I KNOW WHAT THE HEDGES DID LAST SUMMER

In spite of Gillian Anderson, I'm not much of a fan of the X-files, or of conspiracy theories in general. I've seen some of the world's movers and shakers up close, and they seem a lot like the rest of us - that is, most of the time they haven't got a clue, and fly by the seat of their (well-tailored) pants. Anyway, as an economics professor I am by nature inclined to the view that the truth isn't out there, it's in here - that usually you learn a lot more by thinking really hard about the data than you do by sniffing around for supposedly inside information.

Yet conspiracies do sometimes happen. George Soros really did stage a run on the pound back in 1992; Sumitomo's Yasuo Hamanaka really did rig the world copper market for a couple of years; and a cabal of hedge funds apparently did try a squeeze play on Hong Kong's currency and stock market last August. I've even heard a rumor that some guy in Seattle has been trying to take over the ... (That's funny: my computer keyboard froze when I tried to finish that sentence). But no conspiracy could be big or smart enough to play games with the whole world financial market.

Or could it? On a recent visit to Australia I had a fairly spooky conversation with some government officials.

Australia, in case you didn't know, is the miracle economy of the world financial crisis. Even though most of its exports go either to Japan or to the stricken tigers, Australia has managed to ride out the storm so far without even a serious slowdown. The key to this resilience has been a policy of benign neglect toward the exchange rate: instead of raising interest rates to defend the Aussie dollar, the central bank allowed the currency to slide, from almost 80 U.S. cents in early 1997 to the low 60s by the summer of 1998. The result was that while export prices plunged in U.S. dollars, they held up in local currency, and strong domestic demand kept the economy humming.

Luckily, financial markets apparently decided that the decline in the Aussie dollar - unlike, say, the decline of the Indonesian rupiah - represented a buying opportunity rather than a foretaste of things to come. As a result, the currency stabilized itself instead of going into free fall. But there have been some anxious moments. In late August, in particular, it began to look as if the Aussie dollar was going into free fall after all: day after day it fell, reaching a low of barely 56 cents. If it had kept on falling, the Reserve Bank might have had to raise interest rates after all.

What was all that about? Well, the officials I talked to confirmed what I had guessed: a lot of the plunge had to do with hedge funds shorting the currency. But what I didn't know was that some people from the hedge funds actually told the Australians, in effect, that resistance was futile - that they were only a small piece of a coordinated play against Australia, New Zealand, South Africa, and Canada - not to mention Hong Kong, Japan, and China.

Was this just boasting? There is no question that last summer a number of hedge funds did, in fact, bet on the proposition that a lot of dominoes were about to start falling: that the yen was going to plunge, dragging down the HK dollar and the renminbi with it, or vice versa, and that the currencies of commodity-exporting countries like Canada and Australia would get dragged down by the backwash. It is less certain whether the hedge funds were actually the dominant source of speculation against the potential dominoes. And whether they acted collusively is hard, perhaps even impossible to know: if there was collusion, it could have been tacit, a matter of carefully phrased generalities uttered over a bottle or two of expensive wine.

Of course, if there was a conspiracy, it failed. In fact, if you wanted to make up a supposed secret history of world financial markets over the past 6 months, it would go like this: during the summer a few big hedge players - let's call them the Relativity Fund and the Pussycat Fund - agreed to stage a run on Asia plus. They acquired huge sums of cash by borrowing in yen, shorting Hong Kong stocks, getting Australian credit lines, etc.; then they began ostentatiously selling all of the target currencies, spreading rumors about imminent Chinese devaluation, and so on. Meanwhile they put the borrowed money into various high-yielding assets, including things like U.S. corporate bonds and mortage-backed securities, and also some risker things like Russian GKOs. But somehow it all went wrong: Hong Kong refused to play by the rules, then Russia fell apart, and investors around the world got more risk averse. Suddenly the funds found some of their credit lines pulled. And since they had become such gigantic players, this started a sort of cascade of margin calls: for example, as Pussycat began to unwind its yen shorts it drove up the value of the yen, causing losses that forced it to unwind even more. And correspondingly, of course, the assets the funds had been buying - like non-investment grade dollar bonds - plunged in value.

In short, all the strange things that have happened these last few months - including the bizarre runup in the yen and the mysterious near-collapse of U.S. financial markets - are, according to this story, the byproduct of the ravelling and unravelling of a vast get-rich-quick scheme by a handful of shadowy financial operators.

How seriously do I take this? The story does seem kind of out there; but it just might turn out to be the truth.