

Will the EMU Pay Off?

Anticipating the Effects on the Market

This speech was given by Linda Davies at the Financial Panel of the European Research Center, Amsterdam, 11 June 1997.

In addition to Linda Davies, the participants in the meeting included:

Nout Wellink, President Elect of the Dutch Central Bank; **Alan Walters**, former economic adviser to Margaret Thatcher; **Wilhelm Nölling**, Professor of Economics, Hamburg University; **Jacques Attalie**, former President of the European Bank for Reconstruction and Development; **Avinash Persaud**, Vice President and head of research at JP Morgan; **Lawrence Lindsey**, a former governor of the Federal Reserve Board; **André Buitenhuis**, Vice-President of Koninklijke Ahold N.V.; **Bert van de Belt**, Director of Pension Management, PVF Nederland N.V.; **Hans Tesselaar**, Managing Consultant of DCE Consultants; and **Vicky Pryce**, Chief Economist at KPMG.

After lunch or dinner speakers must tread a fine line between giving their audience indigestion or sending them to sleep. I will endeavour to fight physics.

I'm going to talk, not just about EMU, but also about the psychology of risk, speculation and fraud. Indulge me as I digress from EMU for a short while. I thought after a morning of EMU, you might appreciate a mental stretch of the legs as we stroll away onto the wider plains of financial risk upon which we all live.

Among my subjects will be one sector of society which I might call sworn enemies of EMU – the foreign exchange speculators. I will tell you a little bit about how I came to write my first book, Nest of Vipers, and then I shall read a passage where fraud and FX speculation combine. I hope this will give an insight into the mindset of the type of people whose objectives are to exploit instability, people who will attack ferociously the weaker or borderline currencies in the lead up to the implementation of EMU. Finally, I shall use my novelist's imagination and describe a plot against EMU. Perhaps this will be where imagination and reality meet.

The philosophy of EMU, one of promoting stability and accordingly diminishing risks, is a powerful one, but I'd like to set it in a context of human desire and history.

In the financial world, risk, reward and catastrophe are cycles repeated by every generation. Greed, hubris and systemic fluctuations have given us the South Sea Bubble, Barings, Bre-X, Tulip Mania, to name just a few of the thousands of ready examples.

Those of you who buy Dutch bulbs, perhaps you will pick some up at the airport, might flinch from the highest price ever paid for a bulb at the height of Tulip Mania in the autumn of 1636. In today's prices, a single bulb was sold for over thirty five thousand dollars. Speculation can degenerate into craze. Love might be blind, but greed is deaf.

In March this year, Bre-X, the Canadian exploration company, touted its gold find in Indonesia as the world's biggest potential gold mine. Geological reports appeared to confirm the hype. Bre-X rose in value to over four point four billion Canadian dollars. Then the geologist apparently "JUMPED" out of a helicopter, and Bre-X shares became virtually worthless overnight. The stuff of novels, you might say...

Why is this relevant to you? It's relevant because it forms part of the typically unquantified risk arena in which you all operate. No one is immune from the speculators, from the risk of fraud, from the all too human motivations of greed, and ego.

Human nature hasn't changed, but the scope for financial destruction had increased dramatically with technology led interdependence of financial markets, increasing transaction size, and the advent of the derivatives markets.

Now, I'm not a criminal by nature, nor indeed by education, although some might argue that my seven years in the City of London were an excellent training ground. But, to write about financial crime, I need to be able to think like a criminal. While most of you probably spend a lot of time trying to minimise the risks inherent in the financial and business world, I spend most of my time trying to exploit those risks.

While you probably do not like to dwell on what might go wrong, I spend years pondering it. While you look at colleagues and wonder how much they make for you, I am asking myself how much they take from you. While you look at a financial system and recognise the forces tending toward stability, I search for the latent and systemic instabilities, and for those who seek to inflame them. I am not a Cassandra, always prophesying doom, but I get paid to think the unthinkable, and then write about it.

It all started one hot day in July 1991. The markets languished, and I was day dreaming. I sat at my trading desk at my investment bank, where I sold junk bonds, stared at my flickering computer screens, and wondered just how much damage I could do. I had multiple trading counterparties, recorded phone lines, and I operated on the age old City axiom: My Word is My Bond.

My telephone trades could commit me to hundreds of millions of dollars of exposure. But, in my fantasy incarnation, I decided I didn't really want to bring down a bank, I just wanted to make some money. Say, a few hundred million dollars. By the time I left for the evening, I'd worked out how.

I imagined that I was a proprietary foreign exchange trader, trading on the back of my bank's own capital. I had an ally, a finance minister in G7, or a central banker. I was blackmailing him into revealing in advance, G7's currency support interventions, and

interest rate changes. It would be like knowing the winner of the Arc de Triomphe in advance, and having hundreds of millions of dollars to bet with. I could trade on behalf of my bank, and benefit by way of seven figure bonuses. I could also trade on personal account, using the elixir of leverage, and make myself a fortune.

George Soros made a billion dollars legally from breaking the pound on Black Wednesday. Imagine how much money someone could make illegally! And so I wrote *Nest of Vipers*.

The repercussions of their actions filter down to everyone who is either a borrower, or a lender, or has commerce with either. Perhaps only a hermit who shuns the cash society can remain unaffected by their actions. To most FX traders, theirs is a thrilling game, fought with necessary unsentimentality about the world beyond the trading floor. They are financial mercenaries. Their job, is to make a killing.

[At this point in her speech Linda Davies read an extract from her novel Nest of Vipers.]

Those are the kinds of people who could be playing with your money! And attacking your currency.

Bankers who hire money hungry geniuses should not always express surprise and amazement when some of them turn around with brilliant, creative, and illegal means of making money.

Moving back to EMU, and the risks that I perceive from a novelist's perspective. I'd like to take as my starting point, the sterling crisis of Black Wednesday, 16th September 1992.

Black Wednesday reminded us of two things; one the size and power of the Foreign exchange markets, and two, the amounts of money that can be made by well capitalised, well informed, and pro risk traders. I say this as a cautionary warning to countries in the pre currency lock convergence period.

So let's see things from a novelist's perspective. Let's pretend, let's give vent to imagination, not political goals, or economic theses. Let's pretend I am a super-speculator. I am male, post thirty. Good degree, but not necessarily. I could

be like Joe Lewis, the secretive British FX billionaire, reputed to have made over a billion dollars in one year from FX trading from his Bermuda base, incidentally, reversing the charges every time he rang his London brokers. I have a war chest of a hundred million dollars. That will enable me to go into the FX markets and take positions of a few billion.

I'm the kind of person liberal editorial writers loathe, politicians too. For I, and others like me, will exploit ruthlessly any divergence between political aspirations and economic reality. I hate the idea of EMU. I love instability. I'm a financial warrior. I laugh at the image of Norman Lamont, the former British finance minister, standing outside the Treasury raising interest rates every half hour, and drowning in the sea of speculative money that sank the pound. I am the predator, circling the herd, waiting and watching for the weakest member.

I, and the community of foreign exchange speculators contribute ninety five per cent to the daily FX turnover of three trillion dollars. That's three thousand billion dollars every day. That compares to the latest EU central bank reserves of three hundred and eleven billion dollars.

So, my speculator is part of a supremely powerful gang. He loathes EMU, but he will follow its progress as closely as any politician, perhaps more closely. For him, and his tribe of stateless warriors, there are billions of dollars at stake. That is the flag to which they bow, not nationalism, not politics, not dogma. He shall be a hyena waiting for the corpses of the countries that do not make EMU. Can you imagine the lead up to currency lock? Politicians trying to knock their countries and currencies into shape. Let me tell you the dream scenario of my speculator, let's call him Mr FX.

One of the key countries to EMU is having trouble with convergence. Its politicians are determined it will meet the criteria, they're doing what politicians of course will be unable to do once a part of EMU, they are using their un-independent central bank to manipulate monetary policy to a short term goal.

Amongst the political community, it is unthinkable that this currency will not join EMU. But I, and Mr FX make a living from thinking the unthinkable. He thinks this country will not join EMU. He could buy a supremely cheap out of the money put option on this currency, because most people, even the markets, think even if the country doesn't quite meet the criteria, it will be fudged into EMU.

The odds, if you like, on his bet, are fantastic. A rank outsider. And then the unthinkable happens, the country doesn't join EMU. Mr FX and his co-warriors punish it ruthlessly, short selling its currency, driving the exchange rate down with their trillion dollar war chest. Perhaps the countries of the EU try to support the beleaguered currency, going into the markets.

Norman Lamont could tell us all about how successful that will be. Ten billion dollars later, Mr FX and his gang retire to count their profits. But don't worry, they'll be back. Luxembourg is apparently trying to devise a war plan to head off speculative attack by FX predators.

My advice is; get ready! And if you think the speculators can't get at the countries within EMU, think again. It won't be long before our derivatives geniuses dream up a new synthetic currency. Where there is motive, there will always be opportunity.