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For Love of Money: Why Central Bankers and Speculators Need Each Other

By Michael Lewis

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The Vandals' Crown: How Rebel Currency Traders Overthrew the World's Central Banks . Gregory J. Millman . New York : Free Press , 1995 , 250 pp. $23.00. .

Summary: In The Vandals' Crown, Gregory Millman recounts the lucrative tug of war between the world's currency traders and central bankers. It all began because Milton Friedman wanted to make a bet.

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Until the early 1980s, there was a running dispute within the economics profession that descended to the level of a spectator sport. One side was eloquently represented by John Kenneth Galbraith, the other by Milton Friedman. Together they accomplished for economics what Norman Mailer and Gore Vidal did for literature. Friedman published, or perhaps merely allowed to be published, a slender treatise entitled Friedman on Galbraith, which consisted of a roundtable discussion convened to examine, in something less than the spirit of scientific inquiry, the inexplicable global appeal of his rival. For his part, Galbraith was wont to open speeches with a canned joke about the night he was awakened at 3:00 a.m. by an Israeli journalist asking his reaction to Friedman's appointment as an adviser to Israel. "With Milton Friedman as your economic adviser," a sleepy Galbraith told the Israeli people, "you have nothing to worry about from a few hundred million hostile Arabs."

It was a rare case of a dispute between academics that was so bitter because the stakes were so high. Perhaps the most critical question in their debate was what precisely had caused the Great Depression. Galbraith argued on behalf of John Maynard Keynes that the cataclysm had been caused by inherently unstable free markets. Friedman, holding new evidence, explained that the depression was the result of the failure of central banks to respond to a reduction in the money supply. So the government, and not the market, had failed.

By the early 1980s Friedman's view pretty much had replaced Keynes' as the new orthodoxy in economics departments. But what this meant in practice was less clear. Keynes' ideas had spawned government?controlled financial structures around the globe and embedded within central banks and government treasuries a certain smugness about their ability to manage markets. The paradigmatic post -- World War II financial institutions, the World Bank and the International Monetary Fund, had been conceived by Keynes himself precisely to prevent the free markets from regaining control of international capital flows. More importantly, currency exchange values had been placed under the control of central banks -- in part because Keynes had persuaded others of the evils of freely floating currencies.

The new financial order depended for its credibility on Keynes' misdiagnosis of the Great Depression. Yet long after Friedman corrected the diagnosis the old bureaucracies remained. In fact, the Bretton Woods twins still stand more than firm -- since 1981 the World Bank's budget has tripled to $1.39 billion from $435 million, while its staff has doubled to about 10,000. And while the world left the dollar standard in 1971, exchange rates are still managed -- with varying degrees of effectiveness -- by central bankers.

THE DAWN OF FREE MONEY

I had always imagined Milton Friedman in his Chicago study slowly growing mad as the real world took its sweet time catching up to his explanation of it. Gregory J. Millman's new book put my mind at ease on this point. In his enthusiastic description of the slow demise of the postwar financial order, the author recounts a poignant moment in November 1967 when Friedman played an active role in its undoing. The economist had long watched the British government prop up its currency while pursuing reckless fiscal policies. One day he decided to sell the British pound short -- an act worthy of

Keynes, who was a frequent financial speculator.ffi

Friedman soon discovered, to his surprise, that the market for his wager did not exist. Chicago bankers refused to lend him the pounds to sell, on the grounds that the Federal Reserve and the Bank of England still disapproved of private speculation in currencies. He complained at length in a series of articles in Newsweek. The articles suggested to Leo Melamed, then a member of the Board of Governors of the Chicago Mercantile Exchange, the possibility of a currency futures market. Clutching a letter from Friedman (for which he had paid $5,000) Melamed requested the permission of George Shultz, then President Nixon's secretary of the treasury and formerly Friedman's close colleague at the University of Chicago, to open the new market. When Shultz saw no reason to refuse, he exposed the contradiction at the heart of the postwar financial system: it was administered by people with an ideological commitment to free markets.

In August 1971, when President Richard Nixon announced that the dollar no longer would be convertible to gold, he blamed speculators for "waging an all?out war on the dollar." In breaking the back of Bretton Woods he could more honestly have blamed the foreign governments -- the French, in particular -- that refused to hold increasingly inflated dollars. More honestly still, Nixon could have blamed his own inflationary fiscal and monetary policies. But from the moment of Nixon's announcement the markets assumed responsibility for the dollar's value. The subsequent profusion of new financial instruments, such as futures and options, was one response to the explosion in currency speculation. In May 1972, the market in currency futures opened. Friedman, along with every other small investor, was able to sell the British pound short. The first entirely free market for currency speculation in the postwar era was born.

The effect of this post?1972 market and the various attempts by governments to control exchange rates is the real subject of The Vandals' Crown, though the author digresses at length on many others, from the history of paper money to the origin of the Bretton Woods institutions. The price of this breadth is a loss of focus. For example, the book fails to address one of the more interesting questions that arises naturally from its subject: since the end of the dollar standard in 1971, exactly how much have central banks lost defending their currencies? The number is well buried in central bank balance sheets and thus hidden from the taxpayers who pick up the tab. In its published reports, the Federal Reserve occasionally asserts that its various interventions turn a profit for the American taxpayer. But the claim cries out for rebuttal. The Fed intervenes in search not of profits but of some notional value of the dollar. More often than not it is buttressing a weakening dollar or depressing a strengthening one; in other words, acting against the market. Only rarely does it succeed. If this is not a recipe for losing money, then private currency traders could grow rich simply by aping the Fed.

But of course they don't, as Millman nicely demonstrates. Currency traders have grown rich by taking positions in the markets opposite to those of the central banks. The success of these traders has steadily eroded the bureaucrats' control across the financial markets. The bureaucrats' various responses to their new predicament could fill a book; indeed, it has. Millman writes of the moment in early 1992 when Mitsuo Sato, formerly of Japan's Ministry of Finance and chief negotiator of the Japan?U.S. yen/dollar working agreement and now deputy director of the Tokyo Stock Exchange, attempted to quell activity in Japanese stock index futures. Regulators in Japan pretty well shut down the business at home. But in so doing they merely drove the game abroad, to exchanges in Singapore and New York.

The account of Sato's futile attempts to stop trading overseas should be required reading for U.S. trade negotiators. First came a meeting in Singapore with the president of the exchange, Ang Swee Tian, in which Sato began with a civil demand, progressed to political threats, and went from there to personal threats. "At one point," writes Millman, "[Sato] picked up an ashtray and threatened to throw it at Tian's head." Then came another in Tokyo with Ivers Riley, an executive vice president of the American Stock Exchange. "Sato shouted, `Mr. Riley, you don't understand -- no new products!' " Riley recalls. Then Sato began to issue threats. "I felt a couple of times that I was going to get the rubber hose treatments," said Riley. It didn't work. On the night before trading in Japanese stock index futures was to begin in New York, an official in Japan's Ministry of Finance called Riley to say that the Securities and Exchange Commission had just decided against permitting the new contract to open. The next morning Riley called the sec, which told him that it had issued precisely the opposite ruling.

EVERYBODY'S DOING IT

That the state has lost control over its financial markets, however, does not mean that individual speculators have gained control. What has occurred in the markets is a diffusion of power to the point where power, in any meaningful sense, hardly exists. There is a distinction worth making between small and large economies. Any one of a dozen or so speculators in New York City prob?ably could wreak havoc with the New Zealand dollar. And there is not a lot New Zealand can do about it, unless the speculator has some stake in maintaining good relations with the Antipodes. But the embarrassing truth is that destroying the New Zealand dollar is, for a big speculator, a bit like killing a porcupine for its meat. Unless you are very hungry, it is probably not worth the trouble.

The British pound is another matter. The speculation against the pound in 1992 that drove it out of the European Monetary System illustrates the gap between what actually happens in the markets and what people -- even senior politicians -- believe is happening. To this day the received wisdom in British politics is that the pound was collapsed by George Soros. This view is wrong in several respects. First, even as Soros' reputation as a market genius grew, he was removing himself from the market. The decision to sell the pound short was actually made by his colleague, Stanley Druckenmiller. Second, it was not a lone battle; many other speculators were involved. Third, and most importantly, the sum of the speculators' wagers was dwarfed by the trading of large corporations needing to hedge their exchange rate exposure. Millman explains in persuasive detail that currency speculators rode the corporate sales of British pounds like surfers catching a wave. No corporation held sufficient power, or sufficient ambition, to move a market very far. Rather, they acted as a faceless group, exchanging their sterling for dollars, marks, and yen to avoid the incipient collapse of the pound. It was an old?fashioned run on the currency. Once enough people believed that the pound would collapse, it did.

While the size of international currency markets makes it difficult for any one person to dominate them, that same vastness means that even small shifts in currency values can create multimillionaires overnight. It is only a slight exaggeration to say that the free world's central banks have created an industry of rich middlemen. And the rise of these traders represents less a triumph of the market over the central bankers than a gradual fusion of the interests of central bankers and traders. The simple fact is that neither group cares to see the end of their tug of war. The foreign exchange traders make large profits from central bank intervention, which -- far from stabilizing markets -- causes them to be more volatile. The central banks gain importance, stature, and a bureaucratic raison d'être by attempting to manage the currency, bravely defending it against the onslaughts of the speculators, etc., etc. The longer the struggle persists, the less difference there is between the putative combatants.

Indeed, these days trader and central banker are often one and the same. At least half a dozen former governors of the Federal Reserve now hold high?paying jobs on Wall Street, where they provide advice to currency and bond traders. One former Fed governor now employed by an investment bank was recently described by The New York Times as selling his inside knowledge of the Fed for $100 a minute. The value of this sort of advice always will be proportional to the activities of the central bank, and so former central bankers, and those who buy them, share an immediate financial interest in keeping the central bank active.

They also share an interest in the central bank remaining inscrutable. Most central banks, including the Federal Reserve, refuse to explain their actions. They operate on the odd assumption that markets function more smoothly with less knowledge than with more. There was only a brief period in the early 1970s during which the Fed released the minutes of its meetings, five years after they had occurred. The stated reason for this indiscretion was a desire to provide professional economists with data, so they might better understand the institution. But fairly quickly it became clear that the Fed and the economists shared an agenda -- to attack the claims of a new book by a pair of heretics. That book was A Monetary History of the United States, 1867?1960, written by Milton Friedman and Anna Jacobson Schwartz. It explained, among other things, how the Great Depression had been caused by the idiocy of the Federal Reserve.

ffi To our knowledge of Keynes' financial activities, Millman contributes the observation made of him by his fellow Bloomsburian, Lytton Strachey: "He brings off his copulations and speculations with the same calculating odiousness; he has a boy with the same mean pleasure with which he sells at the top of the market, and can hardly tell the difference between pocketing 15 percent and kissing Duncan."

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