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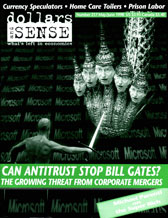
**Currency Speculation**

**How great a Danger?**

By Christian Weller

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The financial turmoil in eastern Asia has thrown its people out of work, shut down factories, and led investors to remove their capital from the area. The severe crisis in South Korea, for example, may raise unemployment to two million people this year, and has already led to drastic actions among those suffering the most. Fathers are stealing rice to feed their children, workers are going on hunger strikes to gain back wages and maintain job security, and Choi Dae-Rim, a labor activist, burned himself to death to protest layoffs.

But one group is sitting pretty in the midst of this mess: currency speculators, who buy and sell currencies to profit from fluctuations in the value of those currencies. Speculators have posted record earnings from such buying and selling since the crisis began last summer, a coincidence that many have noticed. Rightly or wrongly, the president of Malaysia has blamed his country's misfortune on currency speculators—directing much of his ire at financier George Soros—and has called for new constraints on their freedom to bet as they please.

This is just the latest, though most widespread, crisis linked to the operation of currency speculation—following soon after the Mexican financial and currency crisis in 1994-95 and the crisis over several European currencies in 1992 and 1993. Then as now, the crisis was marked by widespread economic suffering somehow linked to speculators, a few of whom amassed spectacular profits amidst the rubble. Then as now, the crisis fueled concern and anger over the functioning of currency markets.

Is this anger justified? Or do currency speculators simply help to grease the wheels of international commerce and investment, while being unfairly blamed for problems that have other roots—such as the international mobility of investment funds. The bottom line is that while currency speculation may not be the primary cause of an economic downturn, it does make financial markets prone to crisis by acting as a transmission belt that can turn small problems into catastrophes.

Equally important, currency speculators also tend to wield their power in a particular direction: They frown upon and thereby block economic policies that limit profit opportunities—such as policies that give a bigger share of the economic pie to poor and working families. So speculators not only play a role in sparking or exacerbating economic crises, but may also prevent progressive solutions to these crises.

**What is Speculation?**

Currency speculation exists whenever someone buys a foreign currency, not because she needs to pay for an import or is investing in a foreign business, but because she hopes to sell the currency at a higher rate in the future (in technical language the currency "appreciates"). This is nothing more than the old rule of buying low and selling high—only with foreign money.

Some currency speculation is necessary to facilitate international trade. Take, for example, a car manufacturer in Germany which exports cars to the United States. As the U.S. importer of German cars is paying her bill in U.S. dollars, the German exporter receives U.S. currency. But the exporter has to pay her workers and suppliers in German currency, and thus needs to exchange the U.S. currency into Deutsche Marks (DM). Someone has to buy U.S. dollars (U.S.$) so that she can buy DM. Currency traders can make money from simply being middlemen in this process, buying the U.S.$ and charging transaction fees. But many also act as speculators, hoping that they can profit from selling the dollars at a higher price in the future.

Another transaction for which currency speculation is needed is so-called foreign direct investment (FDI). FDI occurs when residents of one country buy or establish production facilities in another country. Examples of FDI in the United States include Sony in Hollywood, Mercedes Benz in Alabama, and Rhone Poulenc in New Jersey. If a foreign company wants to build a plant here they need to exchange their foreign currency for U.S.$. Again, they need to find currency speculators who will buy Yen, DM or French Francs because they expect these currencies to gain in value.

The sum of currency transactions that are directly related to trade and investment is considered the "primary exchange market," because it is linked to the exchange of real goods and services. Most currency transactions do not occur in the primary market, though, but in the secondary, or speculative, market—through which five times as much money changes hands as in the primary market.

Treasury Secretary Robert Rubin and other financiers argue that "the proper operations of secondary markets ensure liquidity in the primary markets." In layman's terms, this means that currency speculation is necessary for importers, exporters, and investors, and that more speculation is generally better than less. The more currency speculators are involved in the secondary market, the easier it is for traders and investors to buy and sell foreign exchange when they need to. Hence, "increased liquidity" means easier access to foreign currencies because there is a larger market for such currencies.

Despite this rosy picture, currency speculation can disrupt international trade and economic development. Currency speculators engage in a "guessing game" on whether a currency will increase (appreciate) or decrease (depreciate) in value. To minimize their risk, speculators use strategies that they hope make their guesses more accurate. These include gathering information on what makes for a healthy economy (often from biased sources); following the actions of other speculators, especially large ones; and using "forward exchange" markets. All these strategies can involve self-fulfilling prophecies that lead to financial turmoil, and may prevent governments from implementing humane economic policies.

**The Laissez-Faire Bias of "Information"**

Since currency speculation is a high-risk undertaking, any information that could potentially be important will be collected. Hence, currency traders spend a fair amount of time devouring up-to-date information on their computer screens. Traders look out for basic economic variables such as unemployment, inflation, and productivity growth. They are also interested in the economic institutions of a particular economy, such as labor-management relationships and financial market stability. When these indicators seem to portend higher profits, that suggests to speculators that the currency will rise in value in the future. But if the indicators predict lower profits (such as, in some cases, from falling unemployment), speculators will unload the currency and its value will drop.

Most currency speculators work for multinational banks, such as Citibank, Deutsche Bank, or Union Bank of Switzerland, and hence they think like bankers. What banks want is often represented by the actions of the International Monetary Fund (IMF). For example, the IMF recommendations for Southeast Asia, supposedly designed to stabilize local currencies, include loosening labor standards, deregulating financial markets, and opening local economies further to inroads by transnational businesses. The opposite policies would be interpreted as bad for local economies, and would prompt speculators to sell the respective currency. In short, speculators regard policies which reduce the short-term profitability of financial and industrial businesses as signals to sell a currency, while policies that expand or open profit opportunities are reasons to buy a currency.

Much of what currency speculators go by are their subjective perceptions (often based on the actions of other large speculators), rather than objective standards for evaluating the performance of an economy. For example, during the recent crisis, currency traders argued that the Southeast Asian nations brought about their own downfall because they never got rid of corruption. Yet the business world seems generally to agree that Italy is as corrupt as Thailand, and more corrupt than Malaysia or South Korea, yet nobody has proposed selling-off Italian Lira.

**Herd Behavior**

While the processing and interpretation of information is an integral part of currency markets, "herd behavior" among currency traders is equally important, especially since it makes many interpretations self-fulfilling. If large numbers of traders behave in the same way, a currency will automatically gain or lose in value—just like the speculators had guessed in the first place. If a country introduces more "business friendly policies," such as deregulation or lower labor standards, a few speculators will decide that it is worth buying a currency, thus driving the price of the currency up. To make sure that the value of this currency continues to rise, the original buyers will provide enough information to convince other speculators to buy the currency also. A consensus is formed for a while where everybody believes that the particular currency will only gain in value, and for a while this is true as everybody continues to buy. Thus, the profits which the original buyers had expected are generated by more speculators buying this particular currency.

The trick in making money with currency speculation is to know when to get in or out. At some point the first speculators decide to get out because they have made enough money, or they think that the currency is likely to fall in value. Information that signals speculators to sell are usually indications that local profit opportunities are decreasing. Such signals include more government regulation, tougher environmental standards, or an emerging labor movement. Speculators will begin selling the currency, and if many speculators decide to get out the value of the currency will fall, more speculators will sell, the value will fall further, and a downward spiral will ensue.

If a currency's sell-off is in response to particular domestic events, most governments will attempt to halt the fall of their currency by reversing the policies or events that initially prompted speculators to sell. In the cases of South Korea and Indonesia, the governments have been reluctant to reverse their initial policies, making speculators wary of buying these currencies again.

So far we have been focusing on exchanges in the present, or what currency traders call the "spot market," where U.S.$ are exchanged for French Franc or Dutch Guilder right now. Speculative purchases in the spot market are done with the intent to sell the currency relatively quickly. Many speculators will hold foreign currency that they buy in the spot market for a mere 15 to 20 minutes. After this time a speculator simply decides to take her gain or loss, and to start all over again.

Surprisingly enough, a speculator can make a handsome profit in that short amount of time. Let's say that a U.S. speculator thinks that German Marks (DM) are going to rise in value, so she takes $10 million and buys DM. If the original price is 1.50 DM per U.S.$ (or 66.7 U.S. cents per DM), she will get 15 million DM. After twenty minutes, the value of the DM has increased to 66.8 cents. Her 15 million DM can now be converted back into U.S.$, yielding $10.020 million (0.668 times 15 million), leaving the trader with a profit of $20,000 for less than half an hour of work. Even though the margins between the selling and buying prices of a currency are usually less than 1%, the large volume of each transaction, generally $10 million or more, make handsome profits possible.

Because foreign exchange transactions are potentially so profitable, large speculators (mainly multinational banks) are devoting more and more of their resources to such activities. For example, in the third quarter of 1997, BankAmerica reported $106 million, Chase Manhattan $228 million, and Citibank $435 million in foreign exchange earnings. Since these earnings are the fastest growing part of bank incomes, it is not surprising that billions of new dollars continue to enter the global currency markets, thus enhancing the power of speculators.

**"Forward Exchange" Hedging and Speculating**

Besides the spot market, speculators also make money in the "forward market," where a person can commit themselves to sell a fixed amount of a foreign currency at a specific time in the future, at an exchange rate that is set today. There are two reasons for engaging in a transaction in the forward market. One is if a currency trader knows that she will have a certain amount of foreign currency in her possession at a specific time in the future, such as from an export deal. Or she may simply guess that a foreign currency will move in a certain direction. In the first case, the trader is "hedging" against the risk of losing money if the currency devalues between now and the future date; while in the second case she is engaging in speculation.

Forward markets can be very profitable instruments of currency speculation. If a speculator expects a foreign currency, for example the Swiss Franc (SF), to appreciate over the next three months, she will contract to buy Swiss Francs in three months at a fixed exchange rate. If the current rate is 75 cents per SF, and the speculator thinks that the currency will increase to 80 cents per Swiss Franc, she will try to set up a forward contract. Suppose she writes a contract to buy $10 million worth of Swiss Francs in three months for today's rate, 75 cents per SF, so that she will get SF 13,333,000. If her speculation is correct, she will be able to sell them immediately at the market rate of 80 cents per SF for $10,667,000. She makes a profit of $667,000 from one moment to the next because she guessed right.

One important side effect of forward transactions is that they can become self-fulfilling prophecies, especially in the case of forward sales, which have been at the core of various currency crises. In a forward sale a speculator guesses that the value of a currency will fall in the future. Consequently, she will enter an agreement to sell a fixed amount of this currency at a specified time in the future, at something close to the current rate. If her guess is correct, at the specified future date she will be able to buy the currency cheaply in the market and sell it at the higher contracted exchange rate.

But by offering a forward sales contract to other market participants, the speculator signals that she thinks the currency is going to depreciate in the future. Since foreign exchange markets rely on a lot of intangible information, and since the number of large currency speculators is relatively small, such a signal can have a relatively large impact. If George Soros, for example, decides to offer a forward sale on Thai bhat, other speculators are likely to take notice, and adjust their predictions about the future value of the Thai currency downwards. If a growing number of speculators think that the Thai currency will fall, they will start selling their holdings, thus driving down the value of the currency, and hence making George Soros' prediction come true.

**Exchange Rate "Regimes"**

So far this discussion has assumed that there are no restrictions on exchanging one currency for another, and that foreign currency exchange rates are set only by the supply of and demand for each currency. In this case, we have a flexible exchange rate "regime," since the value of a currency can move whenever supply and demand are out of balance. But to understand some of the most recent currency crises, it is important to note that many exchange rates are not flexible, but are fixed either unilaterally by their own governments against one other currency, or multilaterally in an agreement between different countries. Multilateral fixed exchange rate regimes have included the Bretton Woods system after World War Two until 1973, and the European Monetary System from 1981 to 1993, while unilateral fixed exchange rates are common in emerging economies, such as Poland, Thailand (before the crash), Mexico (before the crash, too), and Brazil.

Contrary to intuition, currency speculation can also occur in fixed exchange rate regimes. In fact, almost all cases of fixed exchange rates have eventually been abandoned because of currency speculation. Under such a regime, a government makes a commitment to buy or sell its own currency to keep it at a fixed exchange rate. If a currency's exchange rate is set too high (overvalued), the nation's central bank has to constantly prop it up. The bank does this by buying its own currency (thereby raising demand relative to supply), or by selling its reserves of other currencies.

But since a central bank holds only limited amounts of foreign currency, it will eventually be unable to buy more of its own currency. At that point, a government has three options. The first is to impose austerity on its own people through higher interest rates and reduced government spending—which will reduce imports, raise exports, and so increase foreign currency reserves.

If the government is unwilling to force a recession, it will have to let its currency depreciate, either by setting a new, lower exchange rate, or by allowing its currency to be flexible ("float"). Either way, if speculators regard an exchange rate as too high and likely to fall soon, they will sell the currency in the forward market. If they guess right, they will be able to buy it in the future at a low market price, and sell it high at the already-contracted for rate. If many speculators sell the currency in the forward market, this will signal that the currency is overvalued, and people will begin selling the currency in the spot market. Eventually, the central bank will be unable to support the fixed exchange rate and the currency's value will fall. This is another self-fulfilling prophecy, as the speculators who originally began the downward trend pull others along with them, thus actually devaluing the currency.

So through herd behavior and self-fulfilling propheses, speculation creates an international economy more prone to crisis. It also makes global capitalism more impatient with reforms that aid the many rather than the few—union protections, environmental regulations, welfare provisions, and efforts to promote employment.

These risks and constraints are a problem for more than the developing economies in Southeast Asia and elsewhere. Nowadays, no single country is large enough to stabilize its own currency if speculators, who have billions of dollars at their beck and call, decide to speculate against it. We all, it seems, have to be vigilant against the risks and ravages of currency speculation.

**What to Do About Speculation?**

Reducing currency speculation is not an easy task, and cannot be accomplished by a single country. Yet policies have been proposed that could lower the total volume of currency transactions, and hence reduce the impact of speculation. One rather radical proposal is to eliminate foreign currency trading by establishing a single currency for several countries, as Western Europe is in the midst of doing. But the downside of such an endeavor can be massive unemployment, as all nations involved in a joint currency try to unify their fiscal and monetary policies—as the "Euro" experience is showing at present (see "The European Monetary Union: Greenspan's Federal Reserve Writ Large," Nov/Dec 1997).

An alternative, called a "Tobin tax" after its originator James Tobin of Yale University, is basically a tax on all foreign exchange transactions. To be successful such a tax would have to be introduced by all trading partners simultaneously—and of course overcome the political opposition of the speculators.

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Resources: *Turning the Tide—Confronting the Money Traders*, John Dillon, 1997, The Canadian Centre for Policy Alternatives (Ottawa); *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, [Bank for International Settlements](http://www.bis.org), 1997.