

## Replies to memos, 09/07/03

Dear Students,

Thanks a lot for turning these great questions. As for my questions, here are the answers. For the question on the gold standard, the predominant response was that the gold standard is unlikely to be back again. That was the answer I expected. The reason I asked this question is to see whether you understand the difference between the current exchange rate arrangement and the gold standard.

As for the corporate governance, you got it right, this is the mechanism to align the interests of the decision-makers with the interest of the shareholders.

### **Q & A**

**1. I am sure that we would not be able to find the specific details about Soros's enrichment in the 1992 with the pound going out from ERM. What were some of those "interesting" strategies he used then against Bank of England?**

G. Soros is the founder and chairman of the Quantum Fund, a privately-owned investment fund registered in Curaçao, Netherlands Antilles. The Quantum fund, one of the biggest macro hedge funds worldwide, has a history of successful deals in the forex markets. For example, it did really well in the collapse of fixed exchange rates in the 1970s and the deregulation of global capital markets.

George Soros became world wide reknown on September 22, 1992, when, speculating against the British pound, he reportedly earned about US\$ 1bn. The Bank of England was forced to withdraw the currency out of the European Exchange Rate Mechanism.

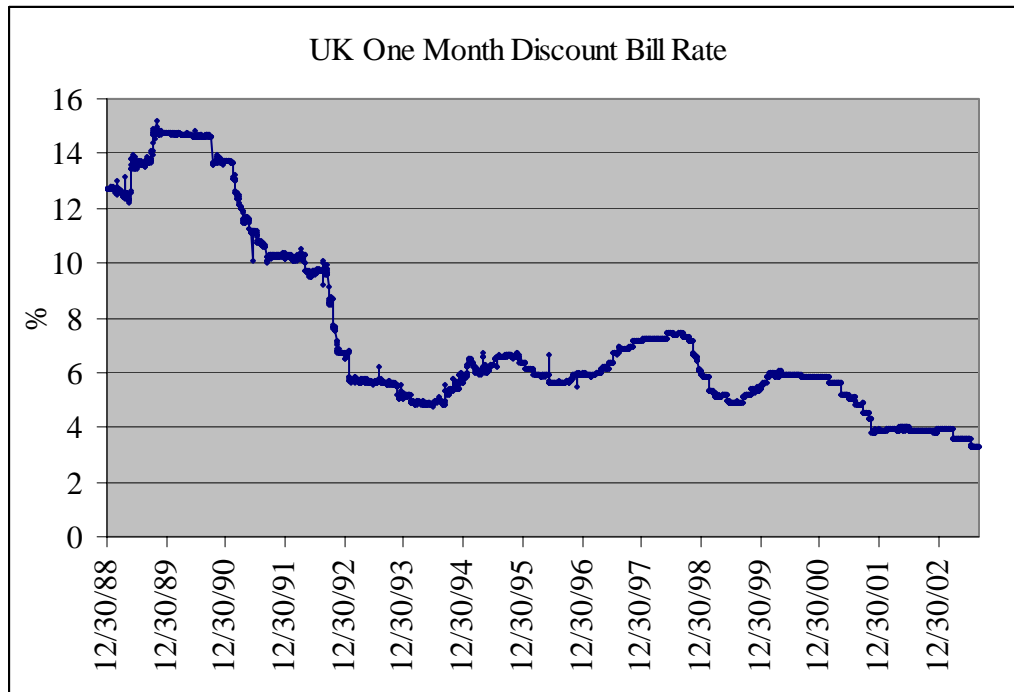
How did this happen? In the beginning of 1992, Soros decided that the British pound would have to be devalued because it had been pushed into the Exchange Rate Mechanism (ERM) at a high rate. Aware that Bundesbank (the German Central Bank at the time) favored devaluing the pound and the Italian lira and also convinced that the high interest rates in Britain would put downward pressure on the Pound/ Deutsche Mark exchange rate, he spent the next few months building up a position from which he would profit from that devaluation.

His strategy was to borrow in British pounds heavily, reportedly up to £6.5b, and convert them into a mixture of Deutschmarks and French francs.

On **Black Wednesday**, September 22, 1992, Mr Soros unwound his position, after British pound was devalued. He paid back his original borrowings and ending with a profit of around US\$1 billion. Mr Soros bought as much as £350 million of British shares at the same time, betting on a strategy that usually equities rise after a currency devaluation.

At the time, Norman Lamont, the UK Chancellor of the Exchequer, attempted to halt the slide of the pound, by means of selling some of the British gold reserves, and putting up the interest rate multiple times (three in a single day). That was not enough to counter the speculative pressure already in place.

Here is a graph of the interest rates at the time in UK.



**Are there any articles that you can suggest I read to learn more about George Soros and the British pound?**

There is a book, written by George Soros, "George Soros on Globalization", the call number in Bobst library is HF1359 .S65 2002. I have not read this book, but it seems that it might shed some light on his strategies. Further, I have posted [on Blackboard](#) an article from WSJ, 1992, which describes the case in point.

**Is there a point to pegging a foreign currency? How can the Chinese government go into appreciating their currency? Can it ever crash?**

Yes, if you want to have stability in times of recovery (e.g. after a major banking or financial crisis, or when you fear your exporters may lose competitiveness), you may wish to disallow exchange rate volatility. Why? Can't the Chinese government manage their currency independently? They could, but then a revalued market rate may hurt the

Chinese exporters (why?). Further, you want to peg to your biggest trading partner, to lower the cost of your exporters (you lower their exchange rate risk exposure).

If the Chinese government is to appreciate the currency, it shall liberalize the financial market, and let market demand and supply form the price of its currency. Currently China fixes the yuan at 8.28 to the US\$, and it has serious restrictions on forex holdings, both by individual and corporate accounts.

Can the yuan crash? Given the conservative approach of the Chinese authorities, it is unlikely that the yuan crashes. However, there are several concerns, the main one of which is the amount of outstanding bad (or nonperforming) loans in the Chinese banking system.

### **Isn't the yuan going to be revalued sometime soon?**

As we see more liberalization in China's financial market, we could expect to see the yuan gaining strength. One could expect a gradual process of liberalization that may take years to accomplish. The article that I distributed in class is very specific on the liberalization process itself.

### **Are Eurodollar accounts common in Europe? If so, which specific countries?**

I could not find stats on that question. For a fact, most of the dollars from export of oil to US are deposited in Europe. Given that the annual flow of oil expenses is substantial, thus I would imagine the amount of Eurodollar accounts in Europe is significant.

On a side note, many countries in Eastern Europe during the past fifteen years were heavily relying on the stability of the dollar, by keeping savings in the form of US\$ denominated accounts, or Eurodollar deposits. Thus, they also had many Eurodollar deposits.

### **Can you explain short selling in a bit more detail?**

The technique of short-selling involves borrowing a security for a so called lending fee, and then selling that security. The borrowers are usually large institutional investors which might wish to make some extra money by lending their portfolio stocks for short-selling purposes, and charging for that a lending fee. Of course, the short-seller has to deliver the stock back when he gets called by the broker of the investor, who lent him/her the security.

### **Could you please explain the "cornering the short-seller" strategy again? Could you explain J. Gould's strategy again?**

Suppose you have sufficient financial means. The strategy many speculators two centuries ago used, was as follows. You start buying the stock. Of course, that implies

that you have to gradually offer higher and higher prices, since the more stock you buy the less likely you will find people willing to sell it to you at the same price. The stock price is monitored by many investors. Some of them might decide that the price has gone way up for a rational valuation. In this case, they will be interested to short-sell it. As long as they do not realize what is the true reason the stock price is going up, they will be short selling it. As this process goes, you accumulate substantial part of the overall supply of the stock in the market. At that stage, it is very likely that the short-sellers' brokers will have to come to you to borrow the shares, since not many independent shares are left in the free float. Then you can call all short-sold shares. That means that in a short period of time all short-sellers have to deliver the shares back. They have two options at that stage

1. Default and not deliver the shares, in which case you have the right to go in the market and buy the shares on their account and at their expense.
2. They can go to the market and buy the shares themselves.

Whenever this market friction happens, the price of the stock will go up. Why? Because, all of a sudden, all short-sellers have to deliver the shares, that is, the demand for shares experiences a sudden increase. Of course, higher stock price means that the short-sellers will realize financial losses, sometimes of very serious magnitude. That is known as “squeezing”, or “cornering” the short-sellers (the former is used when the price pressure you put on the short-sellers is not so big).

Today, the practice of squeezing short-sellers is illegal in the US financial markets. However, this practice is common in overseas markets. Moreover, it is seen not only in stock markets, but also in bond markets, and in commodity markets, such as the market for gold, silver, copper, etc.

Jay Gould was a master in the art of squeezing short-sellers, just like Commodore C. Vanderbilt, at the time. Back in 1869, he even attempted corner the world gold market, and weren't it the interference by President Johnson at the time, that would have happened. Besides, J. Gould would oftentimes do another financial operation. He would start by buying a run-down railroad company. Then, using his exceptional managerial skills, he will bring it up, and eventually IPO it. At that stage, he will start selling the stock. Then he would appoint clumsy management team. Naturally, the unsatisfactory company performance pushes the stock price down, at which stage Jay Gould would attempt buying it back, and then blame the management for the poor performance. And so on...

### **Is it advantageous to the Euro area to peg their currency to the dollar?**

Actually, it is better for them not to. Why? For a fact, they are a strong economy, even though they currently experience a recession. Second, if you have your own currency, then you have a lot of power. How comes? Well, you can print money, for example (this is called seignorage right). Can't do that if you peg to US\$. Further, you have all the tools of monetary policy (i.e. the policy to rule issuance, distribution of money, etc. related to the Euro).

**Are we going to discuss “economic exposure” as well? I learned to define economic exposure as the change in total firm value as a result of a change in exchange rates.**

We will discuss economic (or operating) exposure in greater detail in chapter 9. Your definition is quite good.

**How come the price of US\$ in gold didn’t devalue or revalue until WW2?**

Actually it did, in 1934, the dollar was devalued to 35\$/gold oz from 21\$/gold oz previously.

**Can you explain interlocking directorates again?**

Major corporations operate w/ managerial hierarchies, where on top of the power pyramid is the board of directors. Boards are comprised of anywhere from 6 to 25 members, or even more. Their job is to meet about ten times a year. Between meetings they review reports and other materials important for the strategy of the company. Board committees also meet w/ top management team. Some members of the board of directors also sit on the so-called executive committee of the board, which will typically meet more frequently.

Boards hire/fire the top managers, control all significant policy decisions, and steer the corporation through any difficulties. They speak on behalf of the corporation to other corporations.

CEOs will often serve on the boards of other corporations. This is a matter of prestige (i.e. their advice is valued), and also a good source of business intelligence, or **soft information** (that is, information that is not easy to obtain, verify and transmit to others, because it is very sensitive, & privileged). Outside directors sometimes own shares of the companies on whose boards they serve.

**Why are interlocking directorates favored outside of the US?**

Okey, they are favored outside of the Anglo-American model of corporate governance, which includes countries like US, UK, Australia, New Zealand. Why? Because, it is believed in the corporate value maximization model that the company should take care of all stakeholders (suppliers, employees, buyer groups, environmental groups, shareholders, debtholders, etc). What better way to achieve that than let the CEO of a supplier company sit on your board?

Well that was the light side. However, these arrangements come with a dark side too. Oftentimes CEOs they will start “trading favors” with their appointees in the board of directors, like “if you let me have my own, I’ll let you have your own”. This favor trading will hurt shareholder value since these managers are using CEO wealth to pay each other “favors”.

### **Is high leverage favored outside of US?**

In the corporate wealth maximization model, debt is not so much favored, as it means that it might benefit only shareholders (in the upside) while it can hurt everyone else (in the downside).

### **Are CEO stock options favored outside of the US?**

Not so much as they are in the US. Firms in the corporate wealth maximization model consider profit in a different way – profit should not go only to shareholders, but to all stakeholders. What is then the point to give a CEO stock options, an instrument that will tune up his compensation to the stock price performance, when there are other criteria on which the CEO might be judged, e.g. market share, number of employees, etc?

### **Why would the gold standard come back?**

Good question. You see, even though the gold standard was dubbed “the barbarian relique”, under it, there was little to no inflation at all. Now, compare this with the exchange rate regime after the break-up of Bretton Woods system. Inflation soared. However, the opposite happened with growth. Growth was low in the gold standard, but there was no inflation either. Which one do you think is better? Low growth & no inflation, or high growth & inflation? I guess, the better one is the latter, and that is why we see what we see as an exchange rate system arrangement currently.

### **For the gold standard, why would countries have to ship gold to one another?**

To settle their accounts. Of course, you can keep the gold overseas, but then you have to pay the high cost of safeguarding and insuring this gold. Besides, can you trust the foreign government? What if there is a new government all of a sudden, that is not willing to honor its obligations?

### **Is Sarbanes-Oxley regulating (stopping) interlocking directorates?**

It is legal to have interlocking directorates in the US and Sarbanes-Oxley does not regulate them. Many big corporations have interlocking directorates, including suppliers, buyers, and other auxiliary companies with which they might need to contract in their business.

### **What do you think will need to happen for US immigrant investors to move from salad bowl to melting pot?**

Time has to pass by, so that their preferences for investment change towards their local, US-based stocks.

**Can you discuss on the benefits/advantages of the Eurodollar (i.e. having US dollars in a foreign bank)?**

For foreigners residing in countries with soft currencies, the advantage of Eurodollar account is it would preserve the value since the dollar is one of the strongest currencies in the international financial market.

**In regard to behavioral biases, is there a better reasoning for investors in US biased toward country of origin? For example, an Irish in US may invest more in Ireland b/c of familiarity and lack of being a sophisticated investor as opposed to diversification reasoning.**

Yes, that is correct. The Irish investor will be investing in the Ireland's stock & bond market because he might have a better familiarity with this market as opposed to an Italian US investor. However, the point is, that this Irish investor might pay "too much" attention to the Irish market – it could be better for him to invest some funds, say in the Japanese or French stock & bond markets, instead of investing predominantly in Ireland. That would a bias.

**Isn't preferred stock considered to be a dual class in the US?**

Yes, it fixes the dividend payment to be distributed to preferred stock holders, and usually disallow voting rights.

**Could you elaborate on voting premium?**

The price differential between the preferred and ordinary stock, is the voting premium. Of course, there are public companies in the US that also have dual classes of stocks, the ordinary and the preferred stock.

**Can you give a quantitative example of devaluation and one for depreciation also? I can't quite distinguish between the two.**

For example, if the Hong Kong administration decides to decrease the fixed exchange rate of the US\$/ HK\$, this will be an example of devaluation of the HK\$. If the Euro/US\$ goes down, this would be an example of depreciation of the US\$.

**Is 0.2% really a bad as it sounds? B/c it shows growth for the company...**

It should be clear that 0.2 % is an average benefit to international financial diversification. It is actually a good positive margin, however, the question is, is it a justified compensation for the risk you take?

**Can you explain the article about the Asian currencies?**

In essence, the idea is that many Asian countries established fixed exchange rate systems following the Asian crisis in 1997. That led to accumulation of substantial forex reserves and series of surpluses on the current accounts of these countries. Since most of these countries are fixing their currencies to the US\$, that led to concerns that if US is to trim its huge current account deficit, it would not be able to do it through a depreciation of the exchange rate with these countries, but rather with a depreciation to the Euro (why – because European Union (EU) is the other major trading partner for the US, thus if US is to gain competitiveness in its exports to EU, it better depreciate the US\$ as compared to the Euro). Another concern is that these supercompetitive Asian currencies (like the Chinese yuan, the Malaysian ringgit) are additionally pushed down by their governments, to make them even more competitive, for concerns of export decrease, unemployment in export sectors, and bad bank loans (in China).

This support to exporters does not come free, of course. Stacking US\$ currency under the mattress takes investments away from productive uses. Also, too much US\$ liquidity can create asset price bubbles, just like we've seen with the price of the A-shares in Shanghai stock market.

**What is a current example of how corporate governance abroad is being mediated w/ corporate governance here (US)?**

GM acquired the troubled Korean carmaker Daewoo in November 2002. This has led to a stabilization of the company. How? Managerial skill, sound corporate governance practices, & expertise from GM were added to the managerial team at Daewoo.

Just as a pre-history, the car-manufacturing business of Daewoo was a product of a 20-years-old partnership between GM and Daewoo-Korea. However in 1994 Daewoo decided to pursue that business line on its own, and put an end to this partnership. The recent troubled loans at Daewoo led to a reconsideration of the partnership w/ GM, and today, the company is part of GM. Good lesson in corporate governance.

**Could you give us time at the end of class to fill this out? It's distracting, as we miss the last couple of minutes in order to make the next class on time.**

Next time we finish earlier ☺.