The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

Why August Is the Worst Month for the Markets

By Harold James

August 22, 2012

Summer is a time for beaches and relaxation — and, historically, for all sorts of destructive crises. Time and again, it has proven dangerous for the world to be on holiday.

August is an especially bad month for financial markets. On Aug. 15, 1971, President Richard Nixon ended the commitment of the United States to a fixed gold price, and since then the world has lived with currency volatility and instability. On Aug. 13, 1982 (a Friday), Mexican Finance Minister Silva Herzog went to Washington to tell the International Monetary Fund and the U.S. government that Mexico would be unable to make its scheduled debt payment the following Monday. On Aug. 17, 1998, Prime Minister Sergei Kiriyenko announced that Russia would simultaneously default and devalue. And in the first week of August 2007, IKB Deutsche Industriebank disintegrated as the U.S. subprime crisis spread.

The roots of this seasonal periodicity of crises predate World War I, in the era of the classic gold standard. The explanation at that time was usually found in the predictable timing of the international payments mechanism. In the late summer, farmers in the Western Hemisphere brought their crops to traders for export and demanded cash payment, which the traders needed to raise from their banks. The consequence was a demand for gold in the United States and mounting exchange-rate pressure on Britain and other European importers.

The same pattern of selling pressure on the pound sterling was repeated in the interwar era. Finally, in September 1931, Britain departed from the restored gold standard, which led to the collapse of the system as a whole.

Europe's central bankers had been nervous, even superstitious, about the late summer long before 1931. Montagu Norman, the longest-serving governor of the Bank of England and a romantic and temperamental man, regularly left his office for several weeks at this time of year, owing to nervous exhaustion. Indeed, he was literally at sea crossing the Atlantic when the gold standard broke down; the Bank of England staff advised him with a cryptic cabled message, "Old lady goes off."

It is difficult to think of the harvest-driven seasonal cyclicality of payments producing crises today, but somehow the problem persists. One explanation could be that trading is often thinner during the holiday season, so any disturbance inevitably has a bigger impact.

But the technical side of crises masks a much more dramatic story. How summers and crises go together was obvious in the event that triggered the first big collapse of the gold standard, the outbreak of World War I in 1914. Indeed, this was the Urkrise — the event that made the 20th century so terrible.

Crises are in part about gamesmanship, about taking the other side by surprise. A country poised to embark on some radical and uncharted course of action often believes that vacations produce additional scope for delaying or frustrating the other side's counter-move.

The logic of a summer provocation was abundantly clear in 1914. Austrian Archduke Franz Ferdinand was assassinated in Sarajevo on June 28, but the subsequent diplomatic discussions dragged out for weeks. Germany's top officials ostensibly went on vacation in order to create the impression that the tensions could easily be resolved. Meanwhile, the Germans waited for the French prime minister and president, who had both been visiting Russia (France's ally), to leave St. Petersburg, at which point they rapidly pressed Austria to deliver an ultimatum that they knew the Russians could not accept. The news would arrive while the French leaders were at sea, and would thus find it more difficult to produce an effective and coordinated response.

Vacation logic was also used to maximize bargaining power in recent cases of default or threatened default. Mexico's action in August 1982 took officials elsewhere completely by surprise. In the United States, Treasury Secretary Donald Regan was playing golf with President Ronald Reagan, while vacationing European central bankers were hard to reach in an era before mobile telephones. A predictable funding problem was left unresolved until the moment when creditors would be least likely to present a united front, and most likely to give in to pressure to undertake crisis-management measures.

In August 1998, Russia had only just concluded a gigantic IMF program that appeared to stabilize the country. That arrangement provided enough funds for insiders to exchange their rubles for foreign assets. Once the insiders had saved their own positions, they no longer saw any need to maintain the exchange rate. The IMF was in summer mode, and all of the consultations required complicated conference calls from remote locations.

When a compromise package has been agreed that makes the summer look calm, when the negotiators think that they have earned a good rest — this is the moment for the brilliant surprise.

A debtor's negotiating strategy is to make creditors believe that a collapse would produce some much bigger catastrophe, which can be avoided only by more concessions and more support. That sense is always more likely when the debtor's action comes without warning — the financial equivalent of a pre-dawn attack.

The euro-zone leaders' summit on June 28-29 in Brussels now looks like the most far-reaching and satisfactory recent attempt at European diplomacy. But it might look very different in September.

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