Journal of Business and Economics, ISSN 2155-7950, USA
December 2010, Volume 1, No. 1

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Does It Always Pay off to Reduce Transaction Costs?

Adam Koronowski
(Faculty of Economics and Management, Collegium Mazovia, 01-903 Warszwa, Poland)

Abstract: This paper is intended to identify situations when eliminating or reducing transaction costs may have a negative impact on the economy. When such situations are recognized the theoretical statement that transaction costs always hinder optimal allocation of resources and that they are a source of inefficiency can't be accepted unconditionally. This reservation may rescue us from making mistakes driven by a false pursuit of efficiency. This paper discusses three examples when reducing or eliminating transaction costs badly affects the economy. These examples pertain to, firstly, "cheap banking", secondly, introduction of a common currency (eliminating the costs of exchanging national currencies) under unfavorable conditions and , thirdly, the effects of low transaction costs of international capital movements as a particular case which is subject to the theory of second best. The examples serve to develop the main argument of the paper that sometimes it is better not to put too much emphasis on reducing transaction costs.

Key words: transaction costs; economic optimization; institutional economics
JEL Codes: D02, D23, D61

1. Introduction

Transaction cost is typically perceived in the economic theory as a hindrance to optimal allocation of resources. The lower transaction costs are, the more efficiently the economy operates and optimal allocation of resources should go hand in hand with the efficient markets hypothesis fulfilled. This statement is basically right. However, transaction costs are an effect of certain services provided. Reduction of transaction costs may mean that these services become more effective. It may also mean that the services themselves are eliminated or that their quality declines and only at this price lower costs can be attained. The latter situation needn't be good for the economy. Moreover, transaction costs forestall the fulfillment of the efficient market hypothesis, given other conditions of the hypothesis are in place. We are now more conscious than ever that market participants are not fully rational and that financial markets are not efficient, least because of transaction costs. This may suggest that the role of transaction costs in this less-than-ideal world should be reconsidered. These remarks justify the question chosen for the title of the paper: does it always pay off to reduce or eliminate transaction costs?

The aim of the paper is to answer this question. In fact, it is intended to identify and analyze situations when eliminating or reducing transaction costs may have a negative impact on the economy. When these situations are recognized the theoretical statement that transaction costs always hinder optimal allocation of resources and that they are a source of inefficiency can't be accepted unconditionally. This reservation may rescue us from making mistakes driven by a false pursuit of efficiency.

Adam Koronowski, Ph.D., professor, Faculty of Economics and Management, Collegium Mazovia, Poland; research areas: monetary economics, banking and finance, exchange rates. E-mail: adam.koronowski@aster.pl.

Although I don't intend to dive into definitional matters a short remark in this respect is necessary. As Allen (1999) writes there are two kinds of definitions of transaction costs. "The 'Neoclassical' definition rests on the costs of trading across a market, while the 'property rights' definition centers on the costs of establishing and enforcing property rights". In this paper I accept the first definition and my interpretation of "costs of trading" encompasses such costs of economic activity as currency exchange fees or charges paid to financial institutions' for their intermediating services. This interpretation is in line with much of the economic literature, in particular with its strand analyzing financial markets. It is also worth noticing that transaction costs, even defined in the "neoclassical" mode, are a departure from the pure, neoclassical paradigm. Within this paradigm any transaction costs are a market aberration. When one wants to elaborate on transaction costs, the neoclassical view is to be abandoned. This is the case of "institutional economics" whose representative Oliver Williamson was awarded in 2009 a Nobel Prize for his research on transaction internalization by firms. In this paper I do not develop any sophisticated institutional analysis; I simply accept the fact that the market is not just an abstract device where actors transact directly and without costs and I claim that there are on the market also some useful transactional services which are to be paid and thus they create transaction costs. This does not mean, however, that I neglect some tendencies to "disintermediation" in the financial markets.

"Institutional economists" recognize the importance of transaction costs but they never question–as far as I know–the statement that the lower transaction costs are the more efficiently the economy operates. In this respect this paper goes beyond the achievements of "institutional economics". The thesis that reducing transaction costs may sometimes have negative consequences is not developed here solely within institutional analysis, either; it employs as well some macroeconomic reasoning and the theory of second best which has a general application in economics.

This paper discusses three examples of transaction costs and their meaning for economic performance: firstly, declining credit costs due to securitization and the simplification of bank procedures to assess creditworthiness of a client, secondly, introduction of a common currency and, thirdly, the effects of low transaction costs for international capital movements. These examples serve to develop the main argument of the paper that sometimes it is better not to put too much emphasis on reducing transaction costs.

2. "Cheap banking" and a costly financial crisis

In the financial markets we often have to do with some transaction costs due to financial services provided. These costs explain-at least to a degree–such phenomena as interest rate disparity (which, anyway, never takes prominent values) or–speaking more generally-any examples of no perfect arbitrage in the financial markets. The costs are thus one of the reasons why the markets are not fully efficient.

It is natural that economic agents try to minimize transaction costs. This should bring about a positive outcome in the form of more aggressive exploitation of any profit opportunities. Under some assumptions typical for efficient market hypothesis (e.g., anonymous actors, atomistic actors, rational actors, perfect information, homogeneous goods, the absence of liquidity constraints) this should make the markets more efficient, allocation of resources should be closer to optimum and economic processes should be more effective.

The trend to reduce transaction costs in the financial markets takes two forms. Since the costs are mainly due to intermediation, the first trend is disintermediation. In particular, capital allocation is more and more made on stock markets rather than via bank credit. The system which is based on the exchanges has also some other merits as compared with OTC trade or banking, particularly during a financial crisis. The second trend is to cut the cost

of intermediation where it persists. The need for financial institutions to do so is clear in face of the first trend. This is not an easy task and it also may take financial institutions further than reasonable.

Necessary cost reduction is one aspect of financial institutions' profitability; another one is aggressive "search for yield" in a milieu of easy monetary policy and very low interest rates in major markets in recent years. This latter aspect makes financial institutions to accept more and more risky assets. Moreover, due to financial deregulation which took place mainly in the nineties of the last century they are little restrained in their innovative attitude towards managing their assets. Paradoxically, some measures which were declared as intended to promote safety in the banking sector proved to open new possibilities to accumulate more risk; this is the case, in particular, of the Basle II Accord which prompted banks to develop off-the-balance transactions or securatization. Characteristic of deregulationists' attitude is Greenspan's opinion presented in 1987 to the US House of Representatives Committee on Banking: "…repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk" (Engdahl, 2008a). Greenspan repeated this mantra until final repeal of the act in 1999. The Glass-Steagall Act of 1933 was intended, broadly speaking, to restrict commercial banks from speculative investing in risky assets and from resulting conflicts of interests which laid behind the crash of 1929. The "public benefits" in the quotation above are cheaper, easily accessible credit for broad public.

The drive to cut the costs of financial intermediation (a category of transaction costs) is well expressed in another statement by Greenspan: " Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. (…) With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to broader spectrum of consumers." (Engdahl, 2008b)

The remarks above refer to some features of the financial markets which have led to the present crisis. This paper is not intended to present this subject extensively. It only touches upon these problems to sketch the milieu which prompted hasty, careless and eventually very expensive cost reduction. This reduction came through different "innovations" which, generally speaking, meant the negligence of proper risk assessment and pricing. This process impinged on the stability of financial institutions and–eventually–was at the expense of their shareholders', depositors' and taxpayers' welfare. Financial deregulation and poor supervision created propitious conditions for this abuse.

One could say that there are low cost, cheap products and good quality products. The same applies to financial services; there is to a degree a trade-off between the costs of transacting and the quality of the services which may determine the soundness of the financial sector.

3. Transaction costs and a common currency

In open macroeconomics transaction costs are most often considered to be an explanation of some departures from covered interest rate parity, low of one price (or purchasing power parity) or some other "puzzles" in international macroeconomics (Sarno, Taylor, 2002; Obstfeld, Rogoff, 2000). Of course, transaction costs are microeconomic by their nature and only their results are expressed in some macroeconomic terms. When it comes to monetary unions the microeconomic nature of the transaction costs of exchanging currencies is clearly recognized and their elimination is believed to be one of the advantages to be gained from a monetary union. As Sarno and Taylor (2002) put it "the benefits of monetary integration (…) are found mainly at a micro level (…). They are primarily the elimination of transaction costs and of the risk due to exchange rate uncertainty. While the

welfare gains from the elimination of transaction costs are quite obvious, the welfare gains from the elimination of risk due to exchange rate uncertainty are not".

However, the perspective restricted to microeconomic nature of the cost does not allow for a question whether these costs create any serious distortions which bring about any considerable costs at the macro level. It is also true that the macroeconomic benefits from or costs of the eliminating of transaction costs would be very difficult to separate form other effects–positive and negative-of a common currency, in particular from the elimination of exchange rate risk. In fact, one can not eliminate transaction costs of exchanging currencies without eliminating currencies themselves. Whether it pays off to have a common currency is not clear and the problem is broader than the fact that "the welfare gains from the reduction of risk due to exchange rate uncertainty are not (obvious)". If it was clear that it is always worth having a single currency there would be no need for the theory of optimum currency areas. More important than the insights provided by this very imperfect theory is the empirical evidence that fixing exchange rates (and a single currency) may often bring rather costs then benefits. It strongly suggests that adjustable (or simply flexible) exchange rates of individual currencies may offer a mechanism which makes the economy operate more smoothly without inflationary pressures and downturns. Giving this mechanism up for some illusive advantages such as the elimination of transaction costs we may pay a high cost.

It is not the purpose of this paper to discuss the costs and benefits of fixing the rate or these of a monetary union. I will only mention some papers which on the basis of empirical observation put in doubt the would-to-be advantages. With regard to fixed rates it is worth mentioning De Grauve (1997) who argues that there is no strong link between exchange rate uncertainty and economic growth, Reihart and Rogoff (2002) who claim that freely floating currencies are characterized with very low inflation and reasonable growth rates, Edwards and Yeyati (2003) who prove that flexible exchange rates allow to absorb negative shocks to the economy (GDP). With respect to a monetary union we have–for obvious reasons–less empirical evidence. However, in the literature on the EMU performance there are important opinions that the costs of the undertaking are high and the benefits vague. Examples include (Blanchard, 2006), (Wyplosz, 2003, 2006) or a good case study by Bessone Basto (2007). Also the European Commission (2001, 2005) admits that there are important inflation and growth divergences within the euro area which undermine economic perspectives of some member countries. A theoretical explanation of the economic costs brought about by nominal and real divergences due to a monetary union is presented in (Koronowski, 2009).

If only we had a clear perception and evidence that national currencies do not provide any useful services which make economies more efficient, it would be reasonable to give them up and any gains such as the elimination of transaction costs would be a nice, even if not very valuable, reward. However, as long as national currencies might be superior to a monetary union as an international financial system, the elimination of national currencies and respective transaction costs would bring about macroeconomic costs. Sometimes it is worth paying reasonable transaction costs. After all, no one argues to scrap trains and lorries as a source of transaction (transportation) costs. The problem with currencies is that it is not so simple and obvious.

4. Volatile capital movements, second best solutions and transaction costs

Any consideration of transaction costs mirrors some departures from the ideal world of neoclassical economics. Yet, it does not ruin the whole neoclassical paradigm. That is why reducing transaction costs can be perceived as a way to come closer to the ideal–efficient and effective–neoclassical world. I argued above that even without

questioning the main assumptions of the efficient market hypothesis one has to be very cautious with the postulate to reduce transactions costs as it may come at the expense of the quality or even the existence of some useful services or economic mechanisms. This observation is inconsistent with the neoclassical paradigm and the idea of undoubtedly positive effects of transaction cost reduction. It is so because in the paradigm there is no rationale for the services such as financial intermediation, and consequently their cost. In fact, there is even no room for a firm. According to Oliver Williamson transactions costs are what justifies why firms exist. "This contrasts with the typical view of firms in neoclassical economic theory as, at worst, a market aberration that ought not exist, and at best, a black box production function." (Salomon, 2009) Any scope for the strategy and management science, transaction costs economics or (new) institutional economics is only beyond the neoclassical economics.

However, we could go even further than that. We can question all the assumptions of the efficient market hypothesis and accept the possibility of major market failures; in these days this should not be particularly intellectually demanding. Then, when we recognize such phenomena as asymmetric information, herding behavior or any aspect of bounded rationality (not to say irrationality) transaction costs may–as traditionally argued–reduce the value of transaction. However, this time it might have–contrary to traditional arguments–positive effect. A classic example of such reasoning is Tobin's taxes–any fees charged for foreign portfolio investment with an intent to reduce their amount and volatility. Why shouldn't we apply the same idea to the domestic stock market, for example?

Some transaction costs combined with any other departures from the efficient market hypothesis and optimal allocation of resources may–in accordance with the theory of second best–give better solution than at no cost. If there is a major market failure, also "corrective", second best transaction costs should be respectively high. Formally speaking, even purposeful extra costs (such as Tobin's taxes) may shift an economic system closer to its optimum (may allow for a second best). And much emphasis put on reducing some transaction costs may not only badly influence useful market services and mechanisms–at the expense of economic and financial stability–but it may also move economy further from its second best solution.

Anyway, taking more pragmatic attitude, I don't think that any purposefully designed cost impediments to transacting in the economy are a good solution, except undeveloped economic systems where, for example, liberalization of international capital flows itself seems premature. What is needed is rather creating conditions for possibly undistorted function of the economy: putting in place good regulations, effective supervision, proper incentives–all that was lacking before the present financial crisis. With respect to international relations transparent, coherent and credible policies would help.

5. Conclusion

The elimination of "neoclassical" transaction costs is always first best policy within the neoclassical economic paradigm where there is neither rationale for any intermediation nor any market failures are considered. In the real world, however, the institutional structure of the economy leaves enough scope for intermediation. Too much emphasis to reduce transaction costs may hinder the quality of these services, in particular it may blur the risk and lead to its mispricing. As a consequence financial and economic stability is endangered.

Some market services and economic mechanisms can be even completely demolished as a consequence of the elimination of respective transaction costs as in the case of a common currency when resulting macroeconomic costs may overwhelm microeconomic benefits, including no transaction cost of using many

national currencies.

Moreover, any form of a market failure undermines the postulate to eliminate transaction costs; the theory of second best claims that some departure from the optimum no longer justifies a pursuit to meet other optimum conditions. As there are many examples and explanations of market failures, there is no general rationale for the elimination of some reasonably low transaction costs.

Institutional structure of the economy still changes. In particular, there is a trend to disintermediation in the financial markets. The process should bring about lower transaction costs. Disintermediation does not eliminate transactions, nether it creates any extra–other than transactional-costs, nor it blurs markets; hopefully, it even may bring about more transparency and market efficiency. Moreover, it may help reduce systemic risks combined with large financial intermediating institutions. This simple example shows how positive elimination of transaction costs may be. This paper was not intended to question such observations and conclusions. Its aim was to warn against the temptation to develop them into generalized theorems which nested in some narrow and abstract economic reasoning may be wrong and misleading.

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