

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 6, No. 7 July 21, 1985

## Fine-tuning monetary policy

*Flash update. July 5, 10:00 a.m.:*

*"It is our opinion that the US dollar is due for another sizable leg down. Therefore, we recommend the following:*

- 1. Buy September SF and September DM at the market, placing initial stops at 3050 and 3200 respectively.*
- 2. Assuming that you do not care to follow this speculative opportunity, you are advised nonetheless to hedge short Kuwait dinar and Greek drachma positions by buying Swiss francs in an amount equal to 30% of your long US dollar exposure in dinar and drachma.*
- 3. Please note that we do not think that at this time there is a need to hedge the Saudi riyal, Mexican peso, or Indonesian rupiah."*

Such was the recorded message broadcast over our Hotline service. The message had an uncharacteristic urgency, in spite of the fact that for weeks and months earlier we had been warning that the onset of a US recession and some highly accommodative Federal Reserve Board policy would wilt the dollar (typical was last month's remark, "...it would not surprise us to see the US\$/DM move as low as 2.85 before a dollar improvement sets in."). Perhaps it was to emphasize the immediacy and the certainty of this intermediate move, an impression that may not have registered, given our overall long-term bullish dollar stance. The advice was timely: The dollar plunged to as low as 2.825 DM and 2.33 SF from 3.03 DM and 2.53 SF (July 5) before profit-taking lifted the dollar off its extreme lows, leaving it this past Friday at 2.89 DM and 2.3730 SF.

It is quite clear that the Fed was at the very least partly responsible for this dollar drop: A highly accommodative stance reflected in a protracted and virtually uninterrupted period of free reserves since last November (see Chart 1); a 12.2% annual rate of growth of M1 for the same period; and an overly generous acceleration of the adjusted monetary base in recent months to 10% per annum.

To appreciate the impact of changes in the rate of growth of M1 on the fluctuations of the US nominal rate of exchange, we update Chart 2 first presented in our *Comments* of March 11, 1984. The parallels are so noticeable that they hardly merit further comments.

Can fine-tuning be so easy? Since the Fed is well aware that the leakage (i.e., current account deficit) is wrecking the US manufacturing sector and slowing down dramatically the US economy, can it not force the dollar lower yet and thus engineer a recovery? It would appear that, in fact, that was the Fed's intention in the first half of 1985, which resulted in a wide overshooting of M1 targets and the recent "rebasings" episode. Nevertheless, Federal Reserve Board Chairman Paul Volcker must be given credit for not falling into such a facile trap.

Appearing before a Congressional committee, Volcker warned that a collapse in the value of the dollar posed the "greatest potential threat to the progress we have made against inflation," conceding that the risk of a sharp fall in the US currency would be magnified by a slack monetary policy.

There are, in fact, two risks in continuing to target a lower dollar via an accommodative monetary policy. In the first place, a US\$/DM rate below 2.75 and, surely, below 2.65 (in our necessarily subjective reading of markets) would threaten confidence in the dollar sufficiently to cause capital flows — primarily short-term interest-and-capital-appreciation-oriented funds — to exit the US money markets. The impact on interest rates could be devastating, as one need only to see what impact self-feeding capital outflows had on the UK earlier this year where money rates jumped as much as 600 basis points. Moreover, the widening US budget deficit, now easily poised to exceed \$250 billion during 1985, would aggravate intolerably the interest rate spiral. The precarious health of the US banking and thrift industry could not survive such a scenario of rising rates.

There is a second hitch in the apparently convenient method of targetting a lower dollar. Chart 2 concerns itself

### In this issue

Words of wisdom from the chairman of the FDIC; the Saudis are losing patience; gold's a good long-term bet; and the Mexican peso has yielded good returns so far. Contributions by Albert D. Friedberg and Daniel A. Gordon.

solely with the fluctuations of the nominal rate of exchange. However, to have the slightest impact on the US trade position and its weakened manufacturing sector, the *real rate of exchange must come down*. Simply put, a nominal drop of 10% in the US dollar accompanied by a 10 percentage point increase in inflation vis à vis its main trading partners would leave the dollar's real rate of exchange substantially unaltered.

As we pointed out repeatedly in previous issues (see particularly "Depression, inflation, interest rates, and the myth of monetarism," May 13, 1984), it was the *rising* dollar that kept inflation under control in view of the fact that post-1979 money supply growth was every bit as expansive as pre-1979 money supply growth. A falling dollar will let loose the inflation monster, negating in all probability the early advantages of a competitive currency level. In fact, one could then be contemplating a worst-case scenario of a rising US inflation rate, a falling US nominal rate of exchange, and a rising US real rate of exchange (a continuation of the US dollar's performance of the past five years but in a context of high inflation rather than disinflation or deflation).

Alternatively, of course, the US real rate of exchange could drop in the context of high inflation, high interest rates, and very depressed domestic economic conditions, i.e., living *within* one's means, a situation well known to Latin American borrowers in recent years. In short, while nominal rates of exchange are subject to fine-tuning, real rates are not. The same, of course, is also true of real interest rates or real wages.

The Fed, then, is trying to strike an extremely delicate balance. Acknowledging that the "desire to curb excessive and ultimately unsustainable strength" in the dollar was one reason why it pursued "relatively accommodative" monetary policy since late last year, the Fed also has a great deal to fear from a substantial drop, and in fact would use dollar weakness as a pretext for tightening credit conditions, as clearly stated in an exchange with Representative John Hiler (R. Indiana).

With M1 already above the new, rebased targets (see Chart

3), the Fed is not likely to enjoy a good deal of maneuverability in coming months. In fact, for only the second time this year, the banking system went from free reserves to net borrowed reserves of \$203 million for the two weeks ended July 17, an indication, perhaps, that the Fed had begun to nudge the nation's banks to a less comfortable and more restrictive position.

M1 targets, of course, are not cast in stone. There are other indicators, watched by the Fed, that could result in changes in monetary policy. Aside from the dollar, which as we pointed out, is beginning to emit amber signals, the Fed would consider the state of final domestic demand (still too strong), the overall state of the economy (enormously weakened by the external deficit), key commodity prices (weakness in oil and gold could lead to a further relaxation of policy), M2 and M3 growth rates (modest), and the pace of household and corporate borrowing (booming the first, strong the second).

The conflicting signals emitted by the above indicators almost guarantee that the Fed will a) do no more relaxing for now until b) a major "accident" occurs in any of the above areas. As an example, a *collapse* of oil prices may result in the Fed's easing further while a visible pick-up in third quarter GNP may call for more restraint. *Nevertheless, we strongly believe that the dollar will prove to be the outside constraint on the Fed:* Should it fall by 5% or more from these levels, the Fed will tighten significantly; conversely, should it rise by more than 10%-12% from current levels, the Fed will ease significantly.

**STRATEGY:** *Further downside progress in the dollar will be difficult. To protect our substantial profits, we advise trailing long Swissie and DM positions with stops at 4095 and 3390, basis September '85, close only. These stops will be revised upward in coming days (through the Hotline). On the upside, we advise taking profits on further rises of 5% (approximately 200 points on the September '85 Swiss franc and 175 points on the September '85 DM).*

Chart 1

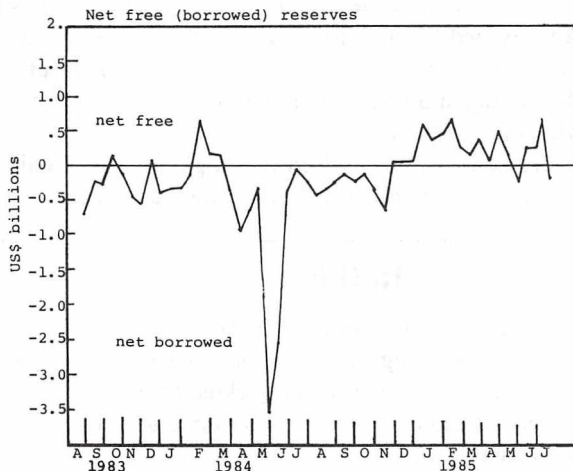


Chart 2

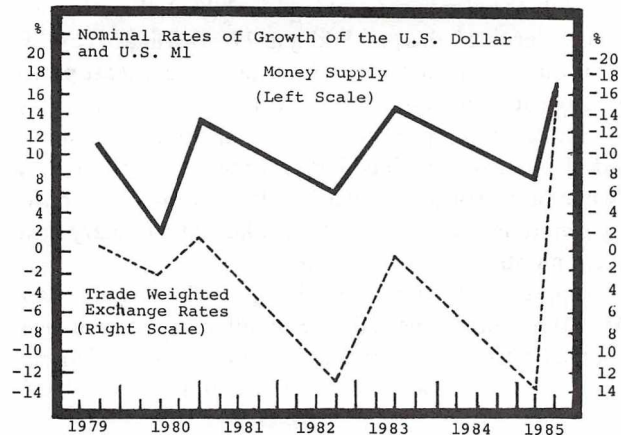


Chart 3

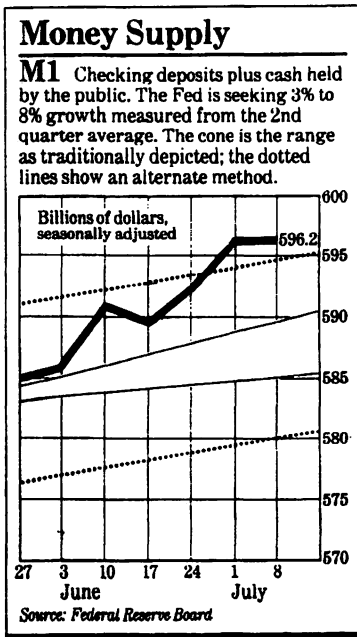


Chart 4

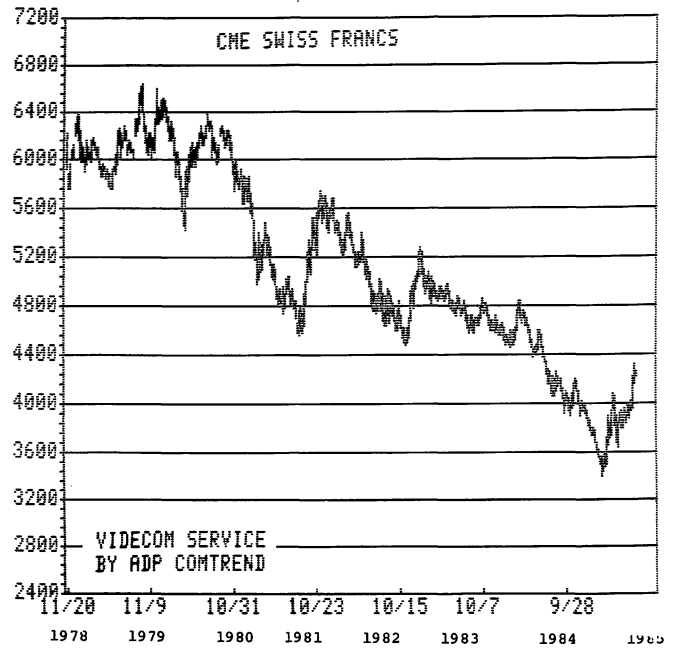


Chart 5

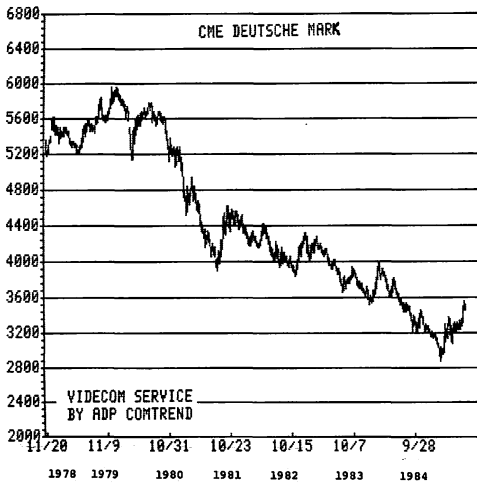


Chart 6

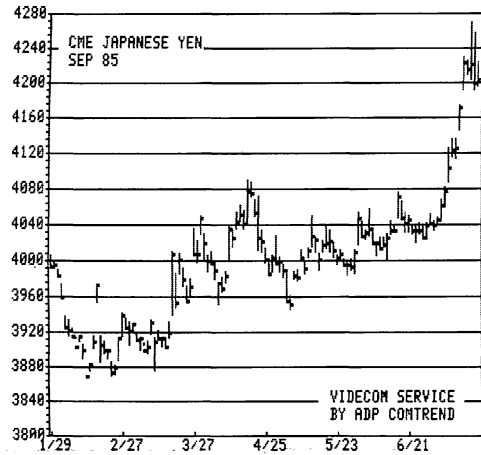


Chart 7

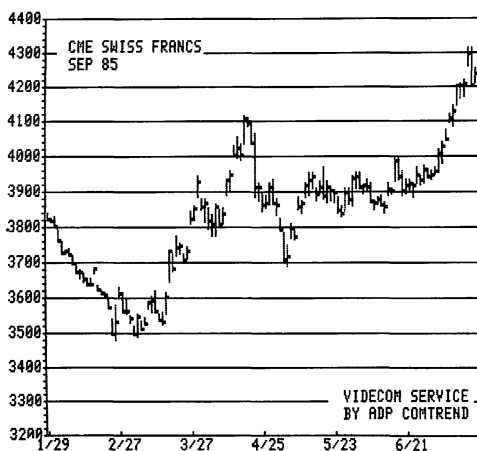


Chart 8

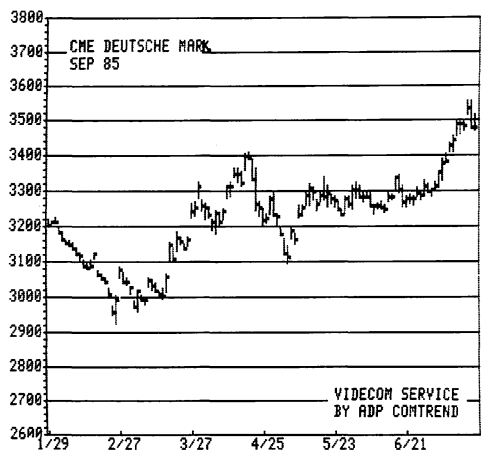


Chart 9

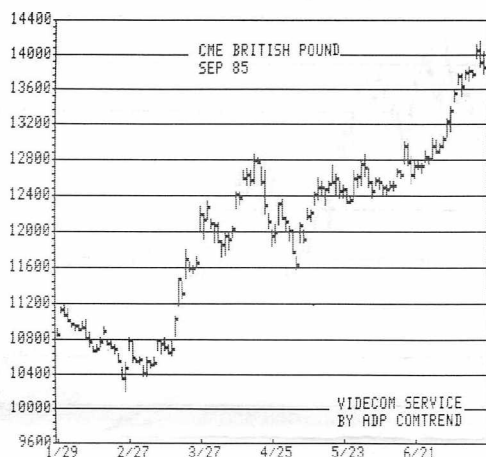
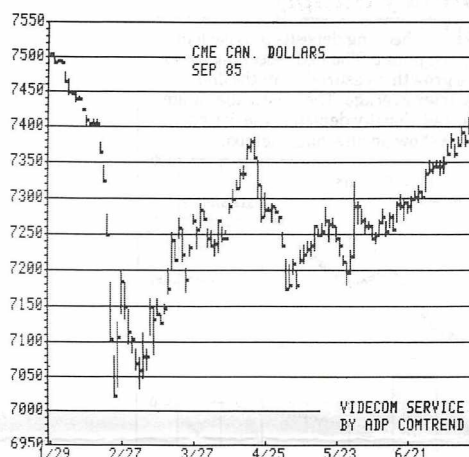


Chart 10



## The banking mess—Part IV

In previous issues we discussed the alarming deterioration of the US financial system and the real risk that it poses to the economy's health and its currency. Since our last note on the subject (November 16, 1984), the situation has worsened considerably. More than two banks fail per week, and almost one thousand banks are now on the watch list, a troubling acceleration. It has been our considered opinion that the deposit insurance scheme (FDIC & FSLIC) lies at the very core of the problem for virtually underwriting any and every possible financial speculative activity.

In a recent statement presented to the subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, US House of Representatives, William M. Isaac, Chairman of the FDIC makes the point quite forcefully, although he inculcates deposit brokers rather than the insurance system itself (as we maintained in the past, we have no quarrel with a *modest amount of co-insurance*, preferably). We reproduce his speech along with some fascinating case studies.

### An Overview of the problem

Just over 50 years ago, the financial system lay in ruin. Nearly 10,000 banks had failed during the first four years of the Great Depression, President Roosevelt had declared a bank holiday and the public clamored for reform. Over a hundred proposals for a federal deposit insurance system had been introduced in Congress during the late 1800s and early 1900s, but none had become law.

The political climate changed dramatically in the midst of the chaos, though there was still powerful opposition to federal deposit insurance, most notably from President Roosevelt and the American Bankers Association. They believed the system would be too expensive and would subsidize marginal, high-risk institutions at the expense of well-managed

firms. But millions of individuals had lost or faced the prospect of losing some or all of their life savings. They wanted action, not excuses. They wanted protection, not philosophy. Their voices were heard; the FDIC was created to restore confidence and stability in the banking system by safeguarding the savings of depositors, up to \$2,500 per customer.

The system worked remarkably well. The holiday was ended and the failure rate plummeted. The fears expressed by opponents of deposit insurance did not come to pass. Bankers and their regulators, freshly scarred by the financial collapse, were extremely conservative. Competition, innovation and service were eschewed out of an over-zealous concern for safety.

Driven by advances in technology, a volatile and changing economic environment, a growing sophistication on the part of investors and heightened competition, the financial world has undergone a virtual revolution during the past two decades. The signal event with respect to the problem at hand — deposit brokerage — was the passage of the Deregulation and Monetary Control Act of 1980, mandating the phaseout of deposit interest rate ceilings.

Prior to decontrol of interest rates, banks and thrifts were pretty much prohibited from bidding for deposits. Funds generally flowed to institutions that were perceived to be strong and could offer the best and most convenient services.

Overall, deregulation of interest rates has been an enormous success. Banks and thrifts have stopped the erosion of their market share dead in its tracks, and consumers and smaller businesses have reaped tens of billions of dollars in additional interest income. The fears expressed by some that rate wars and cutthroat competition would ensue have proved to be largely unfounded.

A major exception to this generally positive record involves the activities of money brokers and their investor clients.

In a few short years money brokering has become a very big and enormously lucrative business. It requires no particular skill apart from salesmanship. Money brokers scour the country in search of hot money seeking the highest available risk-free return. The funds are packaged in fully insured blocks and then sold to the highest bidder, which all too often is a marginal, high-risk institution. A survey conducted by the FDIC last year revealed that of the \$24 billion in brokered funds in FDIC-insured institutions, over \$9 billion was held by troubled institutions.

Let me explain how the system works. Suppose a credit union has \$10 million it wishes to invest in the money markets rather than lend to its members. If there were no deposit insurance system, the credit union would likely invest in Treasury obligations, high-grade state or municipal bonds or high-quality bank or thrift CDs. Yield would be balanced against risk.

No such deep thought is required in the era of deregulation and the money broker. The credit union simply wires the \$10 million to a broker and the broker in turn wires it in fully insured \$100,000 blocks to the 100 banks and thrifts offering the highest rates. The entire transaction is completed nearly instantaneously — no muss, no fuss and, most importantly, no risk to anyone but the FDIC or the FSLIC.

The worst fears of the early opponents of deposit insurance are coming to pass. Marginal, high-risk banks and thrifts are being subsidized by well-run institutions, and the costs are staggering. There is no question that use of brokered funds in these banks has cost the FDIC hundreds of millions of dollars. Schedule B attached to our statement gives a brief case history of several of these banks. While they represent some of the more egregious examples of abuse, they are but a handful of the many examples we and the FSLIC could provide.

We should point out that some brokers are also involved in supplying funds to banks in amounts over the \$100,000 insurance limit. If the CD is not subsequently subdivided among various investors so as to obtain full insurance coverage, we have no objection to this practice. In this situation the broker and/or the broker's customers must perform a credit analysis, measuring the risk versus the yield, instead of blindly relying on our insurance guarantee.

The FDIC recently completed a survey (data as of February 28) of all FDIC-insured banks and thrifts rated 3, 4 and 5 — the lowest categories on our CAMEL rating system — which had fully insured brokered deposits in excess of five percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than \$2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over five percent to almost 50 percent of the sampled institutions' deposits. In one instance a major brokerage firm, in less than a week, placed \$60 million in new funds in a clearly troubled FDIC-insured savings bank, which used the funds to speculate in high-yield corporate (so-called "junk") bonds. . . .

Keep in mind that this survey occurred after nearly two years of intense efforts by the FDIC to control this clear abuse of the deposit insurance system. It is frightening to contemplate how much more massive the problem might have become in the absence of these efforts.

It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of insured brokered funds.

Who are the principal investors in brokered funds? Credit unions were identified as the largest single aggregate dollar holders, followed by S&Ls and commercial banks. Frankly, we find it appalling that the biggest abusers of the deposit insurance system are the very institutions the system was designed to assist.

### The response to the problem

The FDIC has addressed the problem of brokered deposits by regulation and, in individual cases, by use of our supervisory and enforcement powers. We issued a regulation limiting federal deposit insurance coverage for all deposits placed by or through brokers to \$100,000 per broker, per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this is being challenged in the courts.

We have also dealt with the problems resulting from brokered deposit use on a case-by-case basis. When abuses are found, we use our enforcement powers to guard against further deterioration. For nearly two years now, as a matter of routine, we have inserted a provision in all enforcement actions taken against 3, 4 and 5 rated institutions prohibiting further usage of brokered funds. While our vigorous enforcement activities have had a limiting effect on brokered deposit use, I would stress that these actions are not preventive measures. They are, of necessity, initiated after the fact when problems and clear abuse have been identified.

In January of this year, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or five percent of deposits. This reporting requirement provides more frequent and meaningful information than had been available, and increases our effectiveness in dealing with the problems. Institutions reporting heavy usage of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates, without regard for the soundness of the issuing institution. The point must be driven home that when these institutions fail, the cost to the deposit insurance found is greatly increased.

All these measures have helped, but they cannot be expected to solve the problems. In an environment in which a bank or thrift may purchase a massive volume of funding overnight, an institution can radically and precipitously alter its character and its risk to the insurance fund.

### Legislative alternatives

We have received virtually no help from the Congress during the past two years as we have struggled to contain this serious threat to the insurance system. A subcommittee in the House issued two "studies" contending there is no problem despite overwhelming facts to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our back by establishing an exceedingly high cap on shorter term brokered funds, exempting longer term funds altogether and restricting our current enforcement powers over troubled institutions.

The FDIC's joint regulation with the Bank Board to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not prohibit any bank or thrift from using brokered funds or any broker from placing funds; there is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage for funds placed in other insured institutions by credit unions, banks and S&Ls.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are opposed to this market-oriented approach. They would prefer that we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by any troubled institution.

No bank or thrift should be able to leverage upon the federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold \$24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly \$190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through brokers regardless of the term of maturity. Some suggest that longer-term brokered funds — those with maturities of one year or more — ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than do short-term funds. There is absolutely no justification for a distinction between long-term and short-term brokered deposits. Maturity is not the relevant

problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor. I would point out that the bulk of the funds supplied to troubled banks by the major investment firms have a maturity in excess of one year. How much more do these brokers need than a ceiling of \$190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions? A ceiling that will likely grow by 8-to-10 percent per year as capital increases. A ceiling that is nearly eight times greater than the amount of all brokered funds, insured and uninsured, in these institutions today. A ceiling that is over 10 times the size of the FDIC's insurance fund!

Thank you once again Chairman Hubbard and members of this subcommittee for giving us this opportunity to express our views on an issue of great importance to the nation's financial system. I will be pleased to respond to any questions you may have.

## Case Studies of Selected Failed Banks Using Brokered Funds

### Peoples Bank & Trust Company, Wartburg, Tennessee

Bank was closed on February 8, 1985. At that time brokered deposits totaled \$6,400,000 and represented 32% of total deposits of \$20,058,000. In July of 1984 ownership and control of the bank changed and immediately thereafter brokered deposits were introduced into the bank, reaching a high of \$7,100,000 by the end of August, 1984. Brokered deposits provided the major share of the funding for the bank's acquisition of over \$11 million in out-of-territory timeshare and solar-energy contracts from a corporate interest of the new control owners in an elaborate link-financing scheme, which resulted in losses approaching \$10 million.

### Indian Springs State Bank, Kansas City, Kansas

Bank was closed January 27, 1984. At that time brokered deposits totaled \$9,300,000 and represented 34% of total deposits of \$27,074,000 on the date of closing. These deposits provided the funding for a link-financing scheme involving out-of-territory real estate development loans which resulted in enormous losses, rendering the bank insolvent.

### West Valley Bank, Woodland Hills, California

Bank closed February 8, 1985. At that time brokered deposits totaled \$17,600,000 and represented 53% of total deposits of \$33,100,000. Brokered deposits were first introduced into the bank in the second quarter of 1984 and reached a high of \$17,600,000 as of the date of closing. These funds provided funding for the acquisition of over \$6,200,000 in fraudulent insurance premium financing contracts, which resulted in the bank's failure.

### Community Bank, Hartford, South Dakota

Bank was closed June 17, 1984. At the time of closing, brokered funds totaled \$10,400,000 and represented 27% of total deposits of \$39,073,000. Brokered deposits were introduced into the bank in April 1983 and reached a high of \$10,400,000 as of the date of closing. These funds provided funding for the pur-

chase of a \$10,400,000 annuity from an obscure North Dakota insurance company. The annuity was subsequently determined to be worthless, thus eliminating the bank's capital accounts. The bank was persuaded to enter into this transaction by an individual who had promised to purchase the bank at a price well in excess of its market value.

## Energy Futures

### Stay short oil: Saudis losing patience

At tomorrow's Opec meeting, the Saudis are likely to insist on their *right* to produce at the allotted level of 4.3 million barrels per day (mb/d). At the same time, no Opec member has shown a disposition to cut back output. In particular, the Iraqis will be asking for an *increase* in their quota to 1.8 mb/d from 1.2 mb/d as they start filling, almost immediately, the 400 mile pipeline linking its southern oil fields to Saudi Arabia's trans-peninsula system. The pipeline will be transporting 500,000 b/d of oil, which will be lifted at the Yanbu terminal on Saudi Arabia's Red Sea coast sometime in September. A senior Iraqi oil official has acknowledged that the price will be "basically market related."

At the same time, Venezuela and Nigeria are currently being undercut by \$2-2.50/barrel by Mexico's Maya oil and UK Brent respectively, putting them in an intolerable position. Already, Nigeria's output has fallen to 1.1 mb/d from 1.62 mb/d in April and 1.4 mb/d in May.

Internal dissension in Saudi Arabia over Oil Minister Yamani's misguided oil policy has finally begun to surface. As we've pointed out for the past three years, Yamani's grand

strategy would inevitably have to backfire: It encouraged conservation, stimulated new oil discovery and exploration, reduced their total revenues, and to boot, aided Iran in the war effort against its ally Iraq by providing a price umbrella that yielded over \$30 billion to the Teheran government. Little wonder that the grand strategy is about to take a 180° degree about-face.

Whether gradually and inconspicuously (most likely) or suddenly and preceded by an announcement, the Saudis will first move to raise production to their quota. The increased output (approximately 2 mb/d) will put modest downside pressure on prices *if* other Opec members cut back to below quota levels or, much more likely, intense downward pressure, once juggling for market share becomes generalized. As prices and discipline break, the Saudis will move to raise output to 9-10 mb/d. *Prices will go into a freefall, reaching our long-standing target of \$5-\$10/barrel.*

**STRATEGY:** *Regardless of tomorrow's meeting, the die is cast. The Saudis have learned their lesson. Press your short position in the back months (January and forward). Notice how the backwardation is steepening (see last month's comments for an interpretation), forcing ex-ante destocking and putting even more pressure on Opec. (Chart 13).*

Chart 11

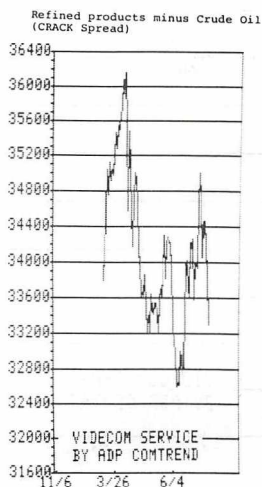


Chart 12

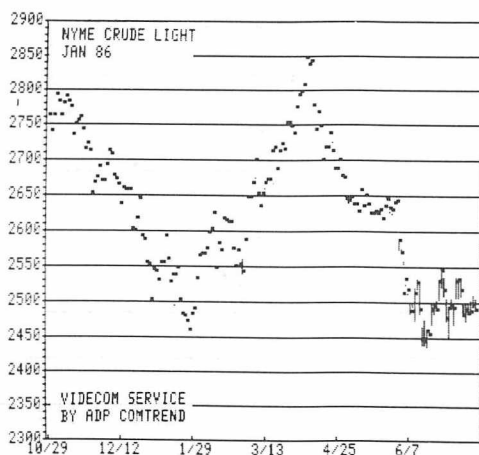
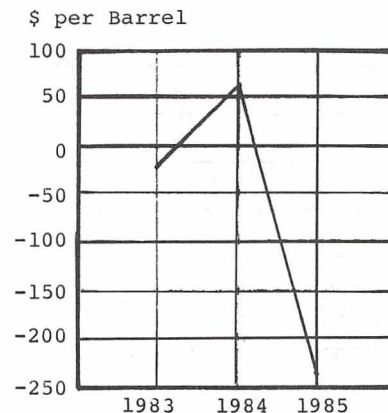


Chart 13

Aug/Jan differential in  
New York Crude Oil (1983-1985)  
on expiration of Aug. Contract



# Precious Metals

## Gold: A good long-term bet

Despite its sluggish action in the face of a weakening dollar, gold remains a good long-term bet on monetary instability, which becomes inevitable as US current account and budget deficits continue to accumulate. It is quite likely, however, that the next major upmove in bullion will not occur until the Fed eases aggressively, a prospect reserved for a semi-depression contingency.

**STRATEGY:** *Traders have been stopped out of gold as well as silver and platinum. Long-term investors, however, should patiently retain their core gold positions.*

Chart 14



# Financial Futures

## Three spreads and a principle

**STRATEGY:** *We favor, at this time, three spreads.*

1. Long September '85 T-bonds/short September '85 S & P 500, as discussed last month (see Chart 15).
2. Long one December '85 T-bond/short 2.6 December '85 Eurodollars, a combination Yield Curve and Ted spread (see

Chart 16).

3. Long August '85 TSE 300 Index/short August '85 Toronto Oil and Gas Index.

*Since we have no logical stop level on the above spreads, we advise setting a dollar stop-loss suitable to each individual trader. As a principle, we would not want to risk in excess of 33% of the margin committed.*

Chart 15

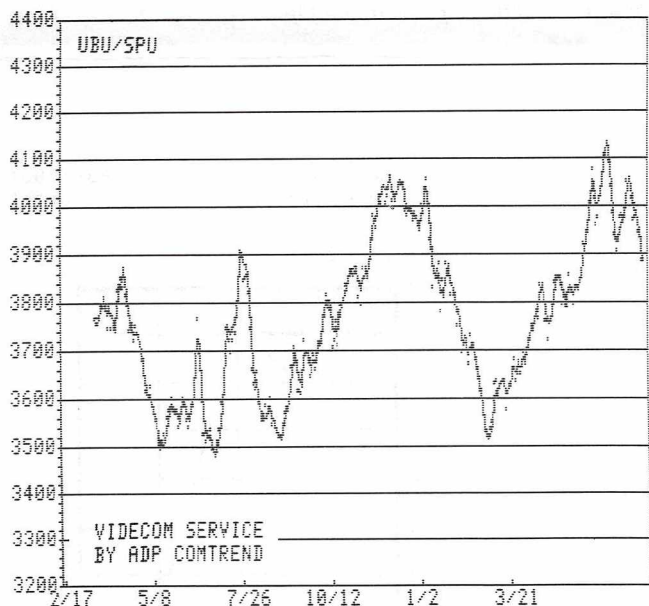
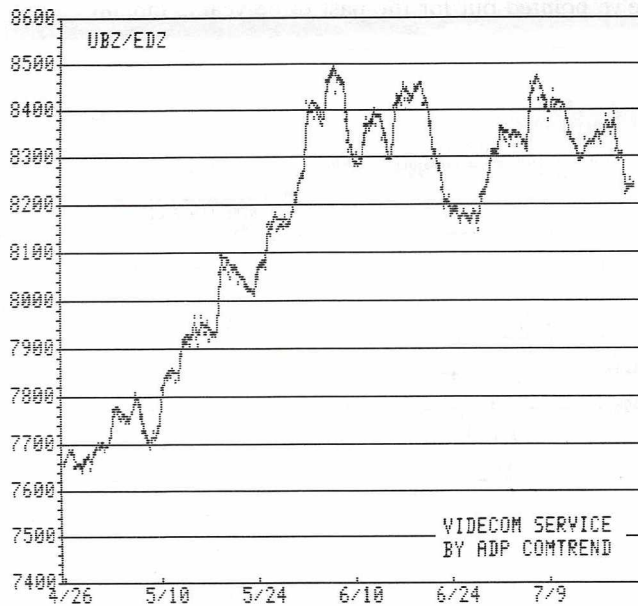


Chart 16



# Currencies

## Mexican Peso: Big returns so far

With typical Mexican ingenuity, the authorities engineered a maxi-devaluation, as we have been forecasting for the past seven months, without actually admitting to one. Dubbed a "slow-motion devaluation" strategy, Mexico abolished its so-called "controlled" free (a Mexican contradiction of terms) financial rate, which had been trading around 248 pesos to the dollar and which had been allowed to drop 21 centavos per day, and empowered its nationalized banks to deal in the free, now called "super-free" financial rate, so as to accommodate an insatiable dollar demand. Very quickly, the super-free rate rose to 370 pesos, opening an enormous gap vis à vis the controlled commercial rate at which 80% of the country's commerce and foreign debt service is traded and which now stands at 232 pesos. This 60% gap will encourage underinvoicing of exports and overinvoicing of imports, thus ultimately forcing an official devaluation.

Assuming that M1 for July stands at approximately 2.5 trillion pesos, money supply in dollars (at the super-free rate) equals approximately \$6.9 billion, slightly more than the level prevailing in early 1977 (after the first devaluation, from 12.50 to 22) and slightly under the level prevailing in late 1982. In other words, the exorbitant monetary inflation of the 1983-1985 period has been shrunk sufficiently to estimate that real balances are now in equilibrium. What remains to be seen is the impact of collapsing oil prices on government receipts and how ever-rising expenditures are to be financed. If the Mexi-

can authorities resort to monetization, then, of course, the peso will continue to fall. If, on the other hand, the government cuts spending in order to offset the decline in revenues and/or obtains new external financing (both unlikely occurrences), then the present rate and its wide forward discount will provide a good profit opportunity.

**STRATEGY:** With Mancera (an extremely capable central banker) at the head of the Banco de Mexico, we are prepared to give the Mexican authorities 10% credibility. We therefore recommend covering 10% of the forward positions at these levels (370 spot and approximately 20 pesos per month on the forwards). One-year positions initiated last November at approximately 313 pesos (212 spot plus 101 pesos for the one year) yield US \$30,500 per sale of US\$100,000 worth of Mexican pesos. Since margin was 20%, our speculation shows so far a 152% return.

Chart 17



## The Exotics

### How to trade the exotics

A few months ago, we introduced you to a new service — trading in exotic currencies. Since then, we've had numerous queries about the special currency contracts we've set up. So to help you out, and clear up any confusion, Chart 18 lists contract sizes and minimum margin requirements for the exotics. For more information, call Daniel A. Gordon, at Friedberg Mercantile Group, (416) 364-2700.

Chart 18

Currency	Contract Size (In local currency)	Margin Required
Australian dollar	500,000	US\$25,000
Belgian franc	25,000,000	25,000
Venezuelan bolivar	3,500,000	35,000

Danish krone	4,000,000	25,000
Portugese escudo	60,000,000	25,000
French franc	4,000,000	25,000
Greek drachma	35,000,000	35,000
Hong Kong dollar	3,000,000	25,000
Italian lira	700,000,000	25,000
Indonesian rupiah	200,000,000	35,000
Kuwaiti dinar	120,000,000	25,000
Malaysian ringgit	1,000,000	35,000
Mexican peso	75,000,000	35,000
Norwegian krone	4,000,000	35,000
Netherland guilder	1,300,000	25,000
New Zealand dollar	700,000	25,000
South African rand	500,000	25,000
Saudi Arabian riyal	1,500,000	25,000
Singapore dollar	1,000,000	35,000
Swedish krona	4,000,000	25,000
Spanish peseta	75,000,000	35,000
United Arab Emirates dirham	1,500,000	25,000

# New Zealand dollar

The relative undervaluation of the "Kiwi" that we alluded to in the December 1984 *Comments* has begun to bear fruit in spite of extreme nervousness and pessimism by Forex dealers. The New Zealand dollar has in addition strengthened as a direct result of some successful bond floatations, which with yields of 15%-17%, have whetted the appetite of hot-money investors.

The Labor government has taken all the "right" measures: freeing the exchange rate, cutting the deficit significantly as a percentage of GDP (expecting the 1985-86 shortfall to be no greater than 2.8% of GDP); and signing a significant free-trade agreement with Australia.

While the inflation rate continues relatively high, a natural result of the successive bouts of devaluation that occurred

in the past year, it is expected to peak in the current quarter and drop to an annual rate of 10% by the first quarter of 1986.

Real economic growth is expected to taper off to 2% according to government predictions, although private estimates are a great deal more pessimistic and expect a sharp contraction towards the end of the 1985-86 fiscal year. If the recession comes about, New Zealand's current account may improve significantly from the NZ\$2.6 billion current account deficit experienced in the 1984-85 fiscal year. On a purchasing power parity basis there is room for further improvement, especially when viewed against a background of pro-market-oriented policies. It should be noted that forward discounts are relatively steep and earn the holder of Kiwi forward balances approximately 1% per month. Therefore, purchases at current levels should benefit from a slight spot appreciation and a sizable forward appreciation.

Chart 19

YEAR	US\$ per New Zealand \$ (PERIOD END)	U.S.		BASKET	
		1970 =1.00	1978 =1.00	1970 =1.00	1978 =1.00
1967	1.1227	0.9935	1.3768	1.0148	1.1256
1968	1.1121	1.0034	1.3905	1.0143	1.1251
1969	1.1198	1.0001	1.3859	1.0076	1.1176
1970	1.1161	1.0000	1.3857	1.0000	1.1091
1971	1.1952	0.8793	1.2184	0.9395	1.0420
1972	1.1952	0.8522	1.1810	0.9268	1.0279
1973	1.4284	0.6990	0.9686	0.8241	0.9140
1974	1.3155	0.7575	1.0497	0.8795	0.9755
1975	1.0437	0.9114	1.2630	1.0510	1.1657
1976	0.9500	0.9059	1.2554	0.9904	1.0985
1977	1.0197	0.7851	1.0879	0.9522	1.0561
1978	1.0666	0.7216	1.0000	0.9016	1.0000
1979	0.9862	0.7644	1.0592	0.9724	1.0785
1980	0.9623	0.7584	1.0510	1.0202	1.1316
1981	0.8244	0.8477	1.1747	1.0317	1.1443
1982	0.7325	0.8707	1.2066	0.9732	1.0794
1983	0.6546	0.9374	1.2990	1.0040	1.1136
1984	0.4776	1.2620	1.7488	1.2262	1.3600
1985 (1Q)	0.4615	1.2215	1.6927	1.1561	1.2823

----- BASKET -----  
 U.S. 24% U.K. 17%  
 JAPAN 30%  
 AUSTRALIA 29%  
 -----

Above 1.00 = undervalued  
 Below 1.00 = overvalued

Chart 20

Year	Foreign Assets (Mln US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Mln US\$)
1970	317	-3.76	-283
1971	547	-0.25	-228
1972	888	+1.74	-88
1973	1139	-0.97	+2
1974	568	-12.82	-1761
1975	55	-8.46	-3092
1976	-98	-5.81	-3772
1977	-231	-4.72	-2664
1978	-234	-2.73	-1980
1979	425	-3.90	-2002
1980	317	-3.46	-2117
1981	729	-5.41	-2984
1982	797	-6.23	-3636
1983	850	-4.68	-3889
1984	1849	-	-4478
1985 (1)	1039	-	-

Chart 22

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.5035 -	.4955 -	.4830	.4685 -	.4410
	.5045	.4985	.4865	.4735	.4530

Chart 21

**HARD CURRENCY COVER** (In millions of U.S. Dollars)

Reserves \* + Previous 12-months current Account \*\*\* = 844  
 (Reserves + 12-months C/A)/ M1 \*\* = 844/1567 = 53.8%

(Reserves + 12-months C/A)/ Broad Money \*\*\* = 844/5196 = 16.2%

\*As at April 1985 \*\* April 1985 \*\*\* 1985(1)-1985 (4) Estimated

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Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	2106	3449
1985 April	1567	5196
% Increase (decrease)	(25.6)%	50.6%

Corresponding %  
 increase in the  
 United States 113% 159%

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(a) 1983 imports as percentage of GNP 24.29%  
 (b) 1974-1983 imports as percentage of GNP 22.14%  
 1983/(1974-1983 average) = (a)/(b) = 24.29/22.14 = 109.7%

Source: IFS

# Australian dollar

It appears that the relatively low level of the Aussie is managing to attract a fair amount of capital, which has swung, of late, the country's balance of payments position, as measured by net official monetary movements, to a surplus despite the widening current account deficit. In due course, we expect the current account to improve, given the extremely competi-

tive level of the Australian dollar. It should, however, be pointed out that the country's international trade performance is heavily dependent on prices of primary resources, and the prospects for these products are not favorable.

We have been patient bulls on the Aussie since February 17, and have managed to collect some forward discounts. We would remain long, setting our sights on the .7500-.7700 level.

Chart 23

YEAR	U.S. DOLLAR PER AUSTRALIAN DOLLAR (PERIOD END)	U.S.		BASKET	
		1967 =1.00	1873 =1.00	1967=1.00	1973 =1.00
1967	1.12100	1.00000	1.34456	1.00000	1.22944
1968	1.11000	1.02509	1.37829	1.02140	1.25575
1969	1.11800	1.04324	1.40270	1.04482	1.28454
1970	1.11500	1.06550	1.43263	1.06658	1.31129
1971	1.19100	0.98180	1.32009	1.03798	1.27614
1972	1.27500	0.89654	1.20545	0.93992	1.15557
1973	1.48800	0.74374	1.00000	0.81338	1.00000
1974	1.32700	0.80389	1.08087	0.88778	1.09148
1975	1.25710	0.80563	1.08322	0.85854	1.05553
1976	1.08640	0.86872	1.16805	0.91105	1.12008
1977	1.14140	0.78476	1.05515	0.89536	1.10079
1978	1.15050	0.77543	1.04261	0.92204	1.13560
1979	1.10550	0.82353	1.10729	1.00843	1.23980
1980	1.18070	0.79471	1.06854	1.00305	1.23519
1981	1.12790	0.83722	1.12570	0.95338	1.17213
1982	0.98060	0.91920	1.23592	0.99317	1.22105
1983	0.89250	0.94714	1.27349	0.97881	1.20339
1984	0.82780	1.02463	1.37767	0.95608	1.17544
1985 (1Q)	0.70510	1.18844	1.59793	1.13941	1.40084

----- BASKET -----  
 U.S. 29% U.K. 11%  
 JAPAN 45% NEW ZEALAND 8%  
 Germany 7%  
 -----

Above 1.00 = undervalued  
 Below 1.00 = overvalued

Chart 24

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR.	
		As % of GNP	%	Current Account (Min US\$)	%
1970	1,817	-2.23		-3019	
1971	3,330	-1.98		-2467	
1972	6,079	+1.10		-1064	
1973	5,776	+0.80		+260	
1974	4,137	-3.30		-1598	
1975	5,653	-0.94		-2935	
1976	2,571	-1.84		-5225	
1977	2,952	-2.99		-5414	
1978	3,411	-4.16		-9130	
1979	4,016	-2.20		-10022	
1980	6,573	-2.97		-11318	
1981	4,474	-5.18		-15026	
1982	8,912	-5.10		-20506	
1983	11,490	-3.77		-22157	
1984	9,214	-4.85		-22164	
1985(1)	-	-		-21562	

Chart 26

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.7160 -	.7113 -	.7038 -	.6943 -	.6790
	.7165	.7131	.7058	.6963	.6815

Chart 25

**HARD CURRENCY COVER** (In millions of U.S. Dollars)

Reserves \* + Previous 12-months current Account \*\*\* = 1794  
 (Reserves + 12-months C/A)/ M1 \*\* = 1794/15187 = 11.8%  
 (Reserves + 12-months C/A)/ Broad Money \*\* = 1794/ 57914 = 3.0%  
 \*As at April 1985 \*\*April 1985 \*\*\* 1985(3)-1986(2)

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**Figures in millions of U.S. Dollars**

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	10496	35782
1985(April)	15187	57914
Δ Increase (decrease)	44.7	61.8

Corresponding % increase in the United States: 113% (M1), 159% (Broad Money)

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 (a) 1984 Imports as percentage of GNP = 13.9%  
 (b) 1975-1984 imports as percentage of GNP = 13.4%  
 1984/(1975-1984 average) = (a)/(b) = 103.7%

Source: IFS

# Forex Rates & Update

<u>Currency</u>	<u>Spot</u>	<u>3-month</u>	<u>12-month</u>	<u>Comments vis-à-vis US\$</u>	<u>Comments vis-à-vis DM spot DM 2.8800</u>
Belgian franc	57.50-57.70	57.59-57.83	57.85-58.20	Neutral	Remain long
Danish krone	10.35-10.36	10.38-10.40	10.42-10.45	Neutral	Neutral
Dutch guilder	3.2275-3.2375	3.2130-3.2231	3.1575-3.1705	Neutral	Neutral
Greek drachma	129.20-129.30	133.70-136.30	147.20-157.30	Short; long Swiss	Remain short
Italian lire	1890-1900	1910-1935	1990-2020	Neutral	Remain long
Indonesian rupiah	1120-1125	1150-1200	N/A	Remain short	Remain short
Kuwaiti dinar	.29950-.29975	.29865-.29965	.29800-.29900	Short; long Swiss	Remain short
Malaysian ringgit	2.4640-2.4670	2.4640-2.4700	2.4640-2.4725	Neutral	Remain short
Mexican peso	365-375	420-440	565-635	Short; see comments	Short; see comments
Norwegian krone	8.36-8.37	8.45-8.47	8.65-8.68	Neutral	Neutral
Portugese escudo	173.45-173.50	176.20-176.40	183.70-184.25	Neutral	Remain long
Saudi Arabian riyal	3.6500-3.6510	3.6540-3.6580	3.6590-3.6650	Remain short	Remain short
Singapore dollar	2.2030-2.2055	2.1865-2.1900	2.1500-2.1625	Neutral	Remain short
South African rand	.5295-.5305	.5170-.5190	.4955-.4985	Remain long	Remain long
Spanish peseta	165.70-165.80	168.40-168.80	176.70-177.80	Neutral	Neutral
Swedish krona	8.38-8.40	8.52-8.55	8.74-8.78	Neutral	Remain long
Venezuelan bolivar	14.10-14.20	14.15-14.30	14.60-15.50	Neutral	Neutral

### Explanatory Notes

Currency expected to firm against both currencies.

Currency expected to strengthen against US \$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US \$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy

Buy

Sell

Sell

Buy

Sell

Sell

Buy

Cover

Liquidate

## Hotline Update

**Tuesday, June 18:** Repeat of Friday, June 14.

**Friday, June 21:** There are no changes to the market letter of June 16.

**Tuesday, June 25:** No changes.

**Friday, June 28:** The rally in crude oil has ended. Liquidate long August positions, suggested to you on June 14 update, at the market. Long-term traders should continue to add to their short positions in the deferred months, namely January and forward.

**Tuesday, July 2:** As suggested on Friday, June 28, you have liquidated profitably your long August hedge position in crude oil and are short the deferred months.

**Flash update, July 5, a.m.:** It is our opinion now that the US dollar is due for another sizable leg down. Therefore we recommend the following:

1. Buy September SF and September DM at the market, placing initial stops at 3050 and 3200 respectively.

2. Assuming that you do not care to follow this speculative opportunity, you are advised nonetheless to hedge short Kuwait dinar and Greek drachma positions by buying Swiss francs in an amount

equal to 30% of your long US dollar exposure in dinar and drachma. 3. Please note that we do not think that at this time there is a need to hedge the Saudi riyal, Mexican peso, or Indonesian rupiah.

If there are no further changes, this tape will take the place of the regular Friday recording.

**Tuesday, July 9:** Repeat.

**Friday, July 12:** A brief recap of recent recommendations: As of Friday, July 5, speculative accounts are long Swiss francs and are hedged in Kuwaiti dinar and Greek drachma positions by way of long Swiss francs. Raise stops to 4095, close only on September Swiss francs and 3390, close only, on September DM.

**Tuesday, July 16:** Repeat.

**Friday, July 19:** As of Friday July 5, speculative accounts are long SF and are hedged in Kuwaiti dinar and Greek drachma positions by way of long SF. Return stops of 4095, close only, basis September SF and 3390, close only, basis September DM, and keep in close contact for further adjustments in the stop levels.

Next regular update Tuesday, July 23.

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