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**COMMENTING ON EXCHANGE
RATE MOVEMENTS
A case study of the British Media**

By SERGEY MINAEV

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Sergey Victorovich Minaev, PhD (International economics), senior research fellow in the Institute of the Scientific Information on Social Sciences, Russian Academy of Sciences; chief economic columnist in Kommersant daily newspaper, Kommersant-Vlast and Kommersant-Dengy weekly magazines, Moscow

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INTRODUCTION

On July 16, 2002 the Chairman of the Federal Reserve Board, Alan Greenspan, presenting the semi-annual monetary policy report to the Congress, said: “A considerable volume of market commentary in recent weeks has suggested that concerns about earnings prospects and the proliferating revelations of serious governance and accounting issues have contributed not only to lower equity prices but also to a decline in the foreign exchange value of the dollar. And some of that commentary has extrapolated the trend of dollar weakness. Given the recent intense interest in the future course of the dollar, I would like to raise a technical issue and a flag of caution regarding those forecasts--or, for that matter, any forecast of exchange rates. There may be more forecasting of exchange rates, with less success, than almost any other economic variable. The reason that it is so difficult is that an exchange rate is a very complex price that balances, on the one hand, the demand for, for example, dollars stemming from the demand for dollar investments and for U.S. exports against, on the other hand, the demand for foreign currencies by U.S. investors desiring to acquire foreign assets and by U.S. importers of foreign goods and services. Hence, exchange-rate movements depend on shifting perceptions of the relative returns from investing in different countries and on the myriad influences on relative tendencies to import and export. The net effect of these factors over any future time period is extraordinarily difficult to assess in advance. Although measures such as real interest rate differentials, differential rates of productivity gains, and chronic external deficits are often employed to explain exchange rate behaviour, none has been found to be consistently useful in forecasting exchange rates even over substantial periods of one or two years”.

Nevertheless, it is a mission of the media to comment on the exchange rates movements as for the general public and specialists these commentaries present a substantial (not always theoretical) interest. It is even more so in the case of the British media, taking into account the long tradition of financial journalism (and readership) in Britain. For the author (*) it is especially important to analyse the British media commentaries on this subject, as his responsibilities as a journalist in leading Russian newspaper (Kommersant), and magazine (Kommersant-Vlast) include the commenting on the exchange rates (not only rouble versus dollar, but also dollar versus euro – not surprising, if one remembers the traditional affection of the Russian citizens towards foreign currencies and their lack of belief in the rouble) and predicting the future rates.

For our analysis we have selected the following media: The Times, The Guardian, Financial Times, The Economist, Reuters. In our view, that selection is quite representative: there are broadsheets of different political stances, an influential weekly magazine and an international news-agency. In the first chapter we present an overview of the comments on the movements of world leading currencies in 1999-2003. In the second chapter we will remember the comments on the currency crises of 1997-1998. The third chapter presents a discussion, including the academic works on the exchange rates and currency crises. Then we will come to some conclusions.

CHAPTER ONE: COMMENTING ON THE STRUGGLE OF THE LEADING CURRENCIES

In 1999-2003 the movements of the leading world currencies were so spectacular (and so unexpected), that it would be useful to arrange comments on these movements in a simple chronological order and to illustrate them with Graphs 1-3, showing the fluctuations of the euro against the US dollar.

Of course, in the past there were also serious exchange rate movements and they also needed explanation. For example, in September 1992 Martin Wolfe and Edward Balls, when discussing the decision to float the pound in the *Financial Times*, noted that the US dollar had depreciated by 20% since the beginning of 1989 (and the Australian dollar had fallen by 35% since then). The explanation proffered was the difference in interest rates: “True, lower interest rates than those in Germany have led to a fall in each country’s exchange rate relative to the D-Mark”.¹ And in 1998 the currency markets surprised by their volatility, uncertainty and turmoil. As Alan Beattie stated in the *Financial Times*, the real excitement had been taking place in 1998 between dollar and the yen: “as Japanese interest rates dropped towards zero the dangerous but lucrative game of “yen-carry trades” - borrowing low-interest yen, changing them into dollars and then benefiting from the higher returns on dollar assets - gained popularity. Chief among the participants were hedge funds” (only the sterling had a relatively uneventful year, compared with the bull runs of 1996 and 1997:” With the interest rate cycle in the UK topping out around the middle of the year and talk of recession growing, the pound drifted down from over DM 3 against the D-Mark to a more sustainable level of around DM 2.80”².

But the introduction of the euro— potentially a rival to the dollar as a world currency — in 1999 especially inspired both the currency traders and British journalists (of course, the possibility of accepting the euro as a national currency in the UK played its role). The fluctuations of the euro in the first year of its life are shown in Graph 1.

When the new currency was introduced on 4 January 1999, Alan Beattie predicted: “Once liquidity returns, the market can start to assess the new currency and view the likelihood of it supplanting the dollar, under threat as a reserve currency from a huge

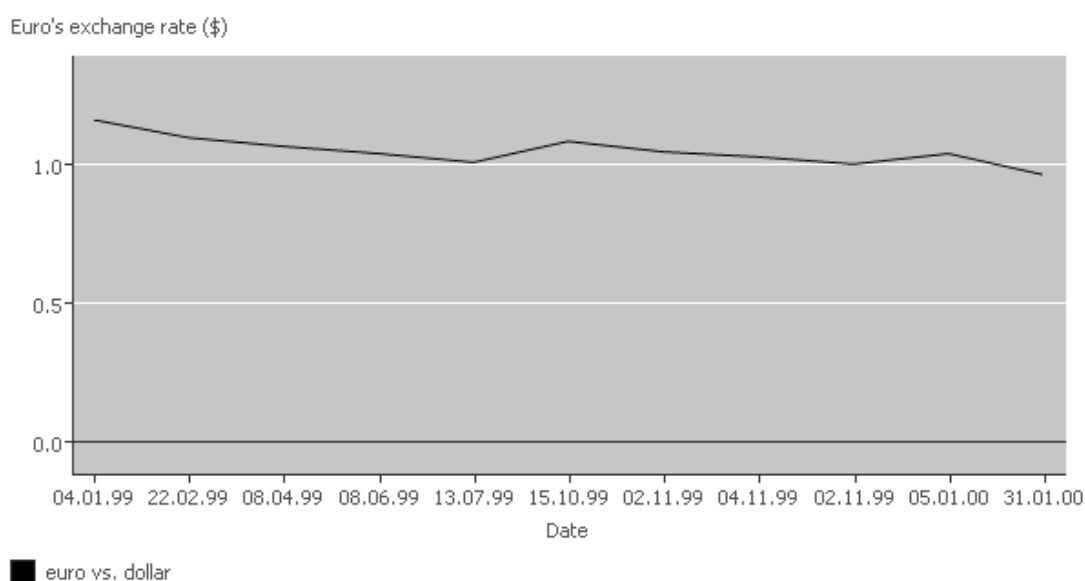
¹ “Pros and cons of a free floating exchange rate”, by Martin Wolf and Edward Balls. *Financial Times*. 21 September 1992, p.4

² “Dollar and yen in turmoil”, by Alan Beattie. *Financial Times*, 4 January 1999, p.10

current account deficit and continued worries about Brazil ³. On the front page the Financial Times celebrated the launch of the euro with the report of George Graham

and Gwen Robinson: ⁴. “Europe launched its challenge to the US dollar’s dominance of the world’s currency markets early today, with the official start of Asian trading in the euro...the new currency for 11 countries with a combined population of 290m and economic output approaching that of the US. Economists expect the euro to gain strength against the dollar and the pound over the coming months. Trading patterns displayed what traders described as a "largely ceremonial" component and the euro did not move substantially from its opening price of \$1.1747 ... Some analysts expect it to move above \$1.20 in the next month or two”.

Graph 1. Euro vs. US dollar: January 1999-January 2000



Source: Minaev, Sergey. *Globalnaya ekonomika:2000 god*, Moscow, INION,2001

On January 7,1999, in his opinion column, Anatole Kaletsky of the Times noted, what for the British proponents of the EMU was extremely unpleasant, namely that the physical creation of the euro was postponed until January 2002: “British tourists will still have to change their money and perform arithmetic acrobatics, not only when they leave Britain, but also when they cross borders between France, Italy and Spain. They will find this particularly galling after being led to believe by the euro lobbyists in Britain that EMU has turned Europe into a single currency promised land”⁵.

On January 6 The Guardian’s financial editor, Alex Brummer, published an article (in fact, a research paper with academic references) on the instability of the pound and its fate⁶. As he pointed out, the enthusiasm with which the birth of the euro had been greeted on the Continent and in the financial markets evidently was not shared by the

³ *Ibid.*

⁴ “Cautious start to euro trading”. by George Graham and Gwen Robinson. *Financial Times*, 4 January 1999, p.1

⁵ “Low interest currency”, by Anatole Kaletsky, *The Times*, 7 January 1999, p.22

⁶ “The sovereign that never ruled”, by Alex Brummer, *The Guardian*, 6 January 1999, p.15

British public. But, stressed Brummer, “stability and the pound have not been historically compatible. Far from being the ‘store of value’ — which the currency is meant to be — ...the pound has been a dead loss... Winston Churchill’s vainglorious decision to peg the pound to gold at the parity of \$4.86 in 1925 was typical. An overvalued currency led to a calamitous decline in exports and a brutal attack on the policy by John Maynard Keynes in his pamphlet, “The Economic Consequences Of Churchill”. In Alex Brummer’s opinion, another error was made in 1945. Victorious Britain claimed a high exchange rate at \$4.03 to the pound - one that reflected its expectation of post-war advantage relative to the destroyed economies of Germany and Japan. The result was a decisive devaluation on September 18, 1949, when the value of sterling was cut by 30% to \$2.60.

The 1949 devaluation proved to be a defining political moment. For much of the next decades a falling pound came to be regarded by politicians as a symbol of economic and political failure... During the past two decades, the pound has lost half its value against the mark. And the Alex Brummer’s conclusion was: “Opposing the euro on rational economic grounds is fair enough. But to suggest that the new currency will be inferior to the pound would be a failure to heed the lessons of Britain’s past”.

On February 4, 1999 the Financial Times published Alan Beattie’s article⁷ on the new role of currency analysts in the modern world: “Recent exchange rate volatility - not least between the dollar and the yen - has hit at a time when many investors such as pension funds are building up their holdings of overseas assets. One spin-off is fast-growing demand for currency analysis”.

Beattie argued, that the inception of the euro, adding another large, mainly closed economy with its own currency, increases the risk that exchange rates could fluctuate more than asset managers are used to, and hedging every exposure could not only become laborious and hinder swift movement; it could also prove too expensive in certain markets. The article ended with the words of Avinash Persaud, described as one of the leading currency analysts: "Our time has come."

There was indeed a fast-growing demand for currency analysis, as the euro began to drop. On February 19, 1999 the euro fell from \$1.12 at the start of the London session, to \$1.11 at the end. The pound also reached highs against the euro. Dealers said the break of the £0.683 level could trigger a medium-term slide by the euro to £0.65. Melanie Carroll of the Financial Times attributed the weakness of the single currency to the poor economic news from Europe. In Germany, the largest economy in the euro-zone, gross domestic product shrank by 0.4% for the last quarter of 1998. Jeffrey Woodruff, currency strategist at Bank Boston in London, was quoted: "The euro is getting what it deserves". He predicted the euro would sink to \$1.10 in a week, and possibly as low as \$1.06 in the medium term⁸.

On February 25, 1999, the pound broke below the \$1.60 level against the dollar for the first time since October 1997 and closed at the end of the London trading session at \$1.599. Against the euro it lost some of its previous gains, closing at £0.685. Alan Beattie and Melanie Carroll tied the pound’s fall to the higher expectations of the UK joining European Monetary Union. They also pointed out the weak short-term prospects for the euro, quoting J.P. Morgan, who had revised down their short-run

⁷ “Volatile exchange rates usher in age of the currency analysts”, by Alan Beattie, *Financial Times*, 4 February 1999, p.27

⁸ “Euro stumbles”, by Melanie Carroll, *Financial Times*, 20 February 1999, p.11

forecast for the euro against the dollar the day before, and said the euro would not recover its launch level of \$1.16 until June (on February 25 euro closed at \$1.095).⁹

On March 5, 1999, the *Financial Times* published a comment by Alan Beattie and Martin Dickson on the weakness of the Europe's single currency: "It wasn't meant to be like this. The single currency, born in the New Year amid a wave of "europhoria", is turning out to be an unexpectedly sickly infant. Since the end of its first week the euro has fallen by 7 per cent against the dollar, and has shown similar weakness against the world's other large currencies."¹⁰

The authors tried to answer the following theoretical questions. Was the weakness of the euro largely the product of an unexpected slowdown in Europe's biggest economy -- Germany? Or was it evidence that Europe's "one-size-fits-all" monetary policy was proving hard to manage? The answer proposed was: a bit of each. Alan Beattie and Martin Dickson pointed out, that the weakness of the core European economies had become more evident, just as the US seemed to have fully recovered: "as a result, the paths of expected interest rates have diverged, pushing the euro down". The authors tended to conclude, that it was the relative strengths of the US and EU economies that determined the behaviour of the new currency, so there seemed little prospect for the euro to significantly strengthen – more than that, they mentioned the possibility for the euro to fall to the parity with the dollar. Nevertheless, they also mentioned the huge US current account deficit as the dollar's evident source of weakness (the only source, in fact), which could eventually place downward pressure on the US currency: "A sudden collapse in global investor confidence, perhaps sparked by a US equity market correction, could also bring the dollar crashing down. But absent this, the euro looks at best to be in for a slow and possibly bumpy appreciation".

On 11 March 1999 the euro closed at \$1.08 and £0.68. The *Guardian* responded with an article, named "Euro traders in low spirits". "Currency movements are difficult to forecast, reflecting as they do billions of individual transactions, each driven by myriad economic factors. The foreign exchange market is best viewed as perpetually in a state of instantaneous but fleeting equilibrium. Fundamental analysis yields very little benefit when a market is in such a state. By definition, all that can be known is known, and is already reflected in prices. It is no surprise, therefore, to find far more technical analysts, or chartists, on currency trading floors than in other City dealing rooms".¹¹

When currency economists predicted the wave of buying of the euro, their arguments were founded on three assumptions: the euro would come to rival the US dollar as a global reserve currency; the European Central Bank would display the same anti-inflation zeal as Germany's Bundesbank; the economic growth gap between America and Europe would be narrowing. Each assumption, the *Guardian* argued, had proven to be false, hence the collapse of the optimism surrounding the currency.

On March 11 Alex Brummer also presented in the *Guardian* an exclusive interview of the financier George Soros. The man, who bet against the Bank of England in 1992,

⁹ "Sterling tumbles on Emu expectations". by Alan Beattie and Melanie Carroll. *Financial Times*, 26 February 1999, p.43

¹⁰ "Europhoria fizzles out", by Alan Beattie and Martin Dickson, *Financial Times*, 5 March 1999, p.15

¹¹ "Euro traders in low spirits". *The Guardian*, 11 March 1999, p. 25

warned, that there were fundamental flaws in the structure of European Monetary Union:” At the core of the euro’s difficulties, are the internal tensions inherent in a common currency without a common fiscal policy”¹².

On April 14, 1999 Janet Bush (director of New Europe, the anti-single currency lobby group) presented in the Times her explanation of the weakness of the single European currency¹³. She wrote, that the previous three months had been entirely predictable (nevertheless, for some reason, they were not predicted — S.M.). Many had expected that the euro would be a strong currency in its early days, bolstered by massive flows of investment funds out of the dollar and backed by a European Central Bank that would keep a tight grip on monetary policy to build up its credibility. “But it was evident, even as the single currency was born, that Europe was suffering just like others from the implosion of demand in emerging markets. Weak economies tend to result in weak currencies: that is the beauty of floating exchange rates, designed as they are to act as a natural restorative when things go badly. Far from helping to bolster the euro, the refusal to cut rates by the European Central Bank until it was far too late, again predictably, was counter-productive. When economies become as evidently weak as parts of euroland - particularly Germany - have become, a policy of tight money undermines, rather than bolsters, the currency”. So the euro was a currency like any other. And its weakness simply reflected the weakness of the German economy.

Martin Wolf suggested in his column on May 26, 1999, that the euro was likely to fluctuate more against the dollar and other outside currencies than the D-Mark used to do, because the European Central Bank cared much less about movements in the external value of the currency, as imports were a comparatively small share of the euro area.¹⁴

On May 25, 1999 Anatole Kaletsky openly raised in the Times the controversial issue of the relationship between the exchange rate of national currency and the economic prosperity of the country, as well as the relationship between the exchange rate and the balance of payments. He stressed that the pound had been comparatively strong during the previous two years and, as a result of that in May 1999 manufacturing output had fallen by 1.2 per cent relative to a year before, while manufacturing employment was down 2.9 per cent. At the same time the rise in the pound had produced an increase of more than 20 per cent in the British people’s wealth and international purchasing power relative to their European neighbours. So in general the strong pound seemed to be favourable for Britain.

Indeed, exports in the previous three months had been 5.5 per cent lower than a year earlier, while imports were 1.7 per cent higher. Britain’s trade in goods and services, which had almost been balance in 1997, moved into a deficit of £7.9 billion in 1998, equivalent to more than 1 per cent of GDP. In the previous three months this deficit had deteriorated much further and was running at an annualised rate of about 2.5 per cent of GDP.

¹² “Soros says euro is doomed to be weak while splits underlie Europe”, by Alex Brummer, *The Guardian*, 11 March 1999, p.1

¹³ “Euro woes should come as no surprise”, by Janet Bush, *The Times*, 14 April, 1999, p. 27

¹⁴ “Emu’s small reward”, by Martin Wolf, *Financial Times*, 26 May 1999, p.20

Even allowing for Britain's large surplus in investment income, this suggested that the balance of payments was in deficit of about 2 per cent of GDP. And nevertheless the pound was still strong. "If the deficit really does look like becoming unsustainable, the pound will fall of its own accord. If, on the other hand, sterling remains strong despite the deficit figures, then there ought to be a strong presumption that a deficit of the size that is now in prospect will either prove transitory or be financeable for quite a long time... Financing the remaining deficit should not prove too difficult, given the large flows of inward investment that Britain has continued to enjoy despite the "overvalued" pound. In asking why this investment has continued to flow into Britain (as it has into America, where trade deficits are proportionately far larger), we come to some of the positive arguments in favour of Britain's present economic regime".¹⁵ So the conclusion was, that the external deficit does not necessarily lead to the weakness of the national currency.

On June 2, 1999 Patience Wheatcroft wrote in the Times: "The euro is a weak currency and likely to get weaker. That is a reflection of the underlying economic picture in the EU generally and Germany in particular. The verdicts of the international markets should have come as no surprise to the governments of Europe but there is no denying the embarrassment it has caused".¹⁶

On June 18, 1999 the European Central Bank intervened directly in the currency markets for the first time, buying euros and selling yen as part of a co-ordinated attempt to influence exchange rates (the ECB said it was acting on behalf of the Bank of Japan (BoJ), which was concerned about the persistent strength of the yen). Nevertheless, the euro fell below parity with the US dollar for the first time on December 2, 1999.

On December 1, 1999 Martin Wolf in his column tried to answer the question, why was the euro so weak, despite the strong current account? He noted, that the US current account deficit was forecast by the Organisation for Economic Co-operation and Development at 3.7 per cent of GDP in 1999, rising to 4.2 per cent in 2000 and again in 2001. The euro-zone, by contrast, had a current account surplus of 0.8 per cent of GDP, followed by forecasts of 0.7 per cent and 0.8 per cent for 2000 and 2001. "Why then should the currency of a zone enjoying low inflation, falling unemployment, sound public finances, increasingly robust growth and a strong external position be weak? The immediate cause lies in the capital account... The narrow basic balance (the current account plus net foreign direct investment) and the broad basic balance (which includes net portfolio flows as well) have been negative for most of this year. There seem to be two principal reasons for this: the unwinding of positions taken by foreign investors prior to the launch of the euro, and the lack of attractiveness of the euro-zone for large-scale inward foreign direct investment, particularly acquisitions."¹⁷

In 2000-2001 the decline of the euro continued (see Graph 2) and the British media went on trying to find the explanations of this movement.

¹⁵"Leave the level of sterling for the markets to decide", by Anatole Kaletsky. *The Times*, 25 May 1999, p.31

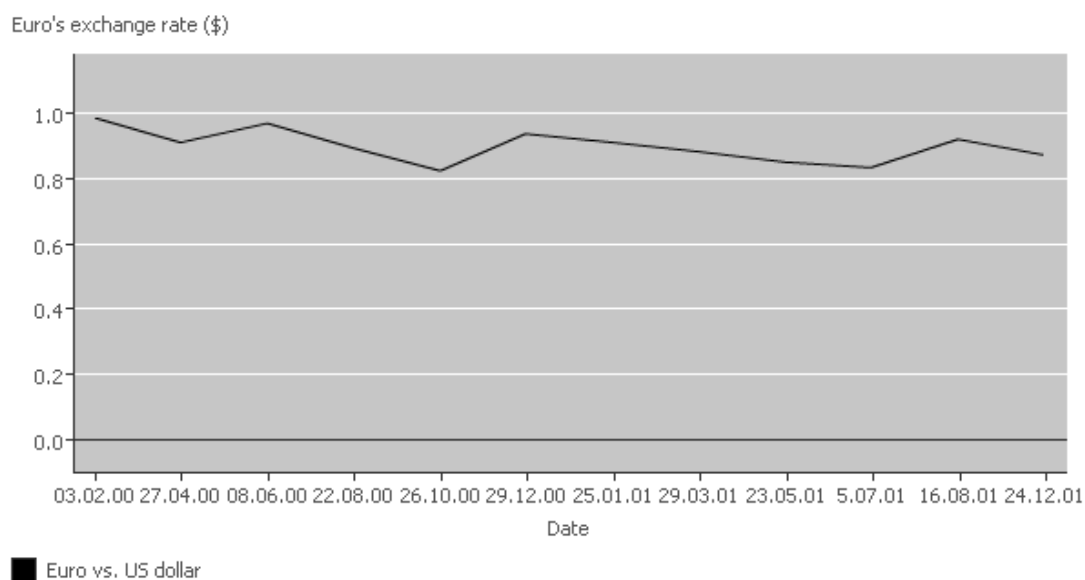
¹⁶"The euro goes into shell shock", by Patience Wheatcroft. *The Times*, 2 June 1999, p.18

¹⁷"Retreat that need not be a rout". by Martin Wolf. *Financial Times*, 1 December 1999, p.21

For instance, in September 2000, after the co-ordinated intervention by the central banks of the Group of Seven largest industrialised nations, trying to rescue a tumbling euro, Martin Wolf wrote a column “Catching the falling euro” in the Financial Times. He noted that the Bank of England’s trade-weighted nominal exchange rate for the synthetic euro (constructed retrospectively, with the weights of each component currency) was almost as low as in May 1985 when Ronald Reagan’s soaring dollar peaked. On the eve of the intervention, the euro fell to under 85 cents, a loss of 5 cents on the month -- since its creation, the euro had lost 28 per cent of its value against the dollar. He also noted, that the weakening euro was exacerbating the inflationary impact of rising oil prices in the euro-zone.

Martin Wolf quoted the World Economic Outlook, where the IMF listed several rational reasons for its weakness: faster growth of the US economy; higher short-term interest rates in the US; huge foreign borrowing in the expanding eurobond markets; the perceived weakness of policymaking in the euro-zone; and, most important, the perception that the US economy’s performance, prospects and likely corporate profitability all exceed those of the sclerotic euro-zone.

Graph 2. Euro vs. US dollar:2000-2001



Source: Minaev, Sergey (Op.cit); Minaev, Sergey. Globalnaya ekonomika:2001 god, Moscow, INION, 2002

The author presented his own explanation of the euro’s weakness: “What seems to be driving the currency is not speculation. The euro-zone has a steadily weakening current account position. It also has persistent outflows of long-term capital. The so-called "basic balance" - the sum of the current account and the long-term capital outflows - has been strongly negative since 1998. Last year, this balance was minus E145bn...So long as the basic balance remains negative, it will be quite difficult for spasmodic and modest sterilised intervention to reverse the euro’s slide”.¹⁸

On May 31, 2001 the euro fell to six-month lows against the dollar (\$0,849) and sterling (£0,596). As Christopher Swann wrote in the Financial Times: “Euro

¹⁸ “Catching the falling euro”, by Martin Wolf. *Financial Times*, 26 September 2000, p.14

enthusiasts in the currency markets could be forgiven for comparing their fate to that of Sisyphus - the figure in Greek mythology condemned for eternity to push a boulder up a hill and then watch it roll back down again. After propelling the euro to a peak of \$0.96 by the start of January, pro-euro investors have seen the currency tumble back to within a whisker of its all time low of \$0.823. In retrospect, the euro's surge at the end of last year - which many thought marked the turning point for the currency - appears just one in a series of failed rallies".¹⁹

In Swann's view, speculative traders had played little part in dragging the euro lower -- the euro's problems were being driven by a seemingly inexorable outflow of investment funds from the euro-zone. Thus Christopher Swann raised one more time an important theoretical problem of the link between capital flows and exchange rate movements. This link, he wrote, has become "an article of faith" for the currency strategists: "Huge amounts of energy are devoted to analysing portfolio flows. ... Not surprisingly, therefore, there was a strong reaction against suggestions by Otmar Issing, the European Central Bank's chief economist, that the relationship between capital flows and the exchange rate was rather weak. Many market professionals now consider the basic balance - a measure of underlying financial flows including the current account, portfolio and foreign direct investment flows - to have been the best guide to the performance of the euro over the past two years".²⁰

But what dictates investors' behaviour? On June 4, 2001 in a *Financial Times* leader, entitled "Fickle currencies" we could read in particular: "The currency markets certainly react to day-to-day economic news. The exchange rate between the euro and the dollar... tends to move in response to relative prospects for economic growth. So while a cut in US interest rates might, in theory, be expected to depress the dollar - because it decreases the returns on US assets - it often has the opposite effect, because investors expect it to boost growth".²¹

On June 4 the *Financial Times* also published a column "The mystery of the ever-rising dollar" by Mieczyslaw Karczmar (the New York-based economic adviser to Deutsche Bank) who doubted the link between the exchange rates and economic growth's rates²². He noted, that from its low point in April 1995, the US dollar had risen 69 per cent against the D-mark, 50 per cent against the yen and 45 per cent in trade-weighted terms, reaching its highest level for 16 years. The dollar had also risen 36 per cent against the euro since its inception. For most of this period, the dollar's climb coincided with US economic expansion, so most analysts attributed the currency's growth to cyclical factors.

But in the four years before the dollar began its rise, the US economy was also expanding, while Europe was growing more slowly and Japan was largely stagnant. During this period, however, the dollar fell sharply. Furthermore, the US economic expansion ended in 2000, yet the dollar had remained strong against all big

¹⁹ Currency fails to sustain enthusiasm. By Christopher Swann. *Financial Times*, 31 May 2001, p.2

²⁰ Economic gloom keeps euro in check. By Christopher Swann. *Financial Times*, 31, May 2001, p.8

²¹ Fickle currencies. *Financial Times*, 4 June 2001, p.1

²² The mystery of the ever-rising dollar. By Mieczyslaw Karczmar. *Financial Times*, 4 June 2001, p.10

currencies, contrary to most economic predictions. “What explains the dollar’s continuing strength despite the apparent turn in the US business cycle? And why did most economists fail to predict it? The inability to forecast the dollar’s behaviour arises mostly from a failure to recognise that it is a unique currency because of its global characteristics and that the US is a particularly attractive place for foreign investment” – wrote Mieczyslaw Karczmar.

In Karczmar’s view, the American currency’s uniqueness was shown in the coincidence of a strong dollar and rising US external deficits. From 1995 to 2000, when the dollar appreciated over 40 per cent, the US current account deficit nearly quadrupled: “Any other country with such deficits would have seen its currency drop but the dollar rose. The reasons lie on the financing side of the balance of payments”. The US has no difficulties in financing its current account deficit: the financing comes voluntarily, because of the size and openness of US capital markets. The US is also in the unique position of being able to finance its deficit in its own currency. Mieczyslaw Karczmar predicted the strong dollar in the future: “Barring the emergence of a devaluationist tendency in US foreign exchange policy, the dollar is likely to remain strong.”

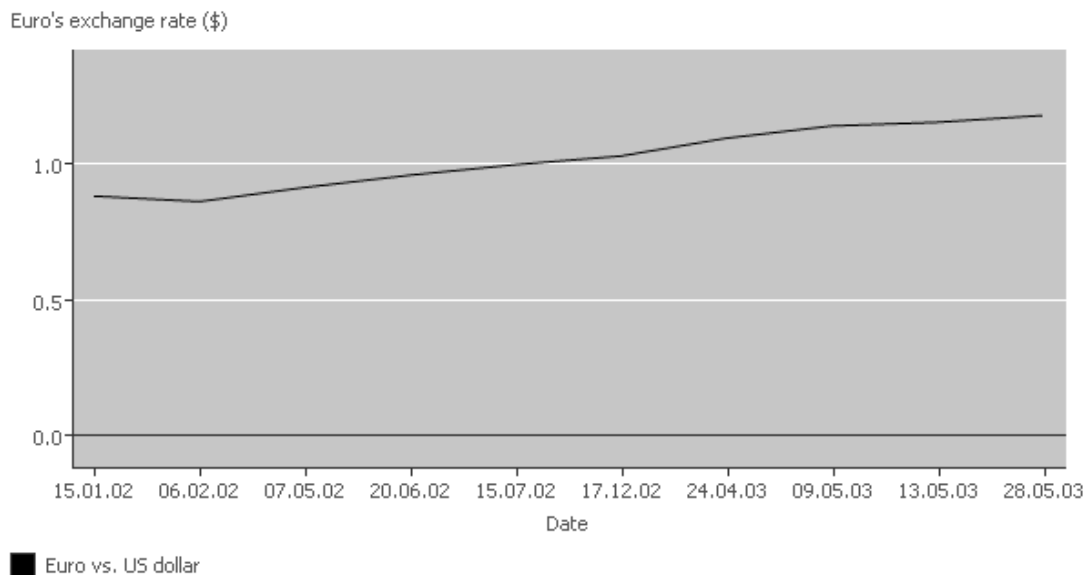
The year of 2002 began with a still weak euro and the article “Why I wouldn’t put my money on the euro”²³ by William Rees-Mogg in *The Times*. He wrote about the risk of taking the euro as a national currency and recalled the sad fate of the mark. The author defined the euro as an inconvertible (into gold – S.M.) paper currency for a regional block of differing economies: “as such, it is quadruply vulnerable”.

The central idea of the article was that Britain should better manage its own independent floating currency, in control of its interest rates and money supply. If, however, Britain desired to take the risk of joining a fixed currency outside its control, it would do better to apply to join the dollar rather than the euro, because the dollar was still much the better currency. Currencies depended for their strength on their economic and political base -- the economy of the United States was technologically superior to the European; it had lower costs and taxes and less regulation. Politically, Europe was halfway between being a group of states and a single power; the US was a single nation, under a proper Constitution. The dollar was a strong tested currency; the euro may well not survive.

In February 2002 the euro began its revival against the dollar. By the end of May 2003 the single European currency was 27% higher in dollar terms, than at the beginning of the 2002 (see Graph 3).

²³ “Why I wouldn’t put my money on the euro”, by William Rees-Mogg. *The Times*, 7 January 2002, p.16

Graph 3. Euro vs. US dollar: January 2002-May 2003



Source: Minaev, Sergey. *Globalnaya ekonomika: 2002 god*, Moscow, INION, 2003; current financial news

Now the euro seemed a hard currency, while the dollar and the pound were seemingly in decline. What had happened? Of course, the most obvious explanation, presented by the British media, was war fears. Anatole Kaletsky in his *The Times* column wrote: “Economics is now an important pressure for a rapid resolution of the stand-off in Iraq. Financial markets and economic activity all over the world have been falling relentlessly since January 29 last year, when President Bush proclaimed his "Axis of Evil" doctrine. The dollar peaked against the euro on the very day of the Axis of Evil speech and has been falling ever since, at least against the euro. The resulting 21 per cent dollar devaluation has done serious damage to economic prospects around the world... The standoff in Iraq has also contributed to the collapse of stock markets. Since the Axis of Evil speech Wall Street has fallen by 20 per cent as measured by the Dow Jones industrial average and by 32 per cent in terms of the Nasdaq composite”.²⁴

As the *Times* reported on February 14, 2003, the pound dropped below euro 1.50 on the foreign exchange markets, “with safe haven flows continuing to bolster the single currency”. Sterling fell as low as euro 1.49, equivalent to 66.94p to single currency, as the build-up towards war with Iraq continued to unnerve the markets. Gold and oil were among the major beneficiaries of concerns about war, with Brent crude surging 66 cents to hit \$33.11 a barrel, its highest level since November 2000. “But the most dramatic moves ... were on the currency markets, with both the dollar and the pound suffering from the war jitters”.²⁵

But, not surprisingly, there were also more sophisticated explanations. As Martin Wolf noted,²⁶ the dollar's latest appreciation coincided with an insatiable foreign

²⁴ “Economic recovery needs a quick resolution of the Iraq stand-off”, by Anatole Kaletsky. *The Times*, 11 February 2003, p. 25

²⁵ “Sterling weakens”, *The Times*, 14 February 2003, p. 29

²⁶ “The price of the falling dollar”, by Martin Wolf. *Financial Times*, 26 June 2002, p.19

appetite for US assets and a huge current account deficit. In the first quarter of 2002, the current account deficit was still 4.3 per cent of gross domestic product, yet foreign demand for US real assets had virtually vanished. In 2000, the net inflow of foreign direct investment and purchases of corporate stocks was \$228bn. In the second half of 2001, this had become a net outflow of \$16bn. "With US interest rates low, the currency looks poorly supported". US productivity growth remains far faster than in other advanced countries, yet the continuation of a strong productivity performance by the US does not give much support to the dollar. As economists at HSBC argued, "one of the most striking features of recent US economic performance has been the dislocation between productivity growth and profits". The forces making for a weak dollar were matched by those for a stronger euro. Above all, the capital outflow has disappeared. In 2000, the basic balance of the eurozone - the sum of the current account, net direct investment and net portfolio flows - was minus euros 153.8bn. In the second half of 2001 this had become plus euros 59.4bn. "As the basic balance shifts, upward pressure on the euro seems unavoidable".

On March 17, the Times published an article, called "The rise and fall of a currency under siege", dealing with the fate of the pound.²⁷ Having sharply appreciated since 1996, by about 17 per cent, and having remained high, Britain's currency suddenly appeared vulnerable. On the trade-weighted index, a measure of its overall value against a basket of rival currencies, the pound had fallen 3.7 per cent since the turn of the year 2003. We could read the following explanation: "What has caused the pound to weaken? Most of the pound's recent decline has come against the euro. This has stemmed in large part from the euro's revival against the dollar, which has faltered as markets fret over a fragile US recovery and the impact of a war in Iraq". But were there any other factors involved? The answer was yes -- a range of forces had weighed on the pound. One had been the Bank of England's cut in interest rates in February 2001. For a period of 14 months, the Bank left base rates unchanged at 4 per cent. During most of that time eurozone rates were only 3.25 per cent, while rates in the US fell to 1.25 per cent. That made the pound a high-yielding currency attractive to flows of "hot money" from around the world that helped to keep it high. After the cut investors could cease to take pound as a high-yielding currency. Moreover, the external trade deficit, which exceeded £1,7 billion in February, could also frighten investors.

In short, the Times simultaneously presented four explanations: a fragile US recovery, the impact of a war in Iraq, the cut in interest rates, and the external deficits. "Will the pound continue to fall? No one can be sure - exchange rates are hard to forecast. But a further decline is viewed as likely. There is a risk of a larger fall, given markets' tendencies to overshoot once a clear direction is established".

The article also raised an interesting question of the link between a drop in the pound and inflation. It tended to regard the pound's drop as inflationary. The direct impact of a weaker currency on prices, it was said, comes through higher import prices, as goods bought from abroad become more expensive in sterling terms. These higher prices may then be passed on to consumers, who might in turn demand higher wages. At the same time, it was admitted that intense competitive pressures could make it

²⁷ "The rise and fall of a currency under siege". *The Times*, 17 March 2003, p. 25

hard for businesses to pass on higher import costs in prices – they could be forced to accept lower margins instead.

On April 24, 2003 when the euro gained half a percent to \$1.1035 in early European trade James Thornhill of Reuters reported: “Analysts said the euro was continuing to find favour as a relatively high-yielding destination, with investors still nervous about ploughing cash back into equity markets. With Japanese interest rates near zero and U.S. short term rates at a four-decade low of 1.25 percent, returns on euro zone government bonds look attractive”.²⁸ Official data, he noted, showed Japanese investors increased their buying of foreign bonds to a net 1.12 trillion yen (\$9.30 billion) for the week of April 14-18, up from 767.5 billion yen the previous week. It seemed the bulk of that buying was being focused on Europe: “Japanese interest in European government securities has certainly picked up and they are buying more on an unhedged basis,” said Steven Pearson, chief currency strategist on Halifax Bank of Scotland Treasury Services, as quoted by Reuters.

On May 2, 2003 the euro broke through 70p to the pound for the first time in four years. Patience Wheatcroft, business editor of *The Times*, responded with the commentary headlined “Euro rise depends on Germany”. “The advances made by the euro in recent days certainly suggest that City traders believe that there is more value to be had on the Continent than in the US or Britain... Yet these movements in the currency markets are all but impossible to square with the economic fundamentals, which suggest that Germany is going from bad to worse”.²⁹ The author’s explanation of the comparative strength of the leading world economies (and of its possible impact on the euro) was as follows. The number one, two and three economies in the euro - Germany, France and Italy - are all underperforming. Even if France and Italy were doing well, the woes of Germany alone was enough to depress the euro’s value. And nevertheless the euro is unbelievable strong. Why? “So why is the euro rising? Some say the answer partly lies in America’s gaping current account deficit, which is frightening investors (But why didn’t it matter previously?—S.M.). Others put the euro’s rise down to nothing more than knee-jerk trader sentiment, often the driving factor of short-term currency moves. For years, the US lived happily with a strong dollar and a large current account deficit because investors believed that returns on American assets would outperform those elsewhere. It is only when the US economy began to turn down that analysts began to question this assumption. This suggests that the dollar’s present woes have less to do with the current account *per se*, and more to do with a lack of confidence in US prospects. Eventually, investors will begin to believe in the US economy again. This should send the dollar higher - even if the US current account deficit remains large”.

During the first week of May, the euro rose 2.25 percent against the dollar to \$1.1535, its highest level since it was launched in January 1999. Reuters reported on 9 May that the euro’s rally was supported by the yield advantage European assets hold over U.S. assets.³⁰ Investment flows to the US had slowed as investors seek higher yields

²⁸ “Dollar under pressure, euro firm on yield plays”, by James Thornhill. *Reuters*, April 24, 2003 08:01 AM ET

²⁹ “Euro rise depends on Germany”, by Patience Wheatcroft. *The Times*, 3 May 2003, p.55

³⁰ “Euro takes a breath near four-year highs”. by Daniel Bases, *Reuters*, May 9, 2003 05:00 PM ET

than those in the United States, where economic growth, albeit higher than in Europe, is sluggish and a record high current account deficit weakens demand for dollars, reported Daniel Bases, quoting John McCarthy, director of foreign exchange at ING Capital Markets in New York, who said: "The numbers out of Europe are pretty bad, but we are not looking at growth differentials or prospects. We're basically looking at yield".

On May 13, 2003, as the single European currency broke above \$1.16 to the US dollar for the first time in more than four years (against the pound, the euro set a record high of 72.13p), Lea Paterson, economics editor of the Times, mentioned also market speculators as a force pushing the euro higher: "Speculators have taken out a near record number of bets that the euro's rally will continue, as the single currency set new highs against the dollar and the pound. As of May 6, the number of net long euro/dollar contracts - that is, bets that the euro will rise against the US currency - had leapt to 32,000, new data revealed... Analysts said that intense market speculation helped to drive the euro higher yesterday". Neil Parker, of RBS Financial Markets, was quoted: "Speculation is normally the driver of currency movements, and in this case it definitely is speculation driving up the euro."³¹

It was the pound's recent weakness (and previous strength) that was discussed by the Economist on May 17, 2003. "Slung out of the ERM in 1992, sterling had sand kicked in its face until mid-1996. Then it started to do the kicking. By January 1999, when the euro was launched, the pound's trade-weighted value (the broadest measure of its worth) had risen by 20%. Over the next year and a half sterling gained still further, particularly against the euro, rising as high as euro1.75 in 2000".³² Why was the pound so strong? In the Economist's view, there were three main reasons. First, Britain restored the credibility of its monetary policy so that currency dealers ceased to worry about a return to high inflation eroding the value of the pound. Second, the economy, and especially the City of London, did well in the 1990s, and this encouraged investment inflows of foreign money. Third, currencies overshoot: dealers marked the pound down too far in the mid-1990s and marked it up too much at the end of the decade. "But now the pound has fallen back to earth. So far this year its trade-weighted value has fallen by 6%. The decline since October has been the biggest since the pound left the ERM. The fall has been especially marked against the euro: sterling has dropped to its rate at the launch of the euro in 1999". What were the reasons now? In the Economist's view the main reason for the fall of the pound was simply the fact that the pound had previously overshoot. But it was also important that the markets had started to question the underlying health of the British economy.

On May 20, 2003 Anatole Kaletsky of the Times again wrote about the US current account deficit – not exactly as a reason for the decline of the dollar (or, more precisely, the rise of the euro, as Anatole Kaletsky noted) but rather as a problem to be solved with a falling dollar: "The main reason why the dollar's decline is said to accord with "economic fundamentals" is the alleged imbalance in the global economy. This is evidenced by the huge deficit in the US current account - \$503 billion last year and likely to rise to \$600 billion (£370 billion) in the year ahead. Another way of looking at this trade deficit is to say that Americans are consuming

³¹ "Bets on euro to rise further". by Lea Paterson. *The Times*, 13 May 2003, p. 21

³² "Why the falling pound brings gloom", *The Economist*, 17 May 2003, p.12

and investing more than they are producing - and borrowing from the rest of the world to make up the difference - at a rate of \$600 billion a year. Borrowing on that scale can be sustained for several years, but not forever. Sooner or later it has to be reduced".³³

Also on May 20, 2003 Reuters' correspondent John Parry discussed the role of currency speculators in the euro's spectacular rise³⁴: "Hedge funds and other speculative investors are back in the limelight in currency markets after billionaire investor George Soros said... he was selling the dollar against most major currencies. Soros's salvo was confirmation of what currency market data had suggested: that short-term currency market investors are a key catalyst pushing the euro higher against the languishing greenback, analysts said.". According to Parry, the dollar's general weakness is driven by the widening U.S. current account deficit, disappointing economic data and investors' search for higher-yielding assets elsewhere. But specifically against the euro, speculators are playing a big role in dragging the dollar lower: "unlike long-term investors, such as pension funds and insurers, speculative investors often do not stay committed to a currency market bet for sustained periods. Hedge funds and commodity trading advisors can be highly leveraged and often protect their positions with stop loss orders, which can exaggerate the speed of a currency's direction".

On May 21, 2003, The Times in its leading article attributed the dollar's decline to the interest rate differentials. "The dollar's decline against the euro is not driven by relative economic growth, as eurozone fanatics would like to think: America's growth is still outpacing that of the eurozone. The forces at work are many and varied but stubbornly high European interest rates are clearly a factor".³⁵

Two days later The Times quoted Warren Buffett, the billionaire investor, who said that the sharp fall in the dollar was little surprise and could be blamed on the vast US current account deficit: "When a country starts running a 4 or 5 per cent current account deficit its currency is not going to appreciate, that's for sure. We are a country that is buying more from the rest of the world than we are selling and we are doing it on a big scale."³⁶

When on May 28 euro hit a record high of \$1.1932 (about 45 per cent from its record low of \$0.8230 in October 2000), Gary Duncan, economics correspondent of the Times wrote, that the rise of the euro was driven by "market anxieties over the US economy and America's looming trade and budget deficits". However, it was not a vote of confidence in the eurozone. Gary Duncan also mentioned analysts who had given warning that the euro could rise more as the dollar continues to tumble. "The sky's the limit," David Bloom, of HSBC in London, said. "This is the beginning of the bear market for the dollar... We've got a situation in which there's a rebalancing

³³ "Dollar fall is wake-up call for Europe", by Anatole Kaletsky. *The Times*, 20 May 2003, p. 26

³⁴ "Soros underscores hedge funds role in weak dollar", by John Parry, *Reuters*, 20 May 2003, 16:41, news

³⁵ "Currency shifts are significant, but not a cause for panic". *The Times*, 21 May 2003, p. 23.

³⁶ "Dollar's fall expected". *The Times*, 23 May 2003, p.27

where the world thought the US was fantastic and now they're seeing the US as just another economy." ³⁷

In May 2003 the author obtained from Mike Nolan of the Reuters the general commentary on the subject of this paper. Mike Nolan noted, that there is very little consensus about the major driving forces behind exchange rate movements of the last three years and the way different media have covered it has depended largely on what timeframe they are watching and what audience they are aiming at (intraday traders/daily newspapers/weekly magazines/broadcast media etc). It also clearly depends on whom they are using as sources for information -- government officials/market traders or analysts/academic or think-tank economists .

Mike Nolan suggested that behind the major exchange rate shifts in the dollar and euro at least since the launch of the euro in 1999 had been the following influences. The introduction of the euro created a 12-country bloc with the some of the highest savings in the world. When the euro was born, these domestic savings invested elsewhere within the bloc were suddenly all denominated in the same currency. Basic asset diversification theory, alongside ongoing deregulation of the asset management industry in Europe, suggested that these savings should seek great currency diversification and the most obvious "other" currency was the dollar. Crucially, this happened at the tail-end of the 1990s stock market bubble on Wall St/Silicon Valley and when European investor appetite for deep and liquid equity markets was at its peak just as EU regulators were allowing investment funds to hold larger and larger proportions of relatively higher risk equity over government bonds and fixed income.

The result was that between Jan 1999 and late 2000, a wall of European money chased U.S. equity returns as the widening U.S. deficits required greater and greater pools of foreign capital to balance the national current account. The result was a drop in the Euro/Dollar exchange rate of some 30 percent during that period -- despite often superior short-term interest rate returns on euro deposits. A key explanation of the latter was that cross-border flows were increasingly more equity focussed than in previous decades and hence more concerned with long-term growth and earnings potential (and hence favouring a low interest rate environment). Prior to the late 1990s, the bulk of intra-G7 cross-border flows had been in fixed income -- where a higher interest rate/bond yield environment typically boosted the currency.

The other big issue behind this exchange rate drop was that the economic impact of exchange rate movements in Europe and the U.S. (where roughly only about 10 percent or less of GDP in euro zone or the U.S. come from overseas trade) was minimised after the euro (most of euro zone trade is between its members). This means there can be greater exchange rate shifts between the blocs before there is sufficient political pressure to do anything about it. The slide of the euro/rise of the dollar halted a few months after Wall St peaked and it became obvious that the stock bubble had been burst. The low was effectively defined by agreement between the G7 nations that the U.S. would have increasing problems funding its yawning current account deficit in an environment of falling stock markets and if the dollar was not to weaken, it would face a larger, more destabilising collapse later on.

³⁷ "Soaring euro poses economic threat", by Gary Duncan. *The Times*, 28 May 2003, p.4

The result was that G7 agreed coordinated intervention to buy euros for dollars in September 2000 as the group's finance ministers met in Prague for the IMF meeting that month. Although the intervention had only a limited effect immediately, and the ECB continued to intervene unilaterally for several weeks after, this bout effectively marked the low for the euro. After that, the U.S. stock market slide and U.S. economic slowdown accelerated the weakening of the dollar and, as above, had two key effects -- one that the European savings that flocked to Wall St started to return home and also that investment fund appetite for equity was seriously dulled, seeing a greater focus again on fixed income, relative interest rates and yield. September 11 and its aftermath only exaggerated these trends by forced investors to put greater amounts of capital in relatively safe government debt and seek the AAA-rated government debt with the most attractive yield. The euro/dollar rebound took root after 9/11 and between May 2002 and May 2003 has jumped about 30 percent. There are many, many other factors at work here -- but the sheer scale of capital that flows between the world's two richest economic areas on a day-to-day basis is virtually impossible to explain fully on a daily basis.

Christopher Swann of the Financial Times, in his remarks to the author, stressed the role of the US current account deficit in the recent weakening of the dollar.

Thus, we read quite different explanations of the behaviour of the world leading currencies -- from the current account deficits, basic balances and currency diversification, to the economic prospects of the US and Euroland (with the implications for long-term interest rates) and the existing interest rates. Now it would be useful to look at the explanations for even more spectacular currency movements -- namely currency crises in East Asia and Russia.

CHAPTER TWO: EXPLAINING THE COLLAPSE OF THE CURRENCIES

It is rather senseless to follow the chronological order of events during the currency crashes in East Asian economies and in Russia –because it is difficult to say, that there are events in the currency markets, if the exchange rates are fixed. The currencies in question did not depreciate gradually, like the dollar or the pound. There were no fluctuations of the exchange rates to comment on. Simply at one moment these currencies crashed: in July 1997 the government of Thailand stopped throwing its foreign exchange away in defending the pegged exchange rate of its national currency. Once the baht was floated, speculators forced all other East Asian currencies with dollar pegs to follow suit. The Philippines and Malaysia followed Thailand in July, then Indonesia floated in August and South Korea in December. The five Asian currencies hardest hit had fallen by 80% against the dollar by the end of the year of 1999.

The Russian rouble collapsed in August 1998, slipping from about 6 roubles to the dollar to 20 roubles in a very short period. So it would be reasonable to analyse the different explanations of these currency crashes, not especially paying attention to the date of the publication (it should be noted, of course, that the journalists in their articles very often offered several explanations simultaneously). The explanations for the sad fate of Asian and Russian currencies seem even more interesting, taking into account the striking differences between East Asia and Russia. East Asian developing economies grew very rapidly during the recession in the high-income countries of the early 1990s. Between 1990 and 1995, for example, average annual growth was 8.7% in Malaysia, 8.4% in Thailand, 7.6% in Indonesia and 7.2% in South Korea. Russia's production tended not to increase, but to decrease. Overall export (mostly manufactured) growth in East Asia in dollar terms was 22.8% in 1995, while in Russia manufactured exports were hardly present at all. Finally, Russia suffered from huge budget deficits, while in East Asia the state budgets were roughly balanced.

The first explanation of the Asian currency crisis, traditionally enough, was the current account deficit. For example, the *Financial Times* wrote³⁸, mentioning also the devaluation of the Mexican peso in 1995 and Czech koruna in 1997: "Still, the Thai and Czech experiences do hold some lessons. Both countries, like Mexico before them, exhibited high current account deficits... The key issue, though, is not so much deficits themselves as how they are composed and funded: borrowing money to fund investment is more sustainable than deficits that merely fuel consumption; and foreign direct investment is a better way of meeting the funding gap than short-term portfolio flows... Speculators will doubtless have run their slide-rules over countries like Slovakia and Ukraine that also have large deficits". Greta Steyn and Simon Kuper noted in the *Financial Times*: "The baht fell next. Thailand... had a current account deficit and slowing economy... Forex (foreign exchange —S.M.) strategists are now making lists of the next currencies to tumble. They say a high current

³⁸ "Emerging markets" Lex comment, *Financial Times*, 5 June 1997, p.29

account deficit is the most reliable sign that a currency is in trouble”³⁹. Martin Wolf stressed that Thailand in 1997 like Mexico in 1994 and 1995 had a current account deficit of 8% of gross domestic product: “In Thailand, as elsewhere in east Asia, difficulties began with the export slowdown last year...Deteriorating export performance and slower economic growth made the current account deficit look unsustainable... The bears rushed for the door”⁴⁰.

The second explanation is closely connected with the first and deals with the question why, in fact, the current account deficits emerged in East Asia. The answer is that an appreciation of national currencies was to blame for the crisis. As Martin Wolf wrote, a big stimulus to exports from East Asian developing countries was the decline in the US dollar against the Japanese yen. For Thailand, with an exchange rate pegged against the US dollar, this meant greater competitiveness in both the Japanese market and against Japan-based production in third markets. But with the rise of the dollar against the yen, Thailand and other East Asian countries lost their competitiveness: there was “an 18% real appreciation of the baht against the yen between 1995 and 1996...It would be just as reasonable to compare the currency turmoil in east Asia today with the disintegration of the hard exchange rate mechanism of the European Monetary System between September 1992 and August 1993. In Europe, German unification made the ERM unworkable. In east Asia, it has been the gyrations of the dollar against the yen”⁴¹.

Jeffrey Sachs, the director of the Harvard Institute for International Development, wrote in the *Financial Times*, that economic reforms and financial liberalisation usually produce a spurt of capital inflows, which chase high rates of return. The inflows in turn lead to currency appreciation, while the spending boom financed by the foreign flows leads to higher prices of non-traded goods, services and real estate. The short-run currency appreciation offers an incorrect reading of future relative prices.

Since the capital inflows must be repaid in the long run by increased net exports, the exchange rate is most likely to have to depreciate in real terms to service the capital inflows. According to Sachs, Thailand’s 1997 crisis had the following features: “overvaluation of the real exchange rate, coupled with booming bank lending, heavily directed at real estate. The overvaluation is tending to push new investment towards non-tradable sectors - notably construction - and away from the tradable sectors that are necessary to provide the wherewithal for future servicing of foreign debts. ...Compared to a base of 1990, Malaysia, Singapore and Thailand had appreciated by about 10%, Indonesia by about 20%, the Philippines by about 30% and Poland and Brazil by more than 100%”.

³⁹ “Speculators target emerging market currencies”, by Greta Steyn and Simon Kuper. *Financial Times*, 11 July 1997, p.4

⁴⁰ “No more than a blip – Thailand’s currency ‘crisis’ - inevitable consequence of overheating”, by Martin Wolf. *Financial Times*, 15 July 1997, p. 22

⁴¹ *Ibid.*

Jeffrey Sachs also noted, that most emerging economies pegged their currencies to the dollar, even though their trade with the advanced economies was roughly equally divided between the US, Europe and Japan. When the dollar appreciated sharply against the yen and the European currencies after 1995, emerging-market currencies were pulled along in its wake: “Even though the Thai currency looked stable at Bt25 per dollar until June 1997, in fact the baht appreciated from Bt 0.25 per yen in January 1995 to Bt 0.21 per yen in June 1997.”⁴² Some authors noted that overvalued currencies and current account deficits in Asian countries were accompanied by very low inflation. For example, Burton Malkiel wrote in the *Financial Times*: “Few analysts even hinted at the possibility of the unprecedented collapse that toppled emerging markets in Asia last year. To be sure, we can see in retrospect that the Asian Tigers and Tiger Cubs that had pegged their currencies to the dollar were becoming less competitive as the dollar appreciated and current account deficits grew. But inflation was low and government budgets were more or less in balance.”⁴³

Thus the collapse of the Asian currencies could even play the positive role – at least, these currencies ceased to be overvalued: “Just as many now call the sterling devaluation of September 16 1992 “white Wednesday”, so people are likely to see the decisions by the Thai and Philippine authorities to float their currencies as the beginning of recovery”.⁴⁴

The third explanation: it was uncontrollable access to world capital markets to blame. In Martin Wolf’s view, “financial instability and market economies go together like a horse and carriage. Look at the number of banking crises that have afflicted high-income countries over the past two decades. But this is particularly true in fast-growing economies with mollycoddled banking systems, inexperienced regulators and sudden access to world financial markets. Merely deregulating such a financial system is not reform. It is a recipe for disaster.”⁴⁵ He noted that, with a fixed exchange rate and eroding controls on capital flows, the authorities could halt neither domestic credit expansion nor the capital inflow. Thus, in Thailand, the ratio to GDP of bank credit to the private sector rose from 28% in 1980 to 89% in 1995. Companies and individuals owed more than \$70bn abroad, a sum equal to about half the country’s economic output.

Jeffrey Sacks also tended to blame financial market liberalisation. As he wrote, throughout Latin America, central Europe and Southeast Asia, banks had been deregulated and privatised, allowing them much greater latitude to borrow from abroad. Banks and near-banks - such as Thailand’s now notorious financial trusts - became intermediaries for channelling foreign capital into the domestic economy. “The trouble is that the newly liberalised banks and near-banks often operate under highly distorted incentives. Under-capitalised banks have incentives to borrow abroad and invest domestically with reckless

⁴² Lessons from the Thais. By Jeffrey Sachs. *Financial Times*, 30 July 1997, p.26

⁴³ Rich in eastern promise. By Burton Malkiel. *Financial Times*, 1 June 1998, p.12

⁴⁴ No more than a blip – Thailand’s currency “crisis” - inevitable consequence of overheating. By Martin Wolf. *Financial Times*, 15 July 1997, p. 22

⁴⁵ Ibid.

abandon. If the lending works out, the bankers make money. If the lending fails, the depositors and creditors stand to lose money, but the bank's owners bear little risk themselves because they have little capital tied up in the bank. Even the depositors and the foreign creditors may be secure from risk, if the government bails them out in the case of bank failure".⁴⁶

The fourth explanation was based on the external forces: speculators and international investors. Greta Steyn and Simon Kuper wrote in the *Financial Times* about the speculators, "who prompted the devaluation of the Thai bath".⁴⁷ They stressed, that, crucially, emerging markets offered far higher yields than the world's biggest economies, where interest rates were unusually low. Many investors borrowed yen at Japanese rates of 0.5% in order to buy high-yielding emerging currencies - the so-called "carry trades". The turnaround came in May, when currencies traders decided Japan would raise interest rates soon. Investors hurriedly repaid their borrowed yen before the interest on their debts rose. High-yielding currencies collapsed.

The fifth explanation could be the high levels of the short-term debt, accompanied by the falling official reserves. One could imagine that the lack of foreign currency in East Asian countries would be the most popular subject for comments, but the falling reserves were mentioned in the press comparatively rarely. Nevertheless, they were mentioned. For example, William Barnes reported from Bangkok on July 3, 1997, that some \$45bn of corporate debt would become due within the next 12 months as the freeing up of Bangkok's financial system had allowed Thai-based businessmen to take out cheap foreign loans facing almost no foreign currency risk. At the same time the Bank of Thailand's reserves fell \$4bn in May to \$33.3bn in June- the lowest level in two years.⁴⁸

The sixth explanation was the poor state of Asian banking system, which led to a property bubble: "Domestic banks have been poor intermediaries, channelling too much money into property, thereby making the corporate sector over-reliant on foreign capital. Other countries in the region, such as the Philippines and Malaysia, should also heed the warning from Thailand and start reforming their financial systems urgently".⁴⁹

The *Economist* in an article, entitled "Why did Asia crash?", wrote: "Diverse as they are, the East Asian countries have two characteristics in common. Throughout the region a boom-bust cycle in asset prices preceded the currency crisis. And in each case, banks and finance companies that lent on overly risky projects lie at the heart of the problem. In an intriguing new paper Paul Krugman of the Massachusetts Institute of Technology shows how these ingredients might suddenly precipitate a crash...Mr Krugman, who pioneered formal economic analysis of what causes currency crises, points out that Asia's

⁴⁶ "Lessons from the Thais", by Jeffrey Sachs. *Financial Times*, 30 July 1997, p.26

⁴⁷ "Speculators target emerging market currencies", by Greta Steyn and Simon Kuper. *Financial Times*, 11 July 1997, p.4

⁴⁸ "Thai currency regime scrapped - Shares climb as baht is freed from link with dollar", by William Barnes, *Financial Times*, 3 July 1997, p.1

⁴⁹ "Floating bath", *Financial Times*, 4 July 1997, p.23

banks and finance companies operated with implicit government guarantees. These, together with poor regulation, distorted investment decisions, encouraging bankers to finance risky projects in the expectation that they would enjoy the profits, if any, while the government would cover serious losses... The model suggests intriguing conclusions. First, Asia's real problem lies with banks and their regulation".⁵⁰ Simon Davis stated in the *Financial Times* in 1998, as a lesson for Russia, that Asian banks pumped the region's abundant savings into excessive property development, market speculation and manufacturing capacity, building a bubble which burst spectacularly⁵¹.

However, it was not so clear, what was to blame for the, so to speak, bad behaviour of the Asian banking system. As Charlotte Denny noted in the *Guardian*, the IMF line was that inefficient financial sectors were the primary cause of the crisis. Those bad investment decisions which were exposed by the crisis would not have been taken if the Asian tigers had deregulated properly and opened up their banking sectors to competition from foreign banks. The alternative line – of the World Bank – was that there was insufficient regulation. Credit flows are dangerous things, particularly short-term flows. So the developing countries in particular should be able to protect their economies from the destabilising effects of large tides of money flowing in and out by taxing short-term foreign borrowing.⁵²

The seventh explanation, not surprisingly, was the mismanagement of the economy due to crony capitalism. For example, the leading article in *The Times*, headlined "The torrid politics behind Asia's turbulent currencies" stated that the run on Asian currencies had been triggered by some bad luck, but a lot of bad management. The bad luck was the rapid rise in the dollar, to which most Asian currencies had been pegged. The bad management had not been limited to governments' reluctance to listen to IMF advice to take remedial action by loosening their links to the dollar, tightening budgets and curbing speculation in property markets. "Asian governments... have been culpably reluctant to tackle the evils of crony capitalism, insider dealing and lax financial regulation. One reason is that far too many Asian politicians are in the money-spinning game up to their Rolexes». For the Asian countries it is common "an interplay between politics and money so intimate that in Indonesia, for example, informal expenses such as licence-buying and straight bribes account for up to 15% of the capital costs of new investment. Thai politicians routinely buy votes and make back the money, with interest, in office".⁵³ For a decade at least, said the *Times*, global risk analysts have tended to shrug off pertinent questions about rigged property markets, dodgy financial practices and unhealthy close links between politics and business with soothing murmurs about the "sound fundamentals" of Asia's boom economies. They may take a sharper look after this.

⁵⁰ "Why did Asia crash?" *The Economist*, 10 January 1998, p.20

⁵¹ "Asia provides a sobering lesson", by Simon Davies. *Financial Times*, 15 April 1998, p.4.

⁵² "Why did the tiger economies turn into lame ducks?", by Charlotte Denny, *The Guardian*, 30 March 1998, p.17

⁵³ "The torrid politics behind Asia's turbulent currencies". *The Times*, 12 August 1997, p. 17

The eighth explanation was a mismanagement of the economy, typical to all countries and not uniquely connected with Asian economies themselves. As Janey Bush wrote in the Times: “There is nothing exclusive about macroeconomic misjudgement and inappropriate vainglory. Running up a huge current account deficit is not an East Asian phenomenon (ask Reagan’s America), nor is pegging one’s currency at an inappropriately high level (ask Britain’s Conservative Party), nor allowing a damaging property market bubble to unbalance one’s economy (ditto).”⁵⁴ The position, expressed in the Financial Times, was quite similar: Asian governments have made themselves vulnerable by internal inconsistencies in economic policy. “The fate of the rupiah was sealed when Indonesia tried 10 days ago to cut interest rates amid concerns about the health of smaller domestic banks. That was not compatible with a managed exchange rate, however flexible the regime. . The days when exports could be promoted by holding the exchange rate down are gone. Freedom of capital movements means Asian countries are paying a heavy price for not allowing their currencies to appreciate in the boom period of 1994 and 1995... A more balanced approach to growth is called for, in which exports are not the only locomotive. In the long run a monetary policy targeted towards domestic price and credit stability is better for business than an artificial exchange rate target”.⁵⁵

The British media responded to the Russian currency crisis responded with less sophisticated theories and more unanimously (perhaps due to the fact that there was no evidence of a property bubble and limitless credit expansion of the banks). Thus, there was more information in the press about Russian reserves and debts. The Economist wrote before the crisis, in the end of 1997, that interest rates had spiked above 50%, as on December 3rd, the central bank’s governor, Sergey Dubinin, said reserves had fallen to about \$18 billion, down from \$21.5 billion on November 21st. More Russians were trading in roubles for dollars: “Foreign investors have been pulling out of Russian markets mainly because they fear for the rouble. They also fear for the banking sector and the scale of its unhedged dollar liabilities. Analysts estimate these borrowings are between \$5 billion and \$15 billion - money that the banks have lent out in roubles but which they will need to repay in dollars. A collapse of the rouble would make these debts much more expensive to repay, probably driving some banks under”.⁵⁶ The Economist also stressed that, in part, Russia was sharing the problems of emerging markets around the world. But weak fiscal management had exacerbated its plight. The only big domestic borrower was the government itself, which had a budget deficit equal to 8% of GDP. So the government ended up paying most of the bill for any rise in interest rates.

In March 1998 John Thornhill reported from Moscow for the Financial Times, that the central bank had bought \$600m of foreign currency, rebuilding its reserves to about \$16bn.⁵⁷ Such was its optimism that on it also had chopped

⁵⁴“Mauling is not exclusive to Asian tigers”, by Janey Bush. *The Times*, 2 September 1997, p.31

⁵⁵ “Asia’s money”. *Financial Times*, 18 August 1997, p.13

⁵⁶ “Russian roublette”, *The Economist*, 6 December 1997, p.36

⁵⁷ “Russia seeks to level debt mountain”, by John Thornhill. *Financial Times*, 16 March 1998, p.27

six percentage points off the refinancing rate to 30%. Yields on Russian eurobonds, which had shot up to 630 basis points over US Treasuries in November 1997, had narrowed again to less than 450 points over. Yields on domestic treasury bills [GKOs] had even tumbled to less than 30% as investor confidence grows. Nevertheless, stressed the author, “although, in theory, resource-rich Russia should have no trouble in sustaining a large volume of debt, it runs the risk of a short-term cash-flow crisis. This year, Russia will spend one-quarter of all federal expenditure - or 4.4% of GDP - on servicing its internal and external debts, some 50% of GDP”.

In May 1998 James Meek of the *Guardian* noted that the Russian reserves - worth \$14.5bn - were considerably lower than the \$20bn of Russian government bonds held by foreigners.⁵⁸ He also reminded the readers of the surprisingly high interest rates in Russia – 150%. However, he did not come to the conclusion that this posed such a problem for the ordinary people: “The mortgage and the overdraft are unknown to Russians”.

The *Financial Times* explained why high interest rates were so dangerous for the rouble: because of the budget deficits and a vicious circle of debt-servicing costs. According to the authors, unlike Asia’s tigers, Russia did not have a foreign currency debt problem, but it had a foreign debt one. “Eventually, investors could refuse to buy government paper leaving the authorities no choice other than to allow the money supply to rip... Before that occurred, pain would be felt in the foreign exchange market. If outside investors decided to liquidate their large holding of government bonds, the government’s foreign exchange reserves would be quickly exhausted. That would force a devaluation of the rouble, undermining the government’s entire stabilisation policy”.⁵⁹

Just before the crisis, the *Guardian* published an article: “Rescuing Russia from the ruble, where the whole situation was described in the following terms: “The case against devaluation is straightforward. A cheaper rouble will not help the government collect taxes, it will not solve the crunch facing the banking system, it will do little for industry’s investment and production planning. Nor will it do anything to offset the impact of the fall in the world oil price. Unfortunately, such thinking is unlikely to inform investor intentions. Funds are being pulled out, the central bank is bleeding reserves, the government is having trouble even in finding sufficient takers for its paper to roll-over maturing debt, let alone raise new money. A number of Russian banks saw their credit ratings downgraded yesterday, reflecting the precipitous deterioration of market conditions in Russia, owing to a severe confidence crisis, and liquidity drying up. One bank even saw its credit rating revised to “not meaningful””.⁶⁰

After the crisis, the *Times* wrote: “Devaluation is not painless. Millions of Russians will discover that this winter as they compete for costlier food

⁵⁸ Russia puts its all into fight to save firm rouble. By James Meek. *The Guardian*, 29 May 1998, p.2.

⁵⁹ Russia - Market jitters. *Financial Times*, 19 May 1998, p.28

⁶⁰ Rescuing Russia from the ruble. *The Guardian*, 14 August 1998, p.20

imports after another inadequate harvest. It is not even painless for business. Russian banks and companies (along with Boris Yeltsin's government) have far too much foreign debt, mainly because the nation's own citizens did not trust them with their money".⁶¹

Thus, we can conclude that as the primary cause of the Russian crisis the British media acknowledged the striking gap between the official reserves and the foreign debt of the banks, companies, and most of all, the government.

The Russian worsening current account was mentioned, of course, but not as the result of currency appreciation. It was very obvious that the problem was caused by the falling oil prices, not by too strong a national currency. As the Economist put it, few Russian manufacturers could honestly complain that an over-strong rouble had been making their goods uncompetitive on the world market⁶². Richard Miles pointed out in the Times that devaluation of the rouble seemed inevitable simply because Russia's economy is highly dependent on commodities, the prices of which were extremely depressed, while many other countries with a similar reliance on commodities had seen a substantial depreciation of their currencies.⁶³ Janet Bush wrote, that Russia was to plug the current account black hole left by the slump in world oil prices. She also noted, that "Russia faces some tough choices if it is emerge from the crisis of confidence that, more than contagion effects from Asia, is due to the collapse in the price of crude oil which, with gas, accounts for more than 50% of its exports"⁶⁴.

Accordingly, the British media did not expect any positive effect of the devaluation for the Russian economy (a striking contrast with the commentaries on the East Asian economies). "The rouble's devaluation will not do much to create jobs in industry, because Russia's miserable output of manufactured exports - chiefly clunky cars, vodka and weapons - is not very price-sensitive. Most of Russia's exports are dollar-denominated commodities, which will not benefit from a cheaper rouble. Although imports have become dearer, those relatively affluent consumers who favour French cosmetics and German cars are unlikely to find Russian goods acceptable substitutes".⁶⁵

⁶¹ "Russians face a winter of Soros." *The Times*, 18 August 1998, p.25

⁶² "A detour or a derailment?", *The Economist*, 22 August 1998, p.22

⁶³ "Heavy casualties in Russian roulette", by Richard Miles. *The Times*, 22 August 1998p.50.

⁶⁴ "Devaluation looms large as lesser of two Russian evils", by Janet Bush. *The Times*, 14 August 1998, p.29.

⁶⁵ "A detour or a derailment" *The Economist*, 22 August 1998, p.22

CHAPTER THREE: DISCUSSION

We can suggest, that the British journalists in their comments on the exchange rates are, in most cases, reflecting the existing academic theories on exchange rates.

Traditionally, economists have identified interest rates, price levels and international payment balances as three classes of economic variables to which the behaviour of exchange rates is linked. For example, Paul Krugman of Princeton and Maurice Obstfeld of Berkley) in their classic textbook “International economics: Theory and Policy” treat the subject as follows. Exchange rates are determined in the foreign exchange market. Commercial banks play a main role in the market because they facilitate the exchange of interest-bearing deposits that make up the bulk of foreign exchange trading. Because the exchange rate is the relative price of two assets, it is most appropriately thought as being an asset price itself. The basic principle of asset pricing is that an asset current value depends on its expected future purchasing power. In evaluating an asset, savers look at the expected rate of return it offers. If risk and liquidity factors do not strongly influence the demand for foreign currency assets, participants in the foreign exchange market always prefer to hold those assets yielding the high expected rate of return.

The returns on deposits traded in the foreign exchange market depend on interest rates and expected exchange rate changes: “Equilibrium in the foreign exchange markets requires interest parity; that is, deposits of all currency must offer the same rate of return ... For given interest rates and given expectations of the future exchange rate, the interest parity conditions tells us the current equilibrium exchange rate. When the expected dollar return on euro deposit exceeds that on dollar deposits, for example, the dollar immediately depreciates against the euro. Other things equal, a dollar depreciation today reduces the return on euro deposits by reducing the depreciation rate of the dollar against the euro expected for the future...All else equal, a rise in the dollar interest rates causes the dollar to appreciate against the euro while a rise in euro interest rates causes the dollar to depreciate against the euro”⁶⁶.

A deeper study of the exchange rates determination, based on the linkages among monetary policies, inflation, interest rates and exchange rates (and including factors other than money supply and demand – for example, demand shifts in markets for goods and services), is summarised in Table 1-1.

⁶⁶ Krugman, Paul; Obstfeld, Maurice. International economics: Theory and Policy, Addison – Wesley World student series, 6-th edition, 2003, p. 351

Table 1-1. Effects of money markets and output markets on the long-run nominal dollar/euro exchange rate

Change	Effect on the long-run nominal dollar/euro exchange rate
1. Increase in US money supply level	Proportional increase (nominal depreciation of \$)
2. Increase in European money supply level	Proportional decrease (nominal depreciation of euro)
3. Increase in US money supply growth rates	Increase (nominal depreciation of \$)
4. Increase in European money supply growth rates	Decrease (nominal depreciation of euro)
5. Increase in demand for US output	Decrease (nominal appreciation of \$)
6. Increase in demand for European output	Increase (nominal appreciation of euro)
7. Output supply increase in the US	Ambiguous
8. Output supply increase in the Europe	Ambiguous

Source: Krugman and Obstfeld, 2003

Keith Bain and Peter Howells of East London Business School, University of East London write that the simplest model of exchange rate determination is the flexible price monetary model. This assumes that capital is perfectly mobile, markets are competitive, and transaction costs are negligible. Uncovered interest rate parity holds – i.e. the expected rate of depreciation of a currency equals the interest rate differential between domestic and foreign bonds. The key determinants of exchange rates are the supply of and the demand for money. “*Ceteris paribus*, an increase in the rate of growth of domestic money supply causing the domestic money supply to grow more rapidly than the foreign money supply causes domestic prices to rise more rapidly than foreign than foreign prices, and, to maintain purchasing power parity, the domestic currency must depreciate. A ten-percentage point increase in the rate of growth of the domestic money supply causes the domestic currency depreciate by ten per cent.”⁶⁷.

Thus, the basic assumption is still interest rate parity: if interest rates on domestic bonds fall, currency will flow out to by foreign bonds, and this flow will continue until people come to expect a sufficient appreciation of the currency to balance the interest rate differentials.

⁶⁷ Bain , Keith; Howells, Peter. Monetary economics: policy and its theoretical basis, Palgrave Macmillan, 2003, p. 293

As Peter Isard of the IMF writes in his “Exchange rates economics”: “By the late nineteenth century, thanks partly to the experience gained in conducting British monetary policy during the gold standard era, it was common knowledge among policymakers, that the behavior of exchange rates could be influenced through the adjustment of interest rates. By rising domestic interest rates, the foreign exchange value of the domestic currency unit could be strengthened... However, it was not until organized trading in forward exchange expanded rapidly following World War I that Keynes (1923) wove together the first systematic presentation. Today this theory is commonly referred to as the interest parity hypothesis”⁶⁸

Let us note, however, that the textbook authors themselves differ in their belief in the universal validity of the interest parity hypothesis. Krugman and Obstfeld tend to be quite enthusiastic (with some reservations, of course): “We often read in the newspaper that the dollar is strong because US interest rates are high or that it is falling because US interest rates are falling... Before we conclude that the newspapers account on the effect of interest rates is correct, we must remember, that our assumption of a constant expected future exchange rate often is unrealistic. In many cases a change in interest rates will be accompanied by a change in the expected future exchange rates... The theory we developed ... suggests that exchange rates should not be completely impossible to forecast. According to the interest parity condition, interest rates differentials should give an indication of how much currency depreciation to expect... Forecasts based on economic models seem to be more successful when used for long-run predictions, that is, predictions of exchange rates years ahead”⁶⁹.

At the same time Bain and Howells note: “The predictions of this model are not supported by evidence, which is not surprising, since neither uncovered interest rate parity nor purchasing power parity hold in the short run... Portfolio models of the exchange rates overcome this by dropping the assumption, that foreign and domestic bonds are perfect substitutes. Uncovered interest rate parity does not apply”⁷⁰. Isard states: “It has become widely acknowledged, that interest differentials explain only a small proportion of subsequent changes in exchange rates (and often mispredict the direction of change).”⁷¹.

Interestingly enough, Krugman and Obstfeld used the model of interest rates and expected exchange rate changes for an explanation of the dollar exchange rate in 2000-2001, during the US economic slowdown. The US economic expansion ended in the autumn of 2000. The Federal Reserve, which had been raising interest rates, changed its policy. Between January and November 2001, the Fed lowered its interest rate from 6.5 to 2 percent. “With aggregate demand for US goods falling and interest rates falling at the same time, a depreciation of the dollar would seem to be a foregone conclusion. Yet that was not what happened... The dollar returned to its upward trend early in the 2001... In terms of our model, could only be explained by a simultaneous, and significant, expected future appreciation of the dollar”⁷². No

⁶⁸ Isard, Peter Exchange rates economics, Cambridge University Press, 1999, p.74.

⁶⁹ Krugman, Obstfeld. Op. cit, pp.347, 349

⁷⁰ Bain, Howells. Op. cit, pp.290, 295

⁷¹ Isard, Op.cit., p. 82

⁷² Krugman, Obstfeld. Op. cit, p.461.

need to recall, that expectations -if there were such expectations- have not been realized in 2002-2003 (S.M).

In the analytical materials of the IMF we can meet an even more sophisticated approach to the role of interest rates in defining the fate of the dollar in 2002-2003 (obviously also not unknown to the journalists). “A precipitous fall in the dollar could also have potentially destabilizing consequences, given the buildup over time of large holdings by foreigners of US financial assets. The composition of these holdings and capital flows has changed over time from equity and foreign direct investment to fixed-income securities...When investors focused on equities, growth differentials and relative productivity improvements – which favored the US – were at the forefront of their concerns. Now, however, given investors disillusionment with equities and their refocus on fixed-income securities, interest rates differentials have become paramount. Consequently, the decline in US yields to levels below those in Europe has reduced the attractiveness of the US fixed-income market and thereby contributed to the dollar’s decline”⁷³. Thus, interest rates differentials are important – but not always.

What about the links between exchange rates and international payment balances? As Isard notes, economists have long emphasised the interdependence between exchange rates and the balance of payments. A rudimentary awareness that exchange rates adjust to international payment imbalances can be traced back to the fourteenth century, when secondary markets had emerged for the bills of exchange issued by different European banking centres. Most models of exchange rates and the balance of payments during the 1940 and 1950 (under the Bretton Woods system) treated the current account as the only endogenous component of the overall balance of payments. At the same time, the exchange rate was regarded as given or fixed by policymakers.

Some of the features of the early current account models continue to be featured in modern models of flexible exchange rates: expectations about the future path of the exchange rates depend on sustainable path for the current account. “The belief that current account developments impose a constraint on the exchange rate in the long run rests on the notion than large and persistent current account imbalances are unsustainable, together with the perception that current account adjustments can be achieved through changes in real exchange rates, all else being equal. Thus, given the time path of other variables that influence the current account, the real exchange rate cannot be sustained at a level that would generate large and persistent current account deficits”⁷⁴.

As we have seen, some of the British journalists share above-mentioned perception. The IMF, the architect of the system of coordinated fixed exchange rates, which paid so much attention to such things as “fundamental disequilibria” in a country’s balance of payments, of course, shares them. It is constantly mentioned in the IMF documents that huge US current account deficit can be unsustainable and poses a threat to the dollar⁷⁵.

⁷³ Global financial stability report. Market developments and issues. March 2003,IMF,p.3

⁷⁴ Isard. Op.cit., p.128

⁷⁵ See World Economic Outlook. April 2002. Recessions and recoveries, IMF; World Economic Outlook. September 2002. Trade and finance, IMF

Even the war-related uncertainty and risk in 2002, according to the IMF's views, influenced the dollar in connection with the state of US current account. "According to market participants, this has increasingly been a negative influence on the dollar. This view of war-related pressure on the dollar, if true, marks an important difference with previous similar occasions when the dollar strengthened (Desert Storm in 1990-91, and post-September 11, 2001). One reason may be the significantly wider US current account deficit now prevailing compared to that during the Gulf War...During that earlier period ...the US current account deficit narrowed rapidly, from 3.5% of GDP in 1987 to near balance in 1991. In sharp contrast, the deficit in the third quarter of 2002 was 4.8% of GDP, an all-time record".⁷⁶ (It is still unclear, in this case, why the dollar was strong after September 11—S.M.).

Of course, the concept of basic balance, so popular among the financial journalists, is also not unknown in academic and analytical literature⁷⁷. It should be mentioned, however, that this concept, basically, acknowledges the vital importance of the current account balance for the exchange rates. The inflow of capital simply compensates, so to speak, for the deficit of the current account – that is why the national currency does not fall and even rises.

It should also be mentioned, that there are various theories, denying the role of the current account deficit and stressing the role of the stock market.⁷⁸

Now it would be useful to present our own vision of the events in the world currency market in 1999-2003. It is obvious that the introduction of the euro coincided with the US stock market boom (now often referred to as a "bubble"). The stocks were rising so fast that it was almost impossible not to invest in them for foreign speculators, pension and hedge funds and ordinary investors. Huge sums in euros moved into US assets. In 2000 foreign private purchases of US assets were \$978bn.; foreign direct investment --\$308bn.

Not surprisingly, such a demand for dollars led to the appreciation of the American currency. Meanwhile, the Fed raised interest rates – not to help dollar, but to curb possible inflation by stopping the endless rise in the stock market. In 2001 the Fed began to decisively lower its interest rates to stimulate the economic growth, which had almost stopped. Nevertheless the inflow of foreign capital in 2001 was roughly the same, as in 2000. Net quarterly portfolio inflow reached 1.4% of US GDP, and net total capital inflow – 1.6% GDP.⁷⁹ The dollar remained strong, as a result, despite the falling interest rates.

Finally, in 2002 after the bursting of the equity market bubble, corporate scandals and high-profile bankruptcies the first quarter of 2002 net portfolio inflows fell to 0,6% GDP. International investments in the US corporate and equity securities dropped to a \$39bn rate in three months to November, down from a \$85bn quarterly pace during

⁷⁶ Global financial stability report. Market developments and issues. March 2003,IMF,p. 14

⁷⁷ See, for example, O'Neil J. The foreign exchange market in 2000 and beyond. Global banking and financial policy review.2000/2001. Euromoney, 2000, P.9-16

⁷⁸ See, for example Dannels J. Pension-related outflows weigh on euro. The 2002 guide to foreign exchange, Euromoney, 2002. p.2.

⁷⁹ Global financial stability report. Market developments and issues. March 2003,IMF,p. 14

2001⁸⁰. No surprise, of course. From December 31, 2001 to February 28, 2003 S&P stock index had lost 26,7%, Nasdaq—39,1%. Now it was strange not to sell American stocks and not to save the money.

The portfolio outflow from the US was invested back to the euro. Not because the interest rates in the Euroland were substantially higher (it was obvious, that the ECB would have to lower them too), but because of the simple fact, that the euro was considered by investors to be relatively “cheap” asset with good potential to rise. It was only natural – they themselves had done everything to make it cheap. They were right: from the end of 2001 through February 2003 the euro rose about 18% against the dollar.

It is highly dubious that the US current account deficit had something to do with that. There was simply no need for it. By the way, it is also highly dubious that the current account deficit in the modern US (and in the modern UK as well) poses such a problem. Unlike many episodes in the past, the present time allows rich western countries with fully convertible currencies not to accumulate huge foreign reserves – they can very well pay for the imported goods with their own currencies, which are not only readily accepted, but even desired by foreigners. For example Japan (which in these sense is, obviously, not quite sure of its own currency) is eager to obtain the US dollars and has been accumulating reserves at an extraordinary rate: in November 2002 they were \$460.5bn, up \$58.5bn since the end of 2001.

As far as Asian and Russian crises are concerned, the British media also present the full range of the explanations, which are vividly discussed in the academic literature. For example, Paul Krugman and Maurice Obstfeld explain the Asian currency crisis in the following way. The Asian output growth was based on the rapid growth of production inputs --- there had been relatively little increase in productivity. High rates of capital accumulation produced diminishing returns and the large capital inflows were not justified by future profitability. Some analysts also have suggested, that excessive lending, driven by moral hazard, helped create an unsustainable boom in Asian economies, especially in real estate. “However, while moral hazard was certainly a factor in the runup to crisis, its importance remains a subject to considerable dispute”⁸¹.

The Russian crisis, in its turn, is explained by the fact, that in 1997 the government had slowed inflation by “substituting borrowing for seigniorage; neither the government’s attempts to collect taxes or reduce spending were very successful, and the state debt therefore had ballooned. When in addition, the prices of oil ... were depressed by the crisis in Asia, investors began to fear, that the rouble, like many of the Asian currencies the year before, was in for a steep devaluation. Interest rates on government borrowing rose, inflating Russia’s fiscal deficit”⁸².

Warwick Mc Kibbin and Will Martin note that there remains considerable uncertainty about the causes of the shocks that have hit the most dynamic of the East Asian economies. Only Korea appeared to have suffered a sizeable terms of trade

⁸⁰ Ibid.

⁸¹ Krugman and Obstfeld. Op.cit. p.690

⁸² Ibid.,p.693

deterioration. “The much criticized policy of pegging nominal exchange rates to the dollar also seems unlikely to have created the level of pressure needed to bring on a full-fledged adjustment crisis of the type observed. Only in Thailand did the US dollar appear to have appreciated significantly against trading partner currencies and even there the appreciation was relatively modest”⁸³. In their opinion, the primary cause of the crisis were the anticipated fall in the productivity of investment and declines in the expected growth rate of returns on investment.

For an overview of the academic explanations of the Asian (and not only Asian) currency crisis we can take, for example, the discussion paper by Jeffrey Sachs and Steven Radelet ⁸⁴. They list three broad categories of explanations for the East Asian crisis (1) shifts in international market conditions; (2) growing weakness and mismanagement (3) instabilities intrinsic in the international capital markets. We can easily notice that these explanations are present on the pages of British newspapers and magazines.

Strangely enough, the authors do not completely agree with the above-mentioned article of Jeffrey Sachs in the Financial Times, where he stresses the role in the crisis of the real appreciation of Asian currencies connected with the real appreciation of the US dollar. “ The sharp real appreciation of the US dollar vis-à-vis the European currencies and the yen after 1994 may have played some role... Somewhat surprisingly, our measure of real exchange rate overvaluation does not seem to be associated with a financial crisis” ⁸⁵. They are not also agreeing with those economists (and journalists), who propose the current account deficits in the Asian countries as the main cause of the crisis. “Some observers have argued, that it is the current account deficit per se, than drives the financial crises, but that is not correct”⁸⁶.

Finally, they strongly disagree with “the popular perceptions that banks were lending recklessly, especially for the real estate, and that investment quality had sharply deteriorated during the early 1990s...Bank lending was increasing rapidly...But it much too easy in hindsight to overstate the degree of bad loans, and to make sweeping statements about the reckless nature of lending and investment in Asia prior to the crisis. In addition to the property investments, there were clearly many profitable ongoing investments in manufacturing activities that were earning a solid rate of return. A substantial share of lending supported labour-intensive manufactured exports, not the kind of activities one normally associates with irrational boom-bust cycles or gambling”⁸⁷. What was the cause of the crisis in authors’ view? The panic of investors and the vulnerability of some countries to panic as measured by high ratio of short-term debt to reserves (not long-term debt – “these crises are indeed crises of liquidity, not insolvency”).

⁸³ Mc Kibbin, Warwick, Martin, Will. The East Asian crisis: investigating causes and policy responses. Brookings Discussion papers in international economics, Number 142, February 1999, p.52

⁸⁴ Sachs, Jeffrey and Radelet, Steven. The East Asian Financial crisis: diagnosis, remedies, prospects. CAER Discussion Paper N29, July 1998, Harvard (Institute for International development, Cambridge, 1998

⁸⁵ Sachs, Radelet. Op.cit., p.27

⁸⁶ Ibid.

⁸⁷ Ibid.

We should remember, that some journalists also drew attention to the obvious fact that Asian countries had comparatively high levels of short-term debt and comparatively low levels of reserves. Low reserves were also often mentioned in connection with Russian currency crisis. That was indeed very important. Why? In our view, we should admit the fact that Russian and East Asian currencies were not convertible *per se* (even if their convertibility was officially declared). Convertibility implies not merely the possibility of a comparatively free exchange of currencies permitted by the governments, but their universal acceptance as units of value to keep in reserves. It is difficult to imagine, that the roubles or even bahts are kept in international reserves of any industrial country. On the contrary, Russia and Thailand needed dollar reserves to attribute, so to speak, value to their own countries. In Russia this was especially obvious, as Russian citizens tended to use namely dollars as the first national currency. It is also quite obvious in the case of so-called currency boards e.g. in Argentina. So the problem of the crisis countries was that their currencies were not interesting for the international financial markets by themselves – the demand for these currencies emerged only in connection with the possibility of obtaining high interest rates and converting them back to US dollars. So in this case the interest rates were indeed very important to make the whole system of this “temporal convertibility” work. The current account position was also very important as it showed the capability of Russia, Thailand or South Korea to earn dollars. So the journalists, who stressed the current account deficits of Asian countries, do not seem so wrong. The cause of the currency crashes in East Asia and Russia, in our view, was the simple fact that these countries had obviously spent their reserves of hard currencies, while investors were not interested in their currencies (East Asian electronics and Russian oil are selling for dollars. Why should Western buyers need bahts or roubles?).⁸⁸

⁸⁸ See also Minaev, Sergey. *Asiatsky finansoviy crisis*. INION, Moscow, 1999

CONCLUSIONS

Our analysis has shown, that in 1999-2003 the commentaries in the British media on the exchange rate movements of the leading currencies (first of all, euro versus dollar) were completely in line with the existing economic theories of exchange rates, stressing the role of current account deficits, basic balances and interest rate differentials. As these theories seem controversial and not always valid, the commentaries and predictions in the media very often were not completely accurate and sometimes were even misleading. Nevertheless, it should be stressed, that these commentaries contained valuable insights – particularly, when discussing the role of the private capital inflows (outflows) and the US stock markets in influencing the exchange rates .

In commenting on the East Asian currency crisis the British media represented the full range of competing views as discussed in the academic literature. It should be mentioned that, in general, the media failed to predict this crisis. On the contrary, the Russian currency crisis was covered rather unanimously, with a focus on the inadequate foreign reserves and excessive foreign debt, so we can even state, that this crisis was predicted by the British media.

In our view, in commenting on the exchange rates, it is useful to distinguish between the currencies of the leading world economies (US dollar, UK pound, euro), which are truly convertible, and the currencies of other countries, which are convertible only formally. In the first case, the current account balance and interest rates have proved to play a comparatively small role (more important are capital flows in the stock markets, which are not necessarily connected with the state of a current account or interest rates). In the second case, we could observe the crucial role of foreign currency reserves, connected with the conditions of the current account balance, of the central banks and governments.