
ECN 160B Lecture 27

International Macroeconomics

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Today (and on Friday)

- Finish an application of Ch 17 material
- To Ch 20 - 22
- Negara and Soros: 1992 speculation on British Pound
- Policy Trilemma open economy (Ch 22)
- More about European Union:
 - From the history to current events

Malaysian Central Bank: 1985-1994

- Malaysian Central Bank & its Financial Guerilla war [Malaysian CB = Bank Negara]
- How does it started:
- G-5 (US, Japan, Germany, France & Britain) meet on September, 22, 1985, and announce
"the intention to encourage appreciation of non-dollar currencies"
- Market reaction: Dollar free fall
- The situation with Bank Negara as a result. Negara dollar reserves suddenly evaporated in their value (Negara used to have \$4.8 billion) → Negara started a sort of financial guerilla war against world leading economic powers

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Source: Millman, "Vandals Crown"

How Rebel Currency Traders Overthrew The World's Central Banks

p. 226-230 "Hidden Risks"

Bank Negara

- Malaysian Central Banker (former Price Waterhouse accountant) Tan Sri Dato' Jaffar bin Hussein in 1988 admits:
 - Bank Negara "honest-to-God trading" gives 40% of CB total overseas income (up from 20% a year before)
 - Negara currency trading made West (US & Europe) fear Malaysia
 - Jaffar exploited the greed of Western Bankers
 - Mechanism - similar to LTCM unwinding

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Jaffar proudly notes that Negara had a reputation of running one of the most sophisticated currency operations in the world

"exchange rate volatility since Plaza agreement of September 1985 has changed the stakes of the game"

Prime Minister Mahathir bin Mohamad: "what is wrong with our protecting our own interest? Why is it when they [rich nations] can protect their interests we cannot? I can't understand it"

Bank Negara: An Example

- Negara used to place several simultaneous transactions of £100 million [Such orders move markets].
- I.e., they were selling pounds short to trigger market panic
- September 21, 1990 sale of £ 500 - 1 billion £ → £ down 4 cents
- British banks incurred heavy losses. They attempted to form a cartel against Negara, but their foreign competitors accommodated Negara traders at non-cartel prices

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Bank Negara collapse

- 1992 loss of \$3.6 billion when Britain withdrew from European Exchange Rate Mechanism (ERM) and £ collapsed, and then Negara lost \$2.2 billion more.
- In 1994 Negara was insolvent and bailed by Malaysian ministry of finance.
- Jaffar resigned attributing losses to "poor judgment" (He expected Britain to maintain the discipline of ERM)

The Analysis of Negara Case

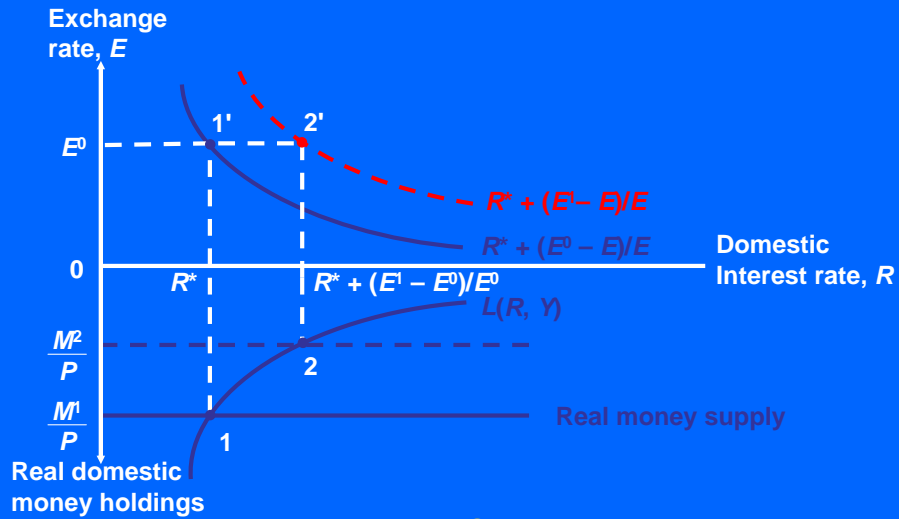
- Analysis:
 - an exception? [yes]
 - a rule of exceptions? [yes]
- US Central Banker comment:
 - "If they tried this on any organized exchange in the world they'd go to jail"
 - In the unregulated international currency markets, there were neither police, nor jailers or jailed: only rough justice of the vandals
- Negara behavior was an equivalent of financial terrorism

Balance of Payments Crises and Capital Flight I

- **Balance of payments crisis**
 - It is a sharp change in official foreign reserves sparked by a change in expectations about the future exchange rate.

Balance of Payments Crises and Capital Flight

Figure 17-7: Capital Flight, the Money Supply, and the Interest Rate



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Balance of Payments Crises and Capital Flight II

- The expectation of a future devaluation causes:
 - A balance of payments crisis marked by a sharp fall in reserves
 - A rise in the home interest rate above the world interest rate
- An expected revaluation causes the opposite effects of an expected devaluation.

Balance of Payments Crises and Capital Flight III

- **Capital flight**
 - The reserve loss accompanying a devaluation scare
 - The associated debit in the balance of payments accounts is a private capital outflow.
- **Self-fulfilling currency crises**
 - It occurs when an economy is vulnerable to speculation.
 - The government may be responsible for such crises by creating or tolerating domestic economic weaknesses that invite speculators to attack the currency.

Why crisis 1992 happened?

- Germany, the Netherlands, Belgium, Luxemburg, France, Italy, and Britain participated in an informal joint float against the dollar known as the "snake."
 - Most exchange rates could fluctuate up or down by as much as 2.25% relative to an assigned par value.
 - The snake served as a prologue to the more comprehensive **European Monetary System (EMS)**.
- Eight original participants in the EMS's exchange rate mechanism began operating a formal network of mutually pegged exchange rates in March 1979.

Soros in 1992

- During the currency crisis that broke out in September 1992, Britain and Italy allowed their currencies to float.
- In August 1993 most EMS currency bands were widened to $\pm 15\%$ in the face of continuing speculative attacks
- Soros and his speculation
 - His gains - more than \$1 bln (at this time Negara lost blns Dollars & was bailed by the government)

Monetary Trilemma in Open Economy

- **Capital Mobility and the Trilemma of the Exchange Rate Regime**
 - The macroeconomic policy trilemma for open economies:
 - Independence in monetary policy
 - Stability in the exchange rate
 - Free movement of capital
 - Only two of the three goals can be reached simultaneously.
 - Exchange rate stability is more important for developing than developed countries.

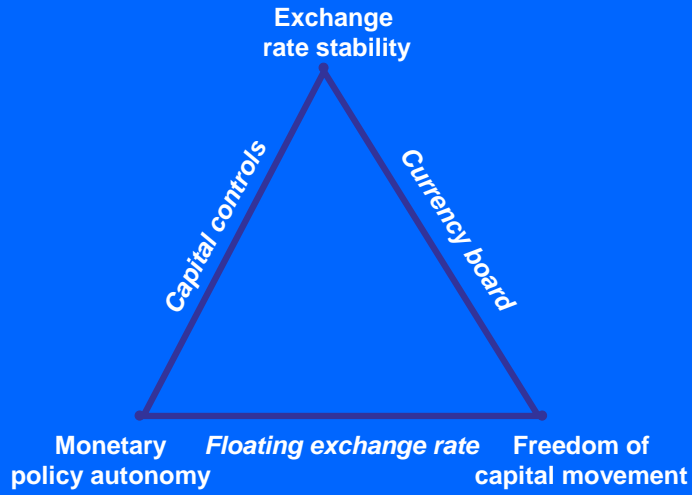
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Policy Trilemma

Figure 22-4: The Policy Trilemma for Open Economies



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Next Lecture / week

- We will cover parts of Ch. 20, 18 - 19
- Your preparation: read KO, Chapters 20 - 22

Summary of Today

- Parts of Ch 20 & Ch 22 - an application of Ch 17 material
- Negara case of "honest to God trading"
- Soros speculation on pounds in 1992
- Negara loss turned into gain for Soros
- Monetary Policy Trilemma
- Have a nice day