The Miner's Canary

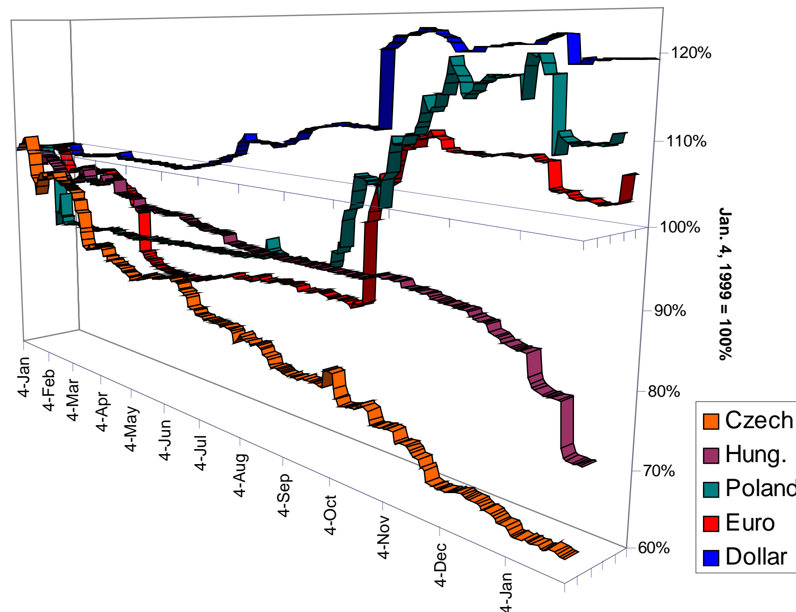
Sometimes we find indicators where we least expect them. Who was paying attention to the Thai baht prior to its collapse in July 1997? Who is paying attention to the currencies of the more successful former communist states of Eastern Europe today, such as the Czech koruna, Hungarian forint, and Polish zloty (pronounced "zloty")?

The problems in South Asia in 1997 stemmed from rapidly increasing trade deficits and external debt levels denominated in hard currencies such as dollars or yen. The problems emerging in Eastern Europe are not of internal origin, but external: A combination of rising interest rates in the U.S. and a weak euro. As these countries try to prevent their currencies becoming overvalued against the euro, they risk becoming undervalued against the dollar. While most of their bilateral trade in goods and services is with the euro zone, the price of many of their key imports, crude oil in particular, is denominated in dollars. They are facing a classic squeeze on their trade balances as their dollar-denominated energy imports surge in price while their exports becoming increasingly expensive in the euro zone.

There is no policy mix known available to Eastern Europe capable of simultaneously weakening their currencies against the euro while strengthening them against the dollar. Only an actual appreciation of the euro against the dollar will accomplish this, and this decision, which must involve raising euro-denominated interest rates, is in the hands of the European Central Bank and its eleven national constituents. Pity poor Poland: It has been a victim of bad geography over the centuries, and now it has to hope for a central bank run by a committee to come to the zloty's rescue. Good luck!

The countries have adopted different interest rate strategies in response to these stresses. The Czech Republic has driven the rate down on 90-day Prague interbank offerings (PRIBOR) by nearly 40% since the euro's inception. Hungary, in its turn, engaged in a period of gradual interest rate erosion on 90-day Budapest interbank offerings (BUBOR). Poland, ever marching to the beat of a different accordion, raised rates on 90-day interbank offerings (you guessed it, WIBOR) by close to 20% during 1999 before cutting rates at the start of 2000.

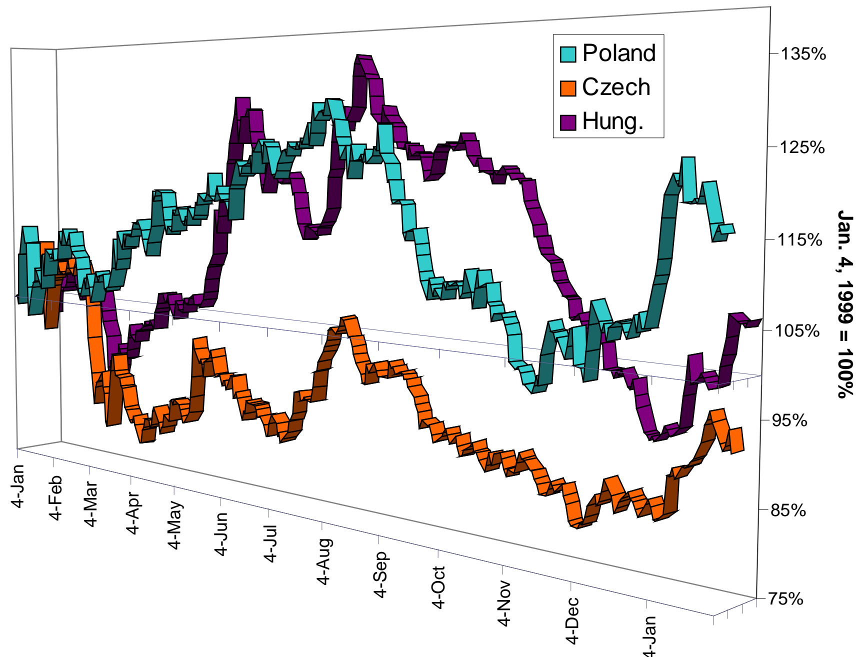
Relative Interest Rate Movements



We have had sufficient experience with politicians and central banks playing currency and interest rate games with their taxpayers' money over the past quarter century to know this is not a good idea. It certainly wasn't in the United States during the 1980s, and it certainly won't be in Eastern Europe today. Like all rapidly growing economies, they depend on international investment flows for capital and development. While much of this money flow is in the form of direct investment in plant and equipment, a good deal is in the form of portfolio investment -- the notorious "hot money" of urban legend.

Should this money exit in a hurry, as it did in South Asia in 1997 and Russia in 1998, where will we see it first, in the foreign exchange market or in their equity markets? We will submit the latter; the actual exchange rates of the zloty, forint, and koruna are too affected by the euro/dollar rate to convey a pure signal.

We can take a look at the relative performances of the Polish WIG 20 index, the Hungarian Traded index, and the Czech PX 50 index against the Morgan Stanley Euro index since the euro's inception for hints of impending trouble. One of the most notable features is the long-lived underperformance of the PX 50 despite continuously lower PRIBOR rates; this indicates growth and profitability strains in the Czech Republic. A second notable feature is the relative rebound of the Traded Index once BUBOR rates were cut at the start of the year. Until Hungarian rates started to fall, the relative overvaluation of the forint to the euro started to squeeze Hungarian profitability. A similar pattern emerged in Poland, although the relative decline of the WIG 20 index in the last two weeks is starting to signal stress from the zloty's fall against the dollar on the back of WIBOR cuts.



As U.S. rates move higher, the dollar's strength against the euro will hurt the smaller economies of Eastern Europe first; they will be the miner's canaries of the system. You'll know when the euro has gotten "too weak" by watching the stock indices of Eastern Europe. If they start selling off at a rapid rate relative to senior Western European markets, the Fed will once again have to put domestic tightening on hold for international reasons, just as it did in the Asian and Russian crises. And, after the initial scare, such actions will once again be quite bullish for the U.S. markets.