

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 6, No. 12 December 15, 1985

A crude roller coaster

For some time, our analyses and evidence have pointed toward the inevitable collapse of Opec. Our position on the dynamics of the crude oil market was further confirmed earlier this month in Geneva. The Opec oil ministers agreed in principle to abandon Opec's long-standing objective of restricting output to maintain a cartel price. Instead, Opec will attempt to obtain and protect a fixed share of the world market for crude oil. The determination of this share and the method by which it will be obtained are the responsibility of a five-member Opec committee that will report to a ministerial conference in March 1986.

To facilitate a better appreciation of what lies ahead for the oil market, we offer yet another analysis of crude's dynamics. From 1980 through 1985, the free world's demand for crude oil fell by 13%. During this period, Opec, in an attempt to prop up oil prices, slashed its output by 41%. Non-Opec producers, in an attempt to cash in on high prices, increased their output by 24%. In consequence, Opec's share of a shrinking oil market fell to 37% from 57%, while the non-Opec share increased to 61% from 43%.

To understand the dynamics that set the crude oil market in motion, we must focus carefully on supply-demand fundamentals. Instead of operating on a normal supply curve in which producers increase their output as prices rise, Opec operates on a backward-bending supply curve. In consequence, when prices rise, Opec's output decreases. This backward-bending supply phenomenon came about in the late 1970s because some members of Opec — Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, and Libya — were running current account surpluses and could, in the face of rising oil prices, easily fund their development requirements with reduced crude output.

Another element that gave rise to Opec's backward-bending supply curve was the fact that some Opec members, particularly Saudi Arabia, felt that they would be better off keeping oil in the ground, rather than producing at levels above their short-term development requirements and investing the consequent financial surpluses abroad. In the late 1970s, their analysis was correct. For example, from 1974 through 1981, nominal crude oil prices rose at an annual rate of 20%

while the nominal yields on Eurodollar deposits averaged only about 11%.

Opec's backward-bending supply curve acted to put dramatic upward pressure on oil prices because each price increase brought forth a further cut in Opec's output, which was followed by yet another price increase, and so forth.

The demand side of the world oil market greatly enhanced Opec's ability to successfully follow a backward-bending supply curve. The quantity of crude demanded in the short-run is very insensitive to price changes. In more technical language, the demand for crude is very inelastic ($e < 1.0$). (For a definition of demand elasticity and representative elasticity values for crude oil, see Chart 1, which is reproduced from *Commodity and Currency Comments*, November 17, 1985.)

With an inelastic demand, each reduction in total production, other factors held constant, leads to a more than proportional increase in price. In other words, supply reductions have considerable leverage in pushing prices upward.

Opec's backward-bending supply coupled with an inelastic world demand for crude worked to Opec's advantage, particularly in the late 1970s. However, these supply-demand dynamics have led Opec into a trap. They have resulted in Opec's so-called swing producers, particularly Saudi Arabia, practically being squeezed out of business. In consequence, the swing producers' oil revenues have fallen to the point where they can no longer adequately fund development plans, military requirements, and the income expectations of their new middle-class technocrats and businessmen. So, from an oil revenue requirement point of view, the swing producers have allowed themselves to be pushed up against the proverbial wall.

In this issue

William Burt offers an alternative explanation for the unusual behavior of oil prices during the Sept.-Dec. period, and we remain firmly short. We remain sidelined in the US dollar and in stock index futures. And we update two financial futures spreads. Contributions by Albert D. Friedberg, Steve H. Hanke, William E. Burt, and Daniel A. Gordon.

If their oil revenue requirement shortfalls were not enough, the real price of oil has been falling, while real returns on financial assets have been running at record levels. In consequence, Opec's swing producers — by not liquidating their oil assets and investing the oil revenues in financial assets — have given up an opportunity to maximize the yield on their combined portfolio of oil and financial assets.

It is clear that Opec has finally reached a turning point. The Opec swing producers must either face the prospect of continuing to attempt to prop up oil prices and being driven out of the oil business, or they must begin to use their excess crude capacity. Given that the latter alternative is the only viable course for the swing producers to follow at this point, we were not surprised by the outcome of the Opec meeting in Geneva. In consequence, as oil prices fall, Opec will follow its backward-bending supply curve. Contrary to the normal supply response to lower prices, Opec will increase its output as prices decline. This output increase, coupled with an inelastic world oil demand, will result in proportionately larger price decreases than output increases (see Chart 1). So, just as Opec's backward-bending supply and the inelastic world oil demand once favored oil, now they will work against it.

When Opec collapses, world crude production will reach about 65 million barrels per day (mb/d). At this world output level, we calculate that market clearing prices will range from \$5.38 to \$16.39 per barrel, depending on the assumed demand elasticities. Hence, an 18% increase in production will result in a 43% to 81% fall in market clearing prices. Since the world oil demand is inelastic ($e < 1.0$), prices are calculated to fall proportionately more than production increases. Therefore, for the world oil market, total oil revenue must fall as output increases and prices fall.

The allocation of these oil revenue reductions will depend on each producer's excess capacity. Producers without excess capacity (including Mexico, Ecuador, and Gabon) will be hit hardest by an Opec collapse. These producers will not be able to increase output to even partially compensate for lower prices. In consequence, if these producers are able to continue to produce at full capacity, their oil revenues will fall in direct proportion to price decreases. Therefore, their oil revenues will fall from current levels by between 43% to 81%, depending on the assumed demand elasticities. (As we pointed out in *Commodity and Currency Comments*, Novem-

ber 17, 1985, these producers' outputs will actually decrease somewhat, when prices decline. Hence, their oil revenues will fall somewhat more than is indicated by the percentages given above.)

For producers with excess capacity, an Opec collapse will be less damaging than for those without excess capacity. (Note that the following analysis for producers with excess capacity represents a correction in the analysis that was presented in *Commodity and Currency Comments*, November 17, 1985.) In Chart 2, we calculate revenue-neutral oil prices for producers with excess capacity. These are the prices that will generate for the producers, if the producers operate at full capacity, the same amount of revenue as was generated when the producers operated at their 4th quarter 1985 output levels and sold that output at \$28.60 per barrel. The interpretation of Chart 2 is straightforward: If a producer operates at capacity and oil prices exceed the producer's revenue-neutral price, the producer's oil revenues will be above their current level. If oil prices are below a producer's revenue-neutral price, then the producer's oil revenues will be below their current level.

By comparing the revenue-neutral prices in Chart 2 with the market clearing prices in Chart 1, we can obtain a clear picture of the revenue implications of an Opec collapse for producers with excess capacity. For example, under the two highest demand elasticity assumptions ($e = 0.2$ and $e = 0.3$), the market clearing prices are about the same as the Saudis' revenue-neutral price. In consequence, under the most optimistic demand elasticity assumptions, Saudi Arabia will be able to generate only about the same level of oil revenues as they are currently generating. Alternatively, if the lowest demand elasticity is assumed ($e = 0.1$, which is perhaps the most realistic short-run coefficient), the market clearing price (\$5.38 per barrel) will be well below the Saudis' revenue-neutral price (\$14.30 per barrel). In consequence, the Saudi's oil revenues will be well below current levels.

Crude's dynamics, which are driven by Opec's backward-bending supply curve and the inelastic demand for oil, have put the oil market on a roller coaster that is hard to stop. Crude dynamics made prices soar in the late 1970s. Similarly, they will now cause prices to plunge.

—By Steve H. Hanke

Chart 1

CRUDE OIL PRICE RESPONSES TO INCREASED CRUDE PRODUCTION
(Reproduced from *Commodity and Currency Comments*, November 17, 1985)

World Crude Production (million barrels/day)	Prices (\$/barrel)		
	Demand Elasticity (e = 0.1)	Demand Elasticity (e = 0.2)	Demand Elasticity (e = 0.3)
55*	\$28.60*	\$28.60*	\$28.60*
56	23.88	26.14	26.93
57	20.01	23.92	25.39
58	16.82	21.93	23.96
59	14.17	20.13	22.63
60	11.98	18.51	21.40
61	10.16	17.04	20.25
62	8.63	15.71	19.18
63	7.36	14.50	18.19
64	6.28	13.41	17.26
65	5.38	12.41	16.39

Notes: (1) The * denotes either the current assumed level of world crude oil production or the current assumed crude oil price.
 (2) The demand model employed is:
 $Q = aP^{-e}$
 where Q = production of crude oil in millions of barrels per day,
 P = price of crude oil in U.S. dollars per barrel,
 e = demand elasticity = $\frac{dQ}{dP} \times \frac{P}{Q}$, and
 $a = \text{a constant} = \frac{55}{28.60^e}$.
 (3) In the table, we increase production and solve for price with alternative demand elasticity assumptions. This is accomplished by rearranging the demand model, so that:
 $P = \left(\frac{Q}{a}\right)^{-\frac{1}{e}}$
 (4) For information on demand elasticities, see: Paul W. MacAvoy, *Crude Oil Prices: As Determined by OPEC and Market Fundamentals*, Cambridge, MA: Ballinger Publishing Company, 1982.

Chart 2

REVENUE NEUTRAL OIL PRICES

Producer	Excess Capacity Ratios	Revenue Neutral Prices in \$/barrel
Iraq	1.06	\$ 26.98
Mexico	1.11	25.77
Algeria	1.14	25.09
Nigeria	1.18	24.24
Iran	1.30	22.00
Indonesia	1.33	21.50
Venezuela	1.38	20.72
Libya	1.82	15.71
United Arab Emirates	1.85	15.46
Kuwait	2.00	14.30
Qatar	2.00	14.30
Saudi Arabia	2.00	14.30

Notes: (1) The revenue neutral price is that price which would generate for the producer, if the producer operated at capacity, the same amount of revenue as was generated when the producer operated at its 4th quarter 1985 output level and sold that output at \$28.60/barrel.
 (2) To compute the revenue neutral prices, divide \$28.60 by the excess capacity ratios.
 (3) Excess capacity ratio = current capacity/4th quarter 1985 output.

Has our ship finally come in? (or Netback Crude: Who owns it?)

By William E. Burt

Last month we advanced a Machiavellian theory to explain the unusual behavior of oil prices during the Sept.-Dec. period. William Burt, a colleague of ours, a well-respected analyst and portfolio manager at FMG, has been kind enough to submit an alternative rational explanation, which we publish here.

Most of what the media writes about commodities and their price fluctuation is of a price-explanatory nature. After the move, reporters contact dealers or executives in the trade and their explanations are duly reported. Many large fluctuations come as a surprise, but explanations after-the-fact are offered freely.

What was extremely unusual about the recent upward explosion on petroleum prices, which finally peaked on Nov. 25 (and then crashed) was that even now we have yet to read an adequate explanation. On the one hand, the bull market occurred amidst overproduction by Opec, well in excess of world demand. This should eventually have resulted in a burdensome inventory build. But paradoxically, futures prices behaved as though inventories were growing tighter and tighter. As prices exploded upwards, the market became more and more inverted.

An explanation must begin with a review of the netback

pricing deals offered by Saudi Arabia, beginning in October. Under these deals, Exxon and other companies would load Saudi oil, transport it around Africa in a supertanker (about a 45 day trip), unload it, and refine it. The products would be used internally, and Saudi Arabia would be paid according to refined product prices at that time.

By comparison, under the old way of business, Exxon would load crude and would pay a price fixed at the time of loading. From then on, Exxon owned the oil. It was at risk of price fluctuation, and the cargo was treated as part of its worldwide inventory. If prices rose excessively, Exxon could sell off its afloat Saudi inventory to profit from the high prices.

An interesting question: Under netback deals, who owns the afloat netback oil? Until the oil has been refined, Saudi Arabia owns the risk. So in any practical sense, it still owns the oil too.

The upshot is that in the nearly two months that passed between when the first tanker was filled and when its cargo had been transported, unloaded, refined and priced, a massive transfer of ownership of the world's oil inventory was underway. Each day, more supertankers full of netback oil were in transit. The oil companies who were to receive it really didn't own it and so did not sell it. It was not part of the free market's

tradable inventory, which was shrinking by the day.

Interestingly enough, the major oil companies did know very well there was a lot of oil on the way, and behaved accordingly. Reuters, commenting on Dec. 4, on plunging oil prices, said, "Traders estimate that some 25 cargoes (over 12 million bbls.) of various North Sea grades for December loading remain unsold and blame refineries processing crude oil under new netback arrangements..."

"Most surplus cargoes appear to be in traders' hands, indicating that equity producers anticipated the arrival of the netback oil, one source said."

And so, the apparent paradox is explained. The whole oil blowoff was the result of evolutionary change in normal practice for a fair chunk of the world's oil business. It will not recur. Now, after two months of excessive production, the boats are arriving, and in just the most recently reported week, the American Petroleum Institute reported US inventories of oil and oil products rose a staggering 20 million bbls.

A final comment on ownership. The companies who have made the netback deals do own the oil in one sense — they control it. There are dozens of supertankers churning our way. What do they contain? GLUT!

Crude Oil Futures

I am optimistic oil prices will steady and that world markets can absorb the extra production by Opec. I just implore Opec not to meet again.

— Egyptian official

... the non-Opec producers must give up part of their share in the market... that's the basic premise of the policy.

— Sheikh Ahmed Zakai Yamani

Britain will not take my customers. Not a single one. If there is to be a price war, we are prepared.

— Tam David-West, Nigeria

Opec's belated recognition that it was engaged in a masochistic game of propping up prices at the expense of market share gave way to a policy change. Some observers are characterizing this shift as more apparent than real, a sort of bluff to prod non-Opec producers to restrain output. A more sensible analysis of the situation should convince anyone that the Saudis, not Opec, have designed this policy change and that they are, finally, quite serious about lowering prices and increasing production. As our lead article points out, they have little to lose and possibly much to gain if prices can be stabilized above the \$15/barrel mark while their production rises to capacity. If non-Opec producers cut back production and accommodate a slightly larger Opec output, well. If not, the Saudis will test the market's resilience by producing and selling ever larger quantities until prices move into the \$18-\$20/barrel area.

To prove their determination, the Saudis have been busy discharging oil at various ports in the past two weeks. The tanker *Aurega* (of 431,000 long DWT) has held crude off Dackar since mid-October but discharged at the Louisiana offshore pipeline at the end of November. The tanker *Volans* (of 362,000 long DWT) off-loaded at Rotterdam and the tanker *Olympia Banner* (of 269,000 long DWT) discharged in the Philippines. These VLCCs had been carrying full cargoes of about 1 million tons of crude, leaving around 16 vessels storing up to 5 million tons. The effects of this aggressive policy of running down floating oil stores, at one time estimated to be around 60 million barrels, will be felt rather dramatically in coming weeks as users withhold from further purchases.

The Saudis have spent the past three months rebuilding their distribution channels, mostly via tempting netback deals; they are likely to press their market share in the same man-

ner, giving them a significant marketing advantage over other producers.

Can prices be truly stabilized in the \$18-\$20/barrel area? We positively reject this possibility. Oil bulls have argued that high-cost producers will be forced to cut back production, thus reducing supplies at lower price levels. As an example, it has been argued that North Sea costs range in the \$12-\$15/barrel area, thus putting an effective floor under the market. A recent article appeared in the *Financial Times of London* (Dec. 12, "Opec plans out a desperate bluff") penned by Dominion Lawson concedes that "North Sea oil is certainly expensive to bring into production, but once the capital costs have been sunk, the fields are relatively cheap to run. *It costs less than \$5/barrel to operate about 95% of the UK's production and the rest still costs no more than \$11/barrel to produce*" (see Chart 3). Clearly, North Sea production, now approaching a significant 3.7 mb/d (including Norway) will continue to gush out after prices have fallen below \$10/barrel.

Our scenario calls now for a first move down to \$18-\$20/barrel followed by a crisis meeting of Opec and some non-Opec producers in which an attempt is made to allocate worldwide output. After a number of months, this attempt will fail (the more participants in an agreement, the easier it is to cheat — for proof ask schoolchildren of small classes). Production will continue to rise in a vicious spiral, an attempt by individual countries to raise market share and maximize revenues. At the same time, users will attempt to minimize inventories, pushing the ex ante gap between supply and demand to record levels. The collapse in prices will be complete.

Where is the bottom? Our guess: somewhere around \$5/barrel.

STRATEGY: *Deferred positions (see Chart 4) have fallen to the lows of early July, only 75¢/barrel above contract lows, vindicating our strategy of continuously "rolling forward." Incredibly (especially in view of the large recent arrivals of crude and products) the spot to six-month backwardation remains at historic highs of nearly \$4/barrel (see Charts 5 and 6). Is it real? Remain firmly short contracts and long gasoil puts. Remain short the Saudi riyal.*

Chart 3

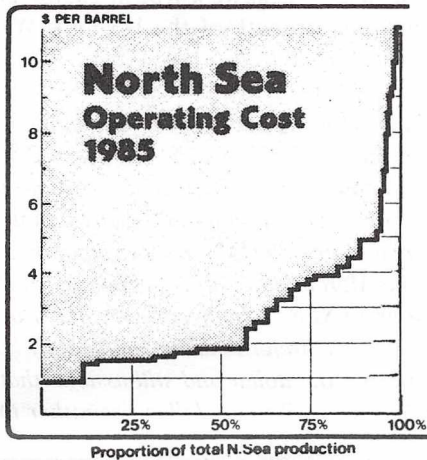


Chart 4

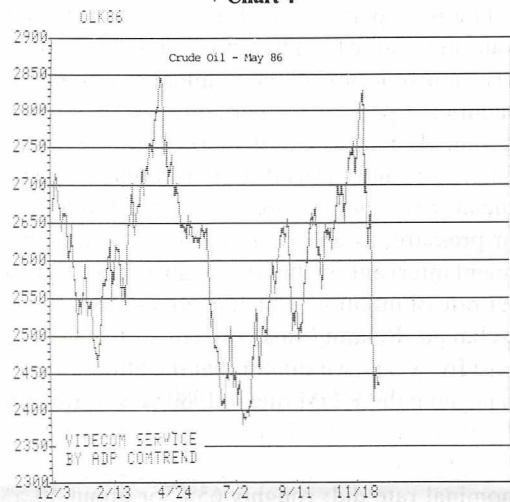


Chart 5

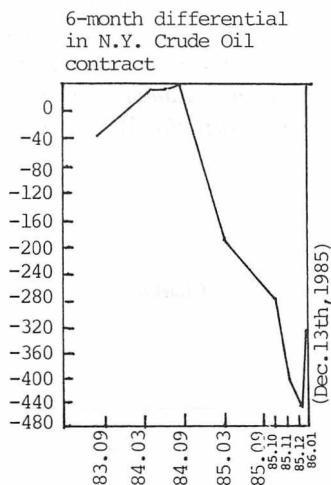
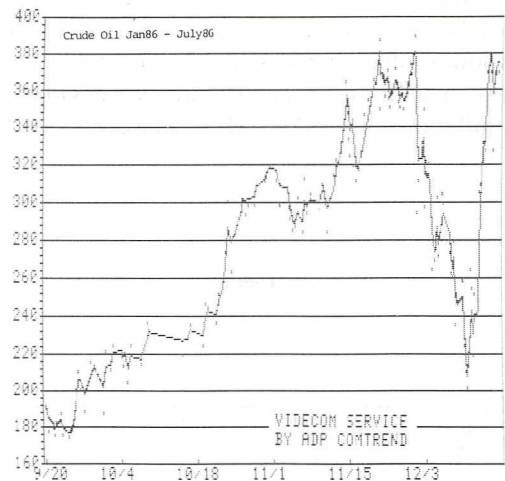


Chart 6



Currencies

US dollar

From Sept. 22 through the end of October, the G-5 and other central banks of the broader G-10 spent an estimated \$10.2 billion to lower the value of the dollar on the foreign exchange market. Out of this total, the US, abandoning its five-year commitment to freely floating rates, spent \$3.2 billion, the highest since the Aug.-Oct. 1980 period when \$3.4 billion was sold.

Since the end of October, intervention has continued; in the most recent mid-week, the Bundesbank entered the market just as the \$/DM crossed the 2.56 level, a crucial short-term chart penetration point.

At the same time, the US conducted some monetary easing maneuvers, primarily through repos, perhaps in an effort to coordinate monetary and exchange intervention

Market behavior for the past several weeks suggests the following:

- The G-5 announcement was far more effective than the actual intervention in quickly lowering the value of the dollar.
- Uncertainty as to size and mode of intervention as well as the fact that the dollar had already been trending lower were clearly of great help in achieving initial successes.
- Progress is slowing down and it now appears that the dollar wants to go up whenever official intervention is absent. Of course, it is still too early to tell, but if in fact the dollar still enjoys upward pressure, then the G-5 international reserves will be drawn down in very short order (2-6 months).
- There is an outside possibility that the G-5 have actually designed an eventual return to fixed rates or fixed bands around the DM 2.50 and ¥200 to the dollar. Such a scheme

has been receiving a great deal of academic support in recent months, particularly if it is not too rigid and allows for some indexation for differential rates of inflation (a Latin American invention). While nominal rates could be fixed for significant periods of time, international reserves become quickly inadequate if there is no coordinated and joint monetary and fiscal effort. Furthermore, and this point is crucial, *real rates cannot be fixed*. Therefore, upward dollar pressure, as an example, can be reined in if given sufficient intervention, but the result will be a substantially higher rate of inflation, which in effect raises the real rate of exchange. Relating this concept to the experience of the past five years, we submit that the alternative of (officially) pegging the \$/DM rate in 1980 at, say, 1.82 (the average for that year) would have overvalued the US dollar via *higher differential inflation* by the same amount as the floating nominal rate did: roughly 65%, or about 10.5% computed per annum above West Germany's inflation rate.

e) If the choice is between fixed nominal exchange rates/higher real exchange rates via higher inflation and rising nominal rates/lower inflation, we prefer the latter simply because of the damaging effects of high interest rates (a product of high inflation) on banks, LDCs, and corporate balance

sheets.

Over the next few weeks we will be in a better position to gauge the *apparent* strength of the US unit. We are still sidelined.

STRATEGY: *If we could be sure that the G-5 are interested on fixing the key \$/DM and \$/¥ rates at 2.50 and 200 respectively, we could sell/grant puts and calls around these levels, earning comfortable premiums. As an example, a March 40 DM call and a March 39 DM put, both straddling the close of 39.96 for the March '86 contract, would earn the option writer 150 points, or \$1,875. In the absence of certainty about the G-5 intentions, we prefer to take a moderately bullish posture, short-term, on the dollar and still assume that the next 10-20 pfenning move will see a dollar rise rather than a fall. Option writers could sell March '86 DM calls and earn \$1,200 per contract. We would insist on protecting these grants with a buy stop at 40.25, basis nearest contract.*

We traded the long yen/short BP cross spread out and in (see Hotline Update of Nov. 26 and Dec. 2) after initiating positions last month and the results are satisfactory. From an initial 345 level, the spread fell to 330 and moved back to 343, providing us a good trading opportunity. We remain with the spread.

Chart 7

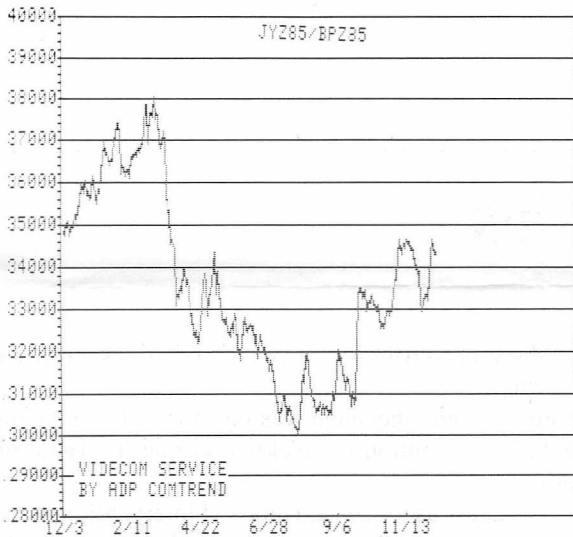


Chart 8

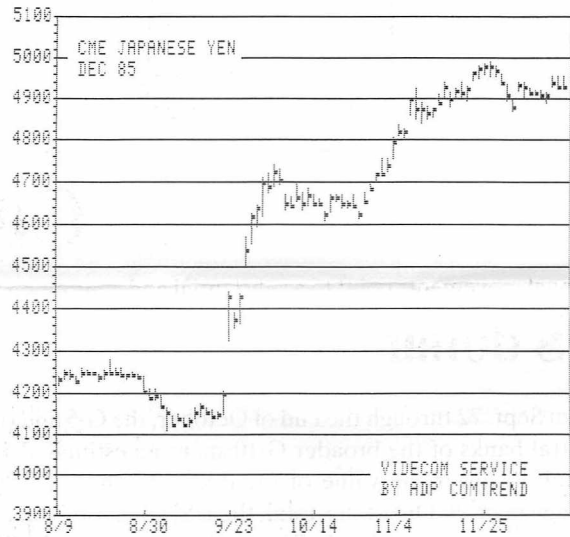


Chart 9

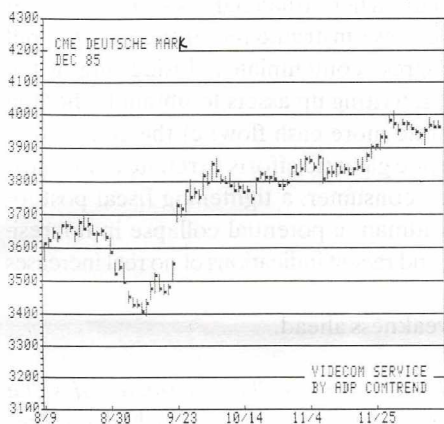


Chart 10

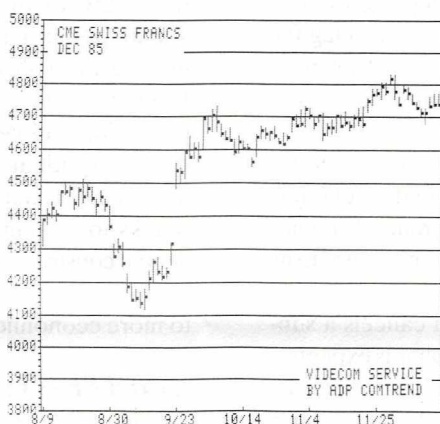
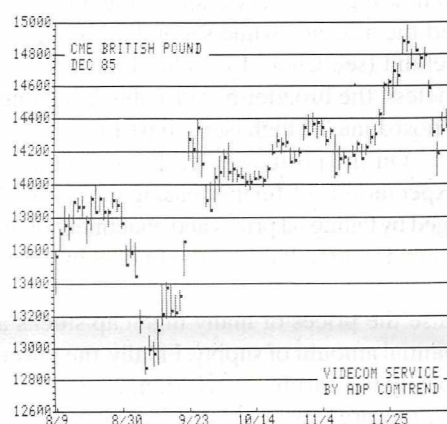


Chart 11



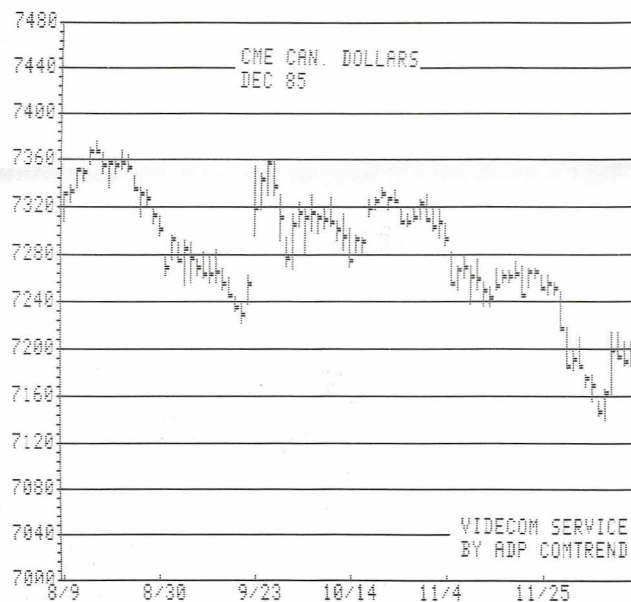
Canadian dollar

The Canadian dollar has firmed in recent days, primarily the delayed reaction to a widening of interest rate differentials with the US. Furthermore, monetary policy in Canada has become somewhat less accommodative. Capital outflows still seem to be running ahead of the current surplus, drawing down international reserves, as the Bank of Canada intervenes to cushion the decline of the dollar. Net official international movements point to a substantial and continuing loss of international reserves.

It is possible that differential tax rates (more favorable in the US) and a better investment and political climate in the US are causing substantial outflows of long-term capital to Canada's southern neighbor. If so, monetary policy will have to work overtime to avoid a serious decline of the currency. Of course, the ultimate challenge lies in remedying the fiscal and political ills now affecting Canada. Time will tell, although we are not hopeful.

STRATEGY: We covered our short C\$ position on Dec. 4 at about 72.07 via the Hotline Update. Short-term, we expect the rally to carry on a little bit further before the major down-trend is resumed. Keep posted.

Chart 12



Stock Index Futures

Fueled by expectations of lower interest rates, a result of an accommodative Fed and falling oil prices, share prices leapt to new highs. A very respectable number of high-cap stocks led the advance while secondary issues continued to lag far behind (see Chart 13, Value Line/S&P 500 spread). Nevertheless, the broader-based Value Line index finally recorded a post-June '83 high (see Chart 14).

On the positive side, the market is being supported by expectations of further easing moves by the Fed — encouraged by falling oil prices and enactment of the Gramm-Rudman amendment to balance the budget by 1991 — and a very firm bond market. Also, frenzied takeover activity continues to raise the prices of many high-cap stocks and cancels a substantial amount of supply. Finally, the lower dollar is expected to help the earnings performance of many multinationals. In all, the present meteoric rise enjoys a set of favorable and obvious factors.

Institutional investors, enamored by the fundamentals, fail to give account to some less obvious factors: a) the Fed has effectively shut the door on 100% junk bond acquisition

activity, a perfectly justifiable move in view of the fact that the government ends up footing the bill for any default through the FSLIC or the FDIC where financial institutions are involved in purchasing these instruments; b) the new tax bill moving through Congress contemplates closing one of the LBO's favorite games: writing up assets to obtain higher depreciation and generate more cash flow; c) the economy is still barely afloat despite gigantic efforts to reflate it; an enormously overextended consumer, a tightening fiscal posture thanks to Gramm-Rudman, a potential collapse in nonresidential construction, and recent indications of no real increases in corporate spending for 1986 (Merrill Lynch survey) point to more economic weakness ahead.

STRATEGY: *The advance has all the characteristics of a "blow-off." As such, one cannot determine how high nor how long this market will rise. The end is certain to be abrupt and quite dramatic, with a good chance of registering a weekly downside reversal. Until such time, keep your powder dry and remain sidelined.*

Chart 13

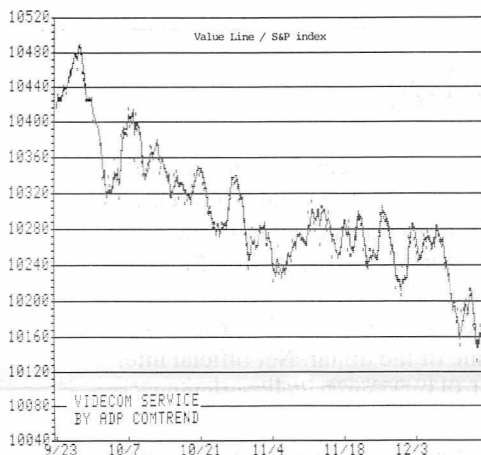
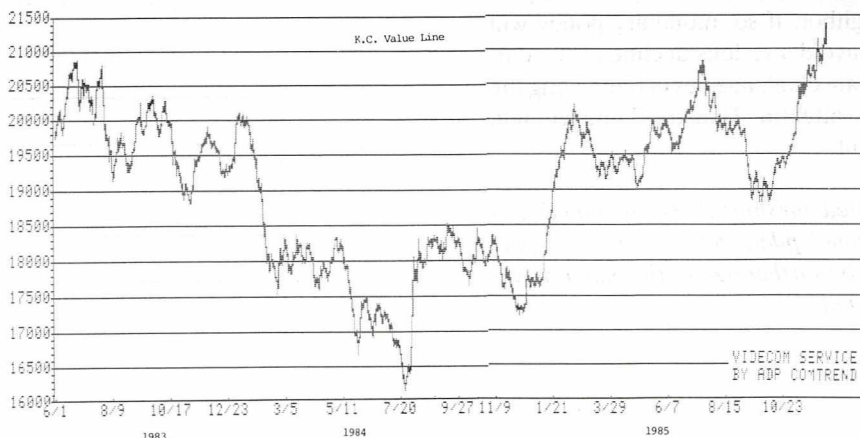


Chart 14



Financial Futures

We review two spreads first recommended in our July 7 issue:

1. Long T-bond/short S&P 500 futures: Continues sideways movement (see Chart 15); stop at 388, basis Dec. '85, has not been triggered. Roll positions forward to March '86, taking advantage of the discount on T-bonds and the premium on S&P 500. Place stops at 379.

2. Short Toronto Oil and Gas Index/long TSE 300: We said last month: "We expect the spread to narrow rather sharply in coming weeks, as we expect industrial shares to rise and oil and gas shares to resume their downward trend as soon as crude reverses." Chart 17 tells it all. Maintain spread; we expect it to narrow even further.

Chart 15

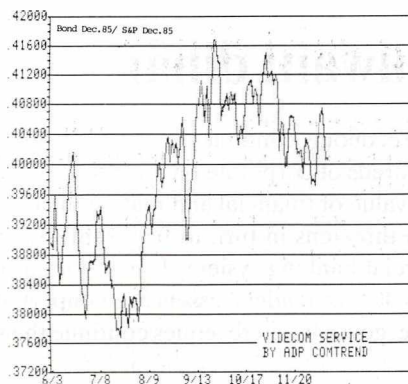


Chart 16

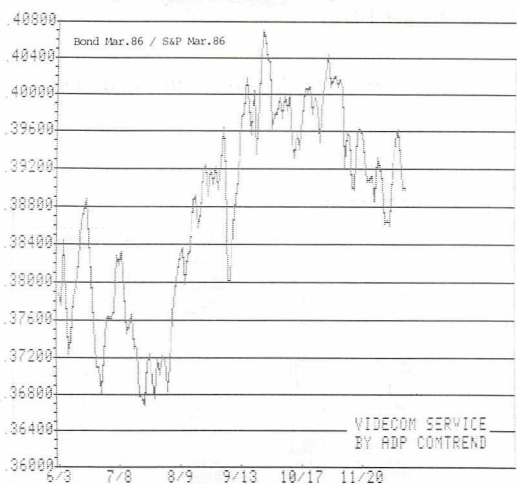
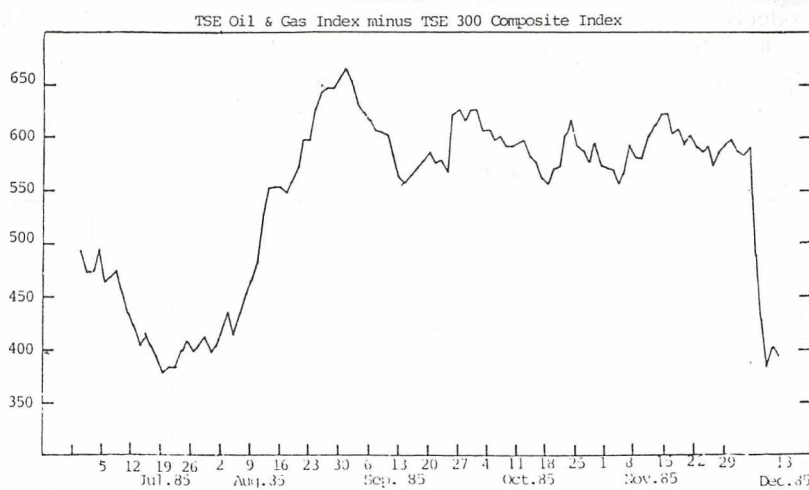


Chart 17

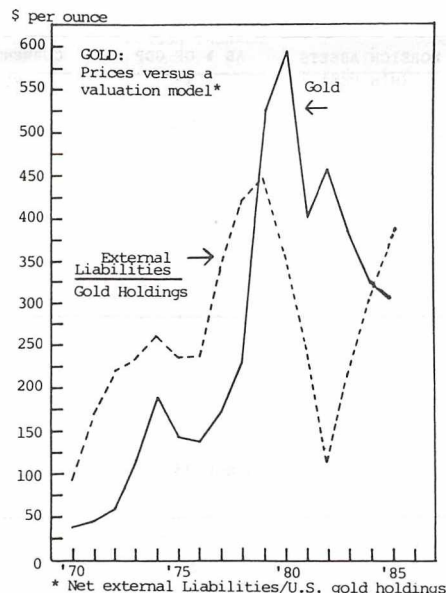


Gold

We said last month that "relatively poor market action in the face of a weakening dollar may presage further shakeout." We therefore advised caution and suggested a 316 stop, basis nearest contract. Despite the fact that we were stopped out, the fundamentals are becoming ever more compellingly bullish (see Chart 18).

STRATEGY: Remain sidelined until further notice.

Chart 18



The Exotics

Kuwaiti dinar

The economy continues mired in a deepening depression with hundreds of corporate bankruptcies and a continuous fall in the value of financial and real estate assets. This asset deflation threatens in turn to bankrupt the nation's entire commercial banking system. It is reported that anywhere from 25%-40% of lenders' assets are nonperforming. At the same time, government revenues continue their fall as oil revenues have been halved over the past five years. The only bright spot is the Emirate's continued foreign trade surplus of US \$4,769 billion, even at the reduced rate of exports of oil and products.

Kuwait's central bank continues to maintain an unusual grip on the nation's money; narrow money supply was dropped by over 25% since 1981, and continues to show quarterly de-

clines in spite of the ongoing deflation. In the end, Kuwait's central bank will have to abandon this strategy and begin a process of reflation, which should have a negative impact on the dinar in the foreign exchange markets.

It is noteworthy that the Kuwaiti government has enlisted the World Bank to help it revive and map out a future course for its oil-based economy. It is not impossible that the World Bank, given its emphasis on outward trade as a prescription to growth, may recommend a substantial alteration of the present dinar parity with a view to stimulate non-oil activities. In recent months the dinar has appreciated slightly against the US dollar, but depreciated sharply against the Deutschemark (see Chart 19).

STRATEGY: Remain short both against the US dollar and DM.

Chart 19

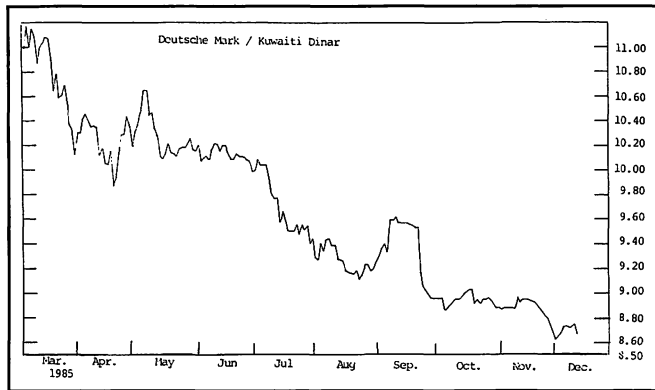


Chart 20

YEAR	KUWAITI DINAR PER U.S. DOLLAR (PERIOD END)	U.S. DOLLAR		BASKET	
		1972 = 1.00	1978 = 1.00	1972 = 1.00	1978 = 1.00
1972	0.3278	1.0000	1.2901	1.0000	1.1069
1973	0.2967	0.8861	1.1431	0.9404	1.0409
1974	0.2896	0.8504	1.0971	0.9284	1.0277
1975	0.2942	0.8698	1.1221	0.9117	1.0092
1976	0.2870	0.8537	1.1013	0.9243	1.0231
1977	0.2901	0.8669	1.0410	0.9045	1.0012
1978	0.2718	0.7751	1.0000	0.9034	1.0000
1979	0.2731	0.8099	1.0448	0.9372	1.0374
1980	0.2713	0.8538	1.1015	0.9176	1.0156
1981	0.2814	0.9104	1.1745	0.9064	1.0033
1982	0.2887	0.9196	1.1863	0.9114	1.0088
1983	0.2926	0.9185	1.1849	0.8751	0.9686
1984	0.3045	0.9856	1.2714	0.8992	0.9953
1985 (1Q)	0.3029	0.9864	1.2725	0.9033	0.9998
1985 (2Q)	0.3029	0.9969	1.2861	0.9140	1.0117
1985 (3Q)	0.2965	0.9781	1.2618	0.9280	1.0272

U.S. DOLLAR BASKET: U.S. 10%, JAPAN 10%, Germany 20%, ITALY 10%, SINGAPORE 10%, NETHERLAND 10%, FRANCE 10%

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 21

YEAR	FOREIGN ASSETS (Mln US\$)	CURRENT ACCOUNT AS % OF GDP	CUMULATIVE 12 QTR CURRENT ACCOUNT (Mln US\$)
1975	3,154	49.29	-
1976	3,128	52.75	-
1977	4,373	32.25	17,414
1978	4,866	39.55	17,616
1979	5,191	57.64	24,719
1980	6,744	55.46	35,463
1981	7,625	56.99	43,112
1982	8,468	23.38	33,953
1983	7,820	23.24	23,766
1984	7,726	25.66	15,558
1985 (1)	8,057	-	-
1985 (2)	8,684	-	-

Chart 22

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

Reserves * + Previous 12-months current Account *** = 11,923
(Reserves + 12-months C/A)/M1 ** = 11923/3154 = 378%

Reserves + 12-months C/A/Broad Money ** = 11923/14991 = 79%

* As at Sept. 1985 ** Aug. 1985 *** 1984

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	675	2363
1985	3154	14991
% Increase (decrease)	367%	534%
Corresponding % increase in the United States	111%	164%

(a) 1984 Imports as percentage of GDP 28.25
(b) 1975 - 1988 Imports as percentage of GDP 33.58
1984/(1975 - 1984 average) = (a)/(b) = 84.1%

Source: IFS

Chart 23

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.29050	.29037-	.28966-	.28990-	.28717-
	.29070	.29080	.29040	.29030	.28973

Belgian franc

There has been little change since our last review of the Belgian franc in March 1985. As we anticipated, the current account has swung to a small surplus of \$193 million in 1984 after a progressive five-year improvement that saw a dismal reading of a deficit of \$4,945 billion, equal to 4.2% of GNP in 1980.

The centre-right coalition continues in power and has managed to stabilize Belgium's fiscal deficit at a still too high 12% of GNP in 1984. It is projected to fall to 10.4% in 1985 despite strenuous government efforts to reduce it further. The deleterious effects of huge fiscal deficits can be gauged, as total government debt equals over 100% of GNP, with foreign debt accounting for one quarter of the total.

Unemployment continues to haunt policy makers as it hovers around the 14% mark; up to 50,000 jobs per year have been lost since the beginning of the 1980s. Major structural reforms in the labor market are needed in order to bring about gains in employment; wage rigidities must be overcome, social benefits to the unemployed must be cut, and protected industries must be allowed to disappear. No monetary or fiscal expansionism can alleviate this problem.

There is not likely to be much change in Belgium's relative position in the EMS, although long-term, the staggering fiscal debt and massive unemployment will weaken the unit via lower confidence and lower investments.

STRATEGY: Remain long against the DM, capturing the forward differentials.

Chart 24

YEAR	BELGIAN FRANCS PER U.S. DOLLAR (PERIOD END)	BASKET			
		U.S. 1970 =1.00	U.S. 1977 =1.00	1970 =1.00	1977 =1.00
1967	49.6280	0.9500	1.6039	0.9552	1.1816
1968	50.0800	0.9726	1.6421	0.9703	1.2003
1969	49.6660	0.9806	1.6556	0.9838	1.2170
1970	49.6750	1.0000	1.6884	1.0000	1.2370
1971	44.7550	0.8989	1.5177	0.9852	1.2187
1972	41.1220	0.8694	1.4680	0.9542	1.1804
1973	41.3200	0.8086	1.3653	0.9597	1.1871
1974	36.1230	0.6953	1.1739	0.8779	1.0860
1975	39.5280	0.7370	1.2443	0.8918	1.1031
1976	35.9830	0.6506	1.0985	0.7958	0.9844
1977	32.9400	0.5923	1.0000	0.8084	1.0000
1978	28.8800	0.5345	0.9025	0.7901	0.9774
1979	28.0480	0.5528	0.9334	0.8465	1.0471
1980	31.5230	0.6615	1.1169	0.9786	1.2105
1981	38.4690	0.8283	1.3985	1.0242	1.2669
1982	46.9200	0.9855	1.6639	1.1253	1.3920
1983	55.4600	1.1168	1.8855	1.1545	1.4281
1984	63.0800	1.2457	2.1033	1.1101	1.3732
1985 (1Q)	62.0700	1.2086	2.0406	1.1206	1.3861
1985 (2Q)	61.5480	1.1978	2.0223	1.1423	1.4130

U.S. 9% ITALY 6%
U.K. 13% FRANCE 23%
Germany 27% NETHERLANDS 22%

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 25

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	2.11	2.75	987
1971	2.93	2.22	1605
1972	3.34	3.60	2659
1973	3.68	2.99	3319
1974	3.53	1.43	3447
1975	3.96	0.28	2332
1976	3.81	0.63	1390
1977	3.42	-0.69	62
1978	2.24	-0.84	-936
1979	-1.61	-2.77	-4448
1980	-1.90	-4.16	-8839
1981	-6.12	-4.28	-12196
1982	-7.49	-3.05	-11733
1983	-9.00	-0.53	-7221
1984	-9.50	0.25	-2854
1985 (1)	-9.61	-	-

Chart 27

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	51.37-	15.39-	51.42-	51.47-	51.47-
	51.42	15.46	51.52	51.62	51.67

Chart 26

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

Reserves * + Previous 12-months current Account *** = 16,199
 (Reserves + 12-months C/A)/M1 ** = 16,199/14735 = 109.9%
 (Reserves + 12-months C/A)/Broad Money ** = 16,199/33423 = 48.5%
 * As at Aug. 1985 ** March 1985 *** 1985 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	15,297	26,346
1985(1)	14,735	33,423
% Increase (decrease)	(3.6)	26.8

Corresponding % increase in the United States 98.7% 154.6%

(a) 1984 Imports as percentage of GNP = 60.39%
 (b) 1975 - 1984 Imports as percentage of GNP = 49.72%
 1984/(1975 - 1984 average) = (a)/(b) = 121.46%

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 2.5200</u>
Australian dollar	.6855-.6865	.6669-.6847	.6285-.6300	Neutral	Neutral
Danish krone	9.13-9.14	9.15-9.19	9.18-9.21	Neutral	Neutral
Dutch guilder	2.8340-2.8355	2.8192-2.8217	2.7750-2.7705	Neutral	Remain long
Greek drachma	149.90-150.20	157.65-161.20	170.00-180.00	Remain short	Remain short
Italian lira	1715-1717	1719-1721	1726-1729	Neutral	Neutral
Malaysian ringgit	2.4295-2.4305	2.4390-2.4430	2.4495-2.4705	Remain short	Remain short
Mexican peso	462-467	Not available	Not available	Remain short	Remain short
*New Zealand dollar	.5210-.5240	.5055-.5100	.4570-.4700	Sell on rally to .5400	Sell on rally to 1.36
Norwegian krone	7.67-7.68	7.75-7.77	8.00-8.05	Neutral	Neutral
Portugese escudo	160-161	165-171	169-182	Neutral	Neutral
Saudi Arabian riyal	3.6500-3.6510	3.6490-3.6510	3.6500-3.6550	Remain short	Remain short
Singapore dollar	2.1230-2.1240	2.1110-2.1130	2.0780-2.0990	Remain short	Remain short
Spanish peseta	156.40-156.55	159.40-160.30	163.90-165.55	Neutral	Neutral
Swedish krona	7.68-7.69	7.76-7.78	7.90-7.94	Neutral	Neutral
Venezuelan bolivar	14.80-15.00	14.95-15.45	15.25-16.25	Remain short	Remain short

Explanatory Notes

*Indicates change in recommendation from last issue

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, November 19: There are no changes.

Friday, November 22: There are no changes. The market letter was mailed on Wednesday. On the back page there was an error in the Saudi riyal. We remain firmly bearish on the riyal against both the DM and the US dollar.

Tuesday, November 26: 1. As noted on Friday's update there was an error on Saudi riyal in the market letter. We remain firmly bearish on the riyal against the DM and US\$.

2. The profitable spread of Japanese yen/BP should be liquidated.

Friday, November 29: A summary of the week's activities:

1. We have liquidated the profitable Japanese yen/BP spread as of Tuesday.
2. We have corrected the market letter error in Saudi riyal, which we remain bearish on against both the DM and US\$.

3. One new recommendation is the purchase of May London coffee at present levels. Place stops at 1890, close only.

Flash bulletin for Monday, December 2, 9:40 a.m.: Reinstate long Japanese yen and short BP spreads at this morning's levels. March '86 yen is trading at 4934 and March '86 BP is at 148.10.

Tuesday, December 3: 1. You have reinstated the long Japanese yen and short BP spread position as of yesterday's flash update at 9:40 a.m.
2. Raise stops on short Dec. C\$ to 7265, close only.

Flash update Wednesday, December 4, 10:00 a.m.: We advise covering short positions in Dec. C\$ at the market, nailing down handsome profits.

Good morning for Monday, December 9: Please excuse our negligence, but due to illness, the regular Friday update was forgotten. A recap of last week's activities contains two changes.

1. We reinstated the long Japanese yen/short BP spread on Monday.
2. We covered Dec. C\$ short positions, locking in a handsome profit on Wednesday.

Tuesday, December 10: There are no new recommendations this week.

Friday, December 13: There are no changes or new recommendations this week. Have a good one!

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