather had them invested by large asset management holding companies. From the end of the 1990s the savings made by Americans from wages and salaries reached zero. Moreover, everyone used loans to buy apartments, houses and cars, farmers bought tractors and land, etc.

President Dwight Eisenhower (1953-1961) was once asked what an American could do most for his country. The answer: buy!

President George W. Bush (2001-2009) announced in his election campaign that all Americans should live in detached houses with gardens. To emphasise this goal, Bush backed it up with an extensive programme for lowering taxes. When he became president he kept true to his word: taxes were cut in three stages in 2001, 2002 and 2003 amounting to USD 1.5 trillion. In 2002, GNP (gross national product) in the United States was USD 10 trillion (or USD 34,000 per capita), and so the tax cuts corresponded to 15% of GNP. The idea was that people would use the extra income they gained from the tax cuts and invest it into house building and buying homes, thus stimulating the construction industry which would pull the rest of the economy along behind. Businesses would use the tax cuts to make investments, the economy would grow, exports would expand and the foreign trade balance would benefit. But things did not turn out quite as planned!

TABLE 1. US FOREIGN TRADE BALANCE, IN USD billion

Year	2000	2001	2002	2003	2004	2005	2006	2007
Trade balance	-479	-447	-508	-584	-702	-832	-878	-855

Source: Hungarian Central Statistical Office http://portal.ksh.hu

It is clear that the drastic deterioration in the US foreign trade balance coincided with the Bush government taking office (2001), and really picked up momentum when the large tax-cutting programme was launched. This means that the USD 1.5 trillion in tax cuts did not finance investments or greater production, and so did not widen the scope of export commodities. So where did this colossal amount of money 'disappear'?

The answer is simple: in the form of speculative capital it began to seek areas providing 'certain' extra profit, but it 'had no intention whatsoever' of flowing into lengthy investments that only make a return after many years. This speculative capital immediately targeted two areas: the energy market and the housing market.

Around 2005 the speculative pressure weighing down on the oil price was tangible, and the OPEC (Organization of the Petroleum Exporting Countries) was powerless against it. By the spring of 2008 the price of one barrel of oil had soared to USD 140 on the global market (admittedly this has now dropped by half and returned to USD 70). There is certainly no way that oil reserves almost running out could have caused this strange (temporary) rocketing of prices, since in the last decade many more new reserves were identified each year than the world managed to consume.

The other main segment of the energy sector is the production of biofuels (biodiesel, bioethanol). Speculative capital soon arrived here too and the USA withdrew its entire corn export from the market, roughly 70 million tonnes a year, and used it to make bioethanol. This required massive investment of capital and the profit in this context is guaranteed by the state. (Supporting bioenergy is a good way of providing hidden subsidies to agriculture!) This represented good business for certain investors, and the mood created by environmentalists could be exploited on the energy front. Of course, biofuels do not result in savings and are not a more environmentally-friendly solution, while in terms of their energy balance they break even at best. Oil and fertilisers, etc. are used to produce corn, rapeseed, sugar cane, etc., but not efficiently by any manner of means. Huge rainforests were decimated in Brazil and Borneo, etc. to plant sugar cane or oil palm for the purpose of producing biofuel. An unbelievable destruction of the environment took place 'for environmental reasons'! (Some scientists even believe that the issue of global warming is just hysteria that is consciously whipped up (Gazdag 2007), and then exploited by certain groups of investors.)

The property business became the third large 'hunting ground' for this speculative capital. The banks welcomed the manna from heaven, the free money, i.e. the extra income that flowed their way thanks to the tax cuts. And let us not forget: there was no extra economic performance behind this extra income! The large nationwide speculation commenced on the property market. Banks undercut each other in the battle to win loan customers, steadily softening the restrictions in place to guarantee security and efficiency. No guarantor was needed, no down payment, no certificates verifying employment, no income certificates, etc. Everyone could get a loan.

The speculative capital caused another severe problem in that it exploited the deliberate weakness of the US dollar. The Bush government did nothing to prevent this because they thought that the weak (or rather steadily weakening) dollar would help redress the very bad (and worsening) balance of foreign trade. But this failed to happen as well! The weaker dollar did not make US exports more competitive, and did not put importers at a competitive disadvantage. Yet the benign real economic impact of the dollar which had strengthened during the presidencies of Ronald Reagan and Bill Clinton (1981-2001, with the administration of George W. Bush's father in-between, 1989-1993) disappeared. Let us focus on this for a moment. A strong national currency creates real efficiency problems for the economy, enforcing technical development and restructuring (Sub pondere crescit palma: The palm tree grows under pressure.) A weak national currency on the other hand lulls businesses into a false sense of security, especially investors in export segments, tying the country's resources down into bad structures (obsolete export structures!). A strong national currency attracts foreign capital. This is clearly evident in the case of the dollar. While the dollar was strong, foreign capital happily flowed into the United States.

TABLE 2. CHANGES IN USD AND EUR EXCHANGE RATE, USD/EUR

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
Trade balance	1.17[1]	1.08	1.12	1.06	0.88	0.81	0.80	0.80	0.73

Source: Hungarian Central Statistical Office http://portal.ksh.hu
Note: [1] Starting January 1, 1999, upon launch of euro.

The truth of this statement was clearly proven at the time of the erroneous economic strategy pursued under the Bush administration. The deliberately weakened dollar (which speculation contributed to in no small measure), did in fact sap the competitive strength from the US economy!

It is evident from Table 2 that initially the euro lost spectacularly against the dollar and in just 9 months from January 1999 to October 2000 had depreciated by 30%. Thereafter, however, when Bush assumed power, the dollar started to suffer and the euro improved. This was not substantiated by any real economic process, and can be attributed merely to speculation-driven exchange rate movements.

Stumbling of the us economy

Between 20 January 1993 and 20 January 2001 (The presidential elections were held on 4 November 1992 and 4 November 2000. The new president is always inaugurated on 20 January of the following year) Democrat Bill Clinton was the President of the United States of America. Clinton, after Ronald Reagan (1981-1989), was the second most successful president in terms of economic policy after World War Two. In just eight years a total of ten million new jobs were created, inflation was pushed below three percent and the pace of economic growth was well above that of Western European states and Japan.

TABLE 3. CERTAIN MACROECONOMIC INDICATORS IN DEVELOPED COUNTRIES

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP (growth, %)																	
EU[1]	1.5	1.0	–0.6	2.8	2.5	1.5	2.5	2.7	3.0	3.8	1.9	0.9	0.8	2.1	1.7	2.9	2.6
USA	–0.5	2.5	2.3	3.5	2.0	2.1	4.5	4.3	4.4	3.7	0.8	1.6	2.5	3.6	2.9	2.8	2.0
Japan	4.3	1.1	–0.2	0.5	0.9	2.9	1.4	–2.8	–0.1	2.9	0.2	0.3	1.4	2.7	1.9	2.4	2.1
Inflation (%)																	
EU	5.6	4.7	4.1	3.2	3.0	2.6	1.7	1.3	1.1	2.1	2.3	2.2	2.1	2.1	2.2	2.2	2.1
USA	3.8	2.8	2.4	2.4	2.4	2.8	2.3	1.6	2.2	3.4	2.8	1.6	2.3	2.7	3.4	3.2	2.9
Japan	2.5	2.1	1.3	0.3	–0.3	0.2	1.7	0.7	–0.3	–0.7	–0.7	–0.9	–0.2	0.0	–0.3	0.2	0.1
Unemployment (%)																	
EU	8.1	9.4	10.9	11.3	10.9	11.0	9.8	9.3	8.5	9.1	8.1	8.5	8.9	9.2	9.0	8.4	7.5
USA	6.7	7.4	6.8	6.1	5.6	5.6	4.9	4.5	4.2	4.0	4.8	5.9	6.1	5.6	5.1	4.7	4.7
Japan	2.1	2.2	2.5	2.9	3.2	3.1	3.7	4.2	4.7	5.0	5.2	5.6	5.4	4.9	4.6	4.3	4.1

Source: until 1999, European Economy, Broad Economic Policy Guideline, OECD Economic Outlook, from 2000: http://portal.ksh.hu
Note: [1] EU-15 until 1998, euro area from 1999.

TABLE 4. US FEDERAL BUDGET AS % OF GDP

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
Trade balance	1.17[1]	1.08	1.12	1.06	0.88	0.81	0.80	0.80	0.73

Source: Hungarian Central Statistical Office http://portal.ksh.hu
Note: [1] Starting January 1, 1999, upon launch of euro.

This set of data shows that the USA easily maintained its supremacy over its two main rivals of the European Union and Japan until 2000. GDP growth is clearly higher there, and while Japan performs better in terms of unemployment, the difference is not substantial and the European Union lags far behind. Japan also comes out on top in terms of inflation, though long-term deflation is not necessarily a positive trend. There is no considerable difference between the EU and the USA. Until 2000 we can say that the gap between the USA and its rivals (playing catch up) did not decline. After 2000, however, the performance of the US economy started to stutter.

Bill Clinton *raised taxes* and handed over the federal budget with a surplus. By 1997 the budget broke even and in 1998 it closed with a *surplus* of USD 70 billion. This all frittered away to nothing under the administration of George W. Bush.

Neoliberal, but anti-monetarist policy!

The downward trends under the Bush administration are clear to see in comparison to the Clinton administration, even though Clinton raised taxes and Bush lowered taxes!

I believe that these results confirm the failure of orthodox neoliberal economic policy. Although Bush's economic policy was orthodox neoliberal, it was also regrettably anti-monetarist. This is the worst combination that can possibly be imagined in today's world!

The underlying axiom of monetarist theory (Friedman, 1986) is that every crisis is triggered by disturbances in the regularity of money supply. Regardless whether it is monetary expansion or contraction, the consequences of both are fluctuations in the monetary sphere which then ripple on through into the real economy and make the economy cyclical; these cycles of course are the famous crisis cycles!

Nobel prize-winning economist Milton Friedman (1912-2006) who hailed from Hungary did not consider even the Great Depression in 1929-33 to be a crisis of overproduction, in fact, he refutes the fact that such a crisis (of overproduction) actually ever existed. He believes that the stock exchanges were disrupted by the irresponsible monetary expansion (oversupply of loans) of governments and bankers who wished to stimulate the economy in the post-war 1920s, and then the even more irresponsible flustering and haste along with the lack of funding triggered the actual crisis.

People used cheap loans to buy shares, but the share market slowly became saturated. When it reached the critical point in October 1929, the governments responded to the panic on the stock exchanges with desperate measures to pull in the monetary reins. This, however, shook the banking system and in 1931 the Creditanstalt Bank in Vienna went to the wall, pulling down the German and Swiss banking systems with it; from there the problems passed through to France, Great Britain, and from there across the Atlantic.

Here there was indeed a sudden case of overproduction, but not in absolute terms, it was due to the narrowing markets caused by the fateful monetary tightening.

Bush's anti-monetarist policy

Of course, if ill-considered monetary expansion could cause such a 'fuss' in 1929, then it was to be expected that it would have similar 'consequences' after 2001 as well. We have to realise that Bush's USD 1.5 trillion package of tax cuts was in fact a typical example of reckless, irresponsible monetary expansion! The action itself is of course fiscal in nature, but its impact on the monetary sphere is clear and direct: a substantial amount of money suddenly appears in the economy that is not backed up by any performance in the real economy.

According to Milton Friedman, the sole task and regulatory tool of the state is to ensure a supply of money aligned to GDP growth and thus the performance of the real economy. The quantity of money must be regulated accurately! This is also why monetarist theory is referred to as the *quantity theory of money*. In precisely determining the quantity of money we come up against the problem of the missing equation. We have 6 macro equations but seven unknowns. Which of these unknowns should we consider to be the exogenous variable outside the system? - that's the big question.[1]

John Stuart Mill (1806-1873), a Scottish economist, believed that money was an ineffectual commodity that was only good for greasing the wheels of the economy, but if it breaks down it can be the cause of much strife. With this thought, Mill became the forerunner of the monetarists. (The monetarist school was established in the 1930s by Arthur Cecil Pigou.)

The other important factor for monetary theory is the primacy of *monetary stability*. As mentioned earlier, a weakening national currency preserves an obsolete export structure, putting the brakes on the pace of technological development. Inflation, on the other hand, generally softens provisions ensuring efficiency because an obsolete, low-efficiency sector can survive and stay upright by pocketing inflationary price gains, shifting the consequences of poor cost management to end consumers and those living from their wages and salaries. I should note that Hungarian economic thinking still stubbornly - and rather incorrectly! - hangs on to the outdated view that fighting inflation is only one of the many economic policy objectives, and not even the most important, as it is preceded in the ranking by the fight against unemployment and stimulating growth. In actual fact, monetary stability commands absolute priority in western economic policy thinking and practices, taking precedence over all other targets. This is because experience shows that results achieved in other areas (growth, equilibrium, employment) are only sustained if they are accompanied by low inflation, more precisely, if they are based on monetary stability. By contrast - and this applies particularly to Hungary! - if we achieve success in other areas of macroeconomics alongside high inflation, then these results quickly peter out as illusory shams, and therefore are not sustainable.

By weakening the dollar the Bush administration severely contradicted the requirements of monetary stability. While inflation was kept successfully under control in spite of the depreciated dollar, the depreciation itself shook confidence in the greenback. The extensive flow of capital into the United States, previously triggered by the appeal of the strong dollar, slowed down and was overcome by the flow in the opposite direction. I remind you again that a strong national currency always acts as a magnet for foreign capital, while a weak (and even more so a weakening) currency repels it. If a Japanese or German car manufacturer invests in the USA, they receive dollars for their products which they convert into their own currencies when repatriating the profit. If the dollar is strong (and especially when it is strengthening, i.e. the trend is what's important), then the German and Japanese investors receive a lot of euros and yen for their dollars. If, however, the dollar weakens then the dollar revenue produces fewer euros or yen.

In 1998 in the last (full) year of the Clinton administration the US foreign trade deficit totalled USD 340 billion, but this was surpassed by the inbound foreign capital on account of the strong dollar, which amounted to USD 370 billion! This means that the USA earned more on the strong dollar in the form of capital imports than it lost due to the foreign trade deficit. (I should add that the foreign trade deficit was naturally not the result of the strong dollar but was caused by other factors. The dollar exchange rate played a minor role in this. The best proof of this is that in the following decade when the dollar weakened sharply, the US foreign trade balance *deteriorated* spectacularly!)

Therefore we can happily say that the trigger for the current crisis was the Bush administration itself with the deliberate (and irresponsible!) weakening of the dollar and the equally irresponsible and substantial tax cuts.

[1] For more on this topic see: Gazdag, 2002.

The latter caused severe disturbances in two ways:

1. It fuelled fluctuations in monetary circles, which logically spread into the real economy and generated (crisis) cycles there,
2. It suddenly created a huge amount of speculation capital, which moved in directions where it encountered 'less resistance' and led to waves of bankruptcies on the property mortgage market.

Thus the reason for the current global crisis is the *anti-monetarist* policy that severely violates the most important theses of monetarist economic theory (which are also cemented in practice!).

It is important to emphasise this because in superficial (or shallow) economic thinking, economic liberalism and monetarism are siblings, or rather Siamese twins. But this is by no means the case!

The primacy of monetary stabilisation and the regularity of money supply do not mean the absolute freedom of capital! On the contrary! Tight and consistent monetary policy sets extremely rigid (efficiency!) restrictions for the functioning of capital. So there is no way we can say that monetarism is identical to ultraliberal economic policy.

On the whole, therefore, we can conclude that the current global economic crisis was triggered collectively by the ill-considered tax cuts and the anti-monetarist financial policy of the Bush administration.

This also contains an important warning for Hungarian economic policy: reckless, sporadic and large-scale tax cuts imply severe risks, for two reasons:

1. They can turn public finances 'upside down' in an instant,
2. They result in wide-scale monetary expansion, which causes unforeseeable disruption to the real economy!

I accept that both the tax burden and the level of redistribution are too high in Hungary today. Nevertheless, I do recommend that taxes and social security contributions should only be lowered cautiously and gradually, keeping an eye on the impacts the (small!) steps have on the real economy!

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