

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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## Inventories: Ps versus Qs

The Department of Commerce's gross national product report for the fourth quarter of 1987 showed a strong increase in GNP growth (4.2%). This report, however, sent negative shock waves through financial markets, because a substantial portion of the GNP growth was due to an increase in nonfarm business inventories. Most analysts saw the up-tick in inventories (see Chart 1) as a harbinger of a recession.

This pessimistic conclusion is based on the following one-sided line of reasoning: (1) inventories piled up because demand was weak; (2) to adjust for the increase in "unwanted" inventories, businesses will reduce orders for new goods; and (3) this will cause producers to reduce output. In short, the conventional view is that there will be inventory adjustment, and that it will result in a slow-down or reduction in the *quantity* of goods produced. Hence, the real economy will slow down, if not go into a recession. Evidence that increases in "unwanted" inventories can act as a drag on real economic activity ("quantities") is presented in Chart 2.

Our analysis of the build-up in inventories is contrary to that subscribed to by most analysts. To understand our contrarian position, consider that two thirds of the build-up in inventories was caused by a swing in domestic auto inventories. This swing was, in large part, the result of the fact that sales were slow because auto dealers dropped their sales incentive programs late in 1987. Since the first of the year, however, the incentive programs have been reinstated. In consequence of the *price* reductions, auto sales have picked up smartly and auto inventories have been eaten into. In addition to the *price* reductions, auto producers have already reduced the *quantity* of their output. For example, the auto industry's capacity-use rate fell from 63.9% in December to 59.0% in January.

In short, *lower prices* and *lower quantities* (production) have both been used to adjust inventories downward. The lessons from this are clear:

1. The so-called "unwanted" inventories can be dealt with by either lowering *prices* to stimulate demand or by lowering *quantities* produced;
2. The use of both *price* and *quantity* adjustments can result in a very rapid inventory adjustment;
3. A speedy inventory adjustment implies that, to the

extent that it relies on *quantity* (production) reductions, it will only act as a drag on the economy for a short duration;

4. Moreover, to the extent that the inventory adjustment relies on *price* reductions, the smaller will be the drag on the economy.

Our analysis suggests that the current inventory adjustment is being accomplished with a heavy reliance on downward *price* adjustments in those sectors that have generated "unwanted" inventories. This is occurring because supply-side spreads (profit margins) are healthy (see: Chart 3). Hence, *price* reductions can be accommodated.

**Implications:** By relying heavily on *price* reductions, an inventory adjustment can be accomplished without a significant slow-down in the real economy. For example, the overall rate of capacity utilization for the economy in January held at 82.2%, which was the December rate. The last time US industry exceeded this level was March 1980, when production was at 83.7% of capacity. With this type of an inventory adjustment, the major change occurs in *prices* not *quantities*. Hence, this implies that, for a relatively short period of time, the major changes will be that *price* increases and profit margins in those sectors that have realized "unwanted" inventory build-ups will be less than they would be otherwise.

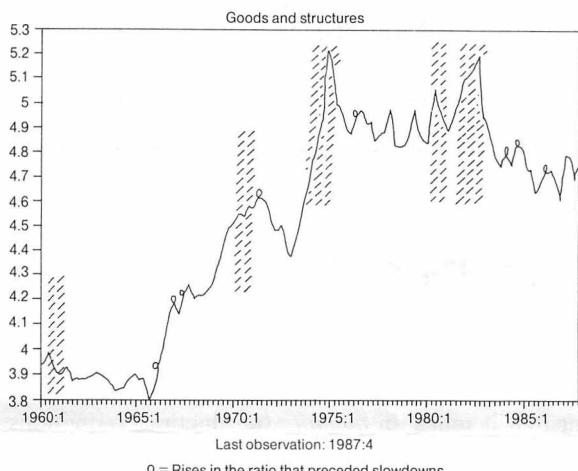
**Strategic implications:** A quick resolution of the inventory overhang carries bullish implications for interest rates and commodity prices.

— Steve H. Hanke

### In this issue

We're short T-bonds and long the CRB Index. We get back into the long side of gold and copper. The oil bear is patient, but ruthless. The stock market still has a long way to go... down. And we reestablish our long sugar positions — how sweet it is! Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

**Chart 1**  
Ratio: Real inventories to final sales



Source: Fidelity Bank

**Chart 3**  
Output-input spreads  
(Manufacturing only)

Year	Spread
1983	+ 11.5%
1984	+ 11.8%
1985	+ 8.7%
1986	+ 6.0%
1986 IV	+ 6.0%
1987 I	+ 6.5%
1987 II	+ 9.2%
1987 III	+ 10.4%
1987 IV	+ 9.9%

NOTE: For a discussion of supply - side, output-input spreads, see: *FC&CC* Nov. 22, 1987.

**Chart 2**  
Overhangs in nonfarm inventories that did not precede recessions

Date	Rise in the ratio of nonfarm inventories to sales of goods and structures (1982 \$)	Effect on GNP growth rate*	Change in growth rate	Percentage deceleration in growth
1966:Q2	+ .10	4.6% to 3.1%	-1.5	33%
1967:Q1	+ .13	3.1% to 2.3%	-0.8	26%
1967:Q3	+ .07	4.1% to 3.5%	-0.6	15%
1971:Q2	+ .05	5.6% to 1.1%	-4.5	80%
1976:Q2	+ .07	4.8% to 2.9%	-1.9	40%
1978:Q1	+ .09	1.3% rose to 8.4%		
1979:Q2	+ .11	-0.2% rose to 1.5%		
1984:Q1	+ .05	9.0% to 4.1%	-4.9	54%
1984:Q3	+ .08	4.1% to 2.8%	-1.3	32%
1986:Q1	+ .06	4.3% to 1.0%	-3.3	77%
1987:Q1	+ .18	3.0% rose to 3.4%		
Average of 8 Periods with Slowdowns				
	+ .07	5.0% to 2.6%	-2.4	45%
Current overhang:				
1987:04	+ .09			

\*GNP growth rates were measured as follows. The first figure is the average real GNP growth for the quarter of the inventory-to-sales ratio rise and the preceding quarter. The second rate is the average growth for the two subsequent quarters.

Source: Fidelity Bank

**T-BONDS**

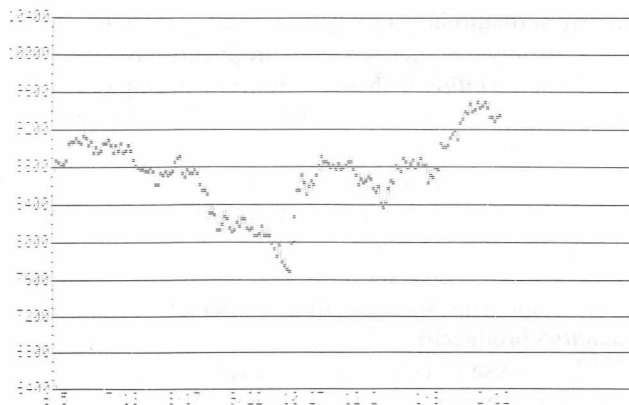
**Betting on inflation**

Buoyed by fears that an inventory recession was either upon us or, at the very least, imminent, T-bond prices soared to their highest level since March 1987, recovering almost 70% of their previous bear move.

Technically, the extent of the retracement just about reaches the outer limit of a counter-trend correction; a move beyond recent highs would, in all probability, indicate that a new bull market was born last October. Our views of the economy, however, remain much the same as they have been for months: After a brief inventory correction, the economy will push forward towards its capacity limits, creating strong inflationary pressures.

**STRATEGY:** We are short, once again, T-bonds via the Hotline (see "Hotline Update" for Feb. 12), with stops at 94.10, basis June, close only.

**Chart 4 — T-BONDS (Day) Mar 88**



**CRB INDEX**

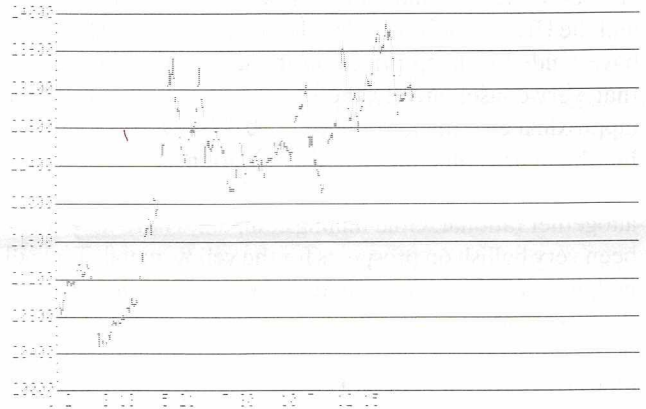
# Building a head of steam

A sharp 5% setback in prices came on the wake of a GNP report estimating that inventory accumulation had accounted for most of the fourth quarter gains. Interestingly enough, while the index broke the near-term October '87 to January '88 uptrend, it held well above the January lows and thus confirmed the underlying strength of commodity prices (see "CRB Index," Chart 10, *FC&CC*, Jan. 24, 1988).

Commodity prices are building up a head of steam to finally and decisively break out above the 10-month range (see Chart 5).

**STRATEGY:** *We were stopped out when the cash index fell below 231.50, as per last month's suggestion. Reenter long positions (cash index now trading at 231.38) in the nearest two contract months and risk a close below 225, basis cash index.*

Chart 5 — CRB Cash

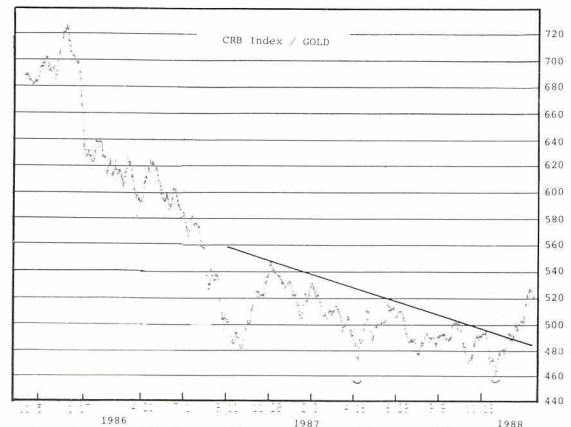


## CRB Spread trading

The CRB index can become an excellent spreading vehicle when "legging" it against a component (complimentary analysis available to clients and subscribers upon request).

Chart 6 depicts a long term CRB decline versus gold possibly coming to an end. Good support seems to exist at .46, and a near-term downtrend has been penetrated around .50. It's interesting to note that deferred CRB contracts trade at a discount, while deferred gold contracts trade at a premium, making the long CRB/short gold spread quite attractive.

Chart 6



**STRATEGY:** *Spread traders should consider a long CRB/short gold spread on a 2.5 gold to 1.0 CRB ratio. Place stops just below .46.*

**GOLD**

# Still on the golden road

Our concern last month that gold was entering a period of near-term turbulence was fully borne out. Driven down by heavy hedge selling, gold prices broke through a significant two-year uptrend at around \$468-\$473/oz., basis spot, and fell nearly \$30/oz. before finding support in the \$440/oz. area. This level, as is clear from Chart 7, is critical because it contained the September-October 1986 run-up and the May-June '87 correction.

The source of the hedge selling became obvious on Friday, February 12, when it was announced that Newmount

Mining, the great US mining concern, had successfully completed a gold loan for one million ounces at \$448/oz. In effect, the company had borrowed gold (at anywhere between 1.5% and 3% per annum instead of the usual money loan that would have cost 8.5%), and sold it to finance the expansion of its gold mining operation.

The effect of this and other gold loans can be summarized as follows: From the company's point of view, it hedges future gold production. If prices rise in the future, the producer will not benefit from the price increase; if prices fall,

the producer will have already realized its sale price. Either way, Newmount has 'locked' in a \$448/oz. price.

From a global picture of supply, and demand for gold, one could argue that gold loans merely shift to the present the large anticipated increases of production, thus tending to dampen near-term prices at the expense of raising late 1988-1990 prices.

In recent days, rumors of two more gold loans totalling 500,000 ounces (Bond Corp. of Australia, 200,000 ounces, and the UK-based Consolidated Gold Fields, 300,000 ounces) have tended to keep prices on the defensive. It is believed that, very conservatively, there are 75 tonnes of gold on loan (approximately 5 million ounces, or 50,000 COMEX contracts), but the figure could be as high as 120 tonnes.

The behavior of mines is somewhat mystifying, although altogether rational: Gold mining companies have traditionally been very bullish on prospects for the yellow metal. Typically, hedging operations were undertaken only *at the bottom of the market*, after a traumatic bear episode convinced the bulls of the rationality of these procedures. What has changed this time? Have gold miners, as a group, become more risk-averse? Or, as is more likely, has gold been *behaving* as if it were in a bear market — thus inducing enough fear in the hearts of these miners to make them run for cover? The price of gold, denominated in Swiss francs (see Chart 8) corroborates this

latter hypothesis. Curiously, this growing move to hedge future output could eventually set off a massive short-covering bull run.

At the time the Newmount gold loan was being processed, that is, bullion was being sold, other relatively bearish news had made an appearance. Fears of a possible inventory recession were being voiced and overall commodity prices showed some unusual weakness (see CRB Chart 5). As our lead article indicates, we do not subscribe to the recession scenario and, therefore, feel that commodity prices probably will resume their uptrend. Clearly, this should benefit gold.

It is difficult to know how many more gold loans are being arranged. Another large string of these, done over a short period of time, is likely to put additional downward pressure on prices. As a result, near-term weakness *can* continue and somewhat lower prices could be seen. In the long run, however, these gold loans lift *future* pressure on prices and may become an extremely bullish factor if hedges are covered "on the way up."

**STRATEGY:** *We sold bullion breaking \$468, basis nearest contract, on close as per last month's comments, and we advised reentering the long side late last week at around \$440/oz., basis spot (see Hotline Update for Feb. 12). Protective stops should be placed at \$437/oz., basis nearest contract, close only.*

Chart 7 — COMEX GOLD

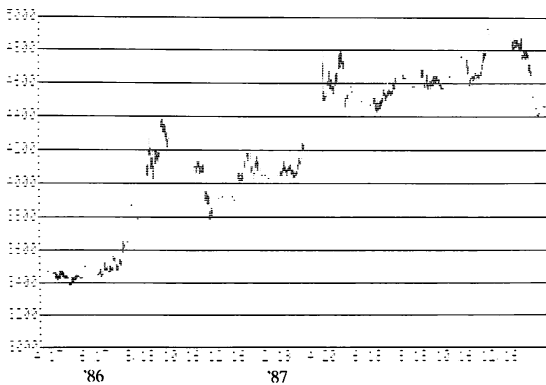
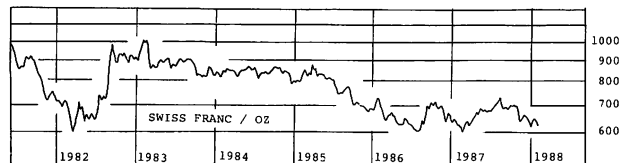


Chart 8 — GOLD — Swiss francs/oz.



**COPPER**

# The correction has run its course

The extremely steep backwardation that developed late last year did a *fair* job in attracting lenders of copper to the market and deferring would-be users who could afford to wait a few months (see our discussion on backwardation in last December's issue). As a result, combined LME and COMEX warehouse stocks have stabilized between 63,000 tonnes and 73,000 tonnes for the past eight weeks after their spectacular prior decline.

Backwardations, however, are only helpful in redistributing supplies and reactivating idle material, a near-term palliative, until global supply and demand conditions ease. This is, in effect, what has happened in the copper market. With

the stability of stocks, the backwardation has narrowed considerably and the urgency to own material *now* has subsided (see Chart 9).

Nevertheless, a strong economy and low stocks/usage ratios will put, once again, upward pressure on prices as soon as one can detect the subtlest shift in traders' inflationary expectations. This may come with the release of first quarter GNP figures, or even sooner.

**STRATEGY:** *We reentered the long side of the market (see Hotline Update for Feb. 5) and are long May '88 copper, with stops at 7890, close only.*

Chart 9 — COPPER — March/May

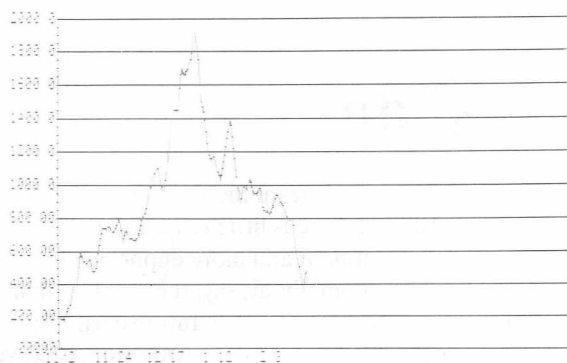
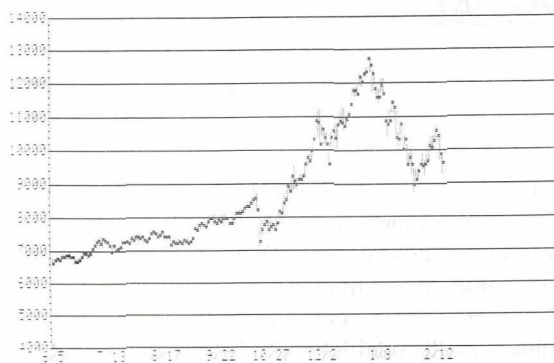


Chart 10 — COMEX COPPER MAR 88



**CRUDE OIL**

## The patient, ruthless bear

Since hitting a peak above \$22/barrel in the late summer of 1987, crude prices have eroded almost continuously and now threaten to plunge below the psychologically important \$15/barrel area.

Opec production in February has been averaging 17.2 million barrels per day (b/d), slightly above January's 16.7 million b/d and clearly in excess of recent seasonal needs. It is unlikely that Opec output can be decreased significantly from these levels if — as is quite certain — Saudi Arabia refuses to turn into a swing producer.

As is well known, in years past Saudi Arabi had taken the brunt of the cutbacks, going down to as low as 2 million b/d (summer of 1985) from a 4.3 million b/d quota. At this time, the Saudis must reason that a 2 million b/d cutback could theoretically make the difference between \$18/barrel and, say, \$14/barrel. With a 4.3 million b/d output and a \$14/barrel price, total revenues would equal \$60 million per day. With a 2 million b/d output and an \$18/barrel price, total revenues would equal \$36 million per day — an astonishing 40% drop in income! Clearly, the Saudis can no longer afford to be swing producers. Given their inability to come to the aid of Opec, three possible scenarios present themselves:

1. A continuation of the present rate of output. Prices drift lower, which in turn may cause further destabilizing speculative selling. Ultimately, a new Opec meeting is convened and an attempt is made to prop up prices verbally. Short-covering interrupts the speculative freefall, but lack of substantial progress forces a new price erosion. In this scenario, prices hit \$9-\$10/barrel, rallying to perhaps \$12-\$13/barrel, and then resume their downtrend to eventually hit \$5/barrel or less. As prices move lower, cheating increases, and output moves towards full capacity. This probability: 33%.

2. Opec meets in a hurry and convenes a new, overall production ceiling, which, including Iraq, cannot rise above 14.5 million b/d. This extremely difficult maneuver will surely be resisted by a fair number of members, including Kuwait, UAE, and Nigeria, primarily on the basis of individual *alloca-*

*tions*. In this scenario, prices firm initially to reach, once again, \$17-\$18/barrel. Opec plays its waiting card: Given enough time, so they say, consumption will rise sufficiently to absorb greater Opec output. Good luck.

To date, Opec has shown some remarkable cohesion in times of distress and may pull it off. Probability: 33%

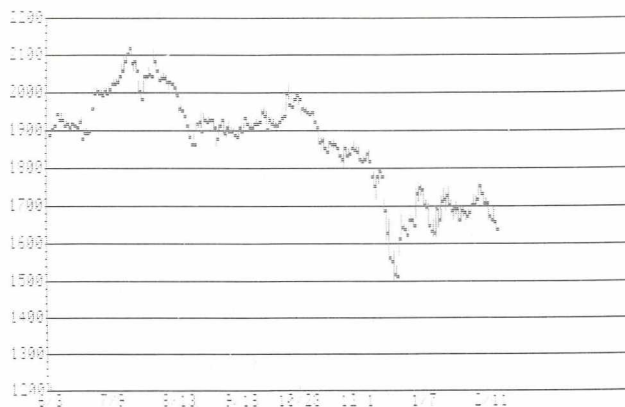
3. Saudi Arabia and other Gulf producers bolt away from Opec and raise output to full capacity. At first, prices collapse to well below \$5/barrel but then begin to stabilize, probably in the \$7-\$8/barrel area. The two important assumptions: Gulf production displaces other Opec and non-Opec producers as prices fall below costs of production; consumption begins a long, upward increase. This probability: 33%.

In sum, with the clear military, political, and economic weakening of Iran — the one-time hardliner who put the fear of Allah in King Fahd's head — there is only *one chance in three* that crude price recover to the \$18/barrel mark.

The bear is patient... but ruthless.

**STRATEGY:** Remain short; retain stops at 17.70, basis April '87, close only.

Chart 11 — NYME CRUDE LIGHT APR 88



**STOCK INDEXES**

# Dow still on long slide

The superior performance of secondary issues is reflected in the steady improvement of the SP/Value Line ratio, the Amex Market Value Index, and the NY advance/decline line. The lack of a significant number of new highs, however, indicates that the secondary market is merely "bouncing" better from a deeply oversold condition than the heavily (institutionally) over-owned large capitalization stocks, a poor sign of market strength.

Monetary conditions in the US continue to be negative for the stock market (see Chart 12), as money supply growth falls below the rate of growth of nominal GNP. Similarly, in Canada, secondary bank reserves continue to be squeezed down, an illiquid backdrop to equity prices.

Bulls have argued that stock prices in constant dollars, at the bull market peak, were still substantially lower than in the mid '60s (see Chart 13). On this basis, considering the 25%-30% drop that has occurred since, stock prices have to be downright cheap. What is remarkable about Chart 13 is the extraordinary stability of prices from 1900 to 1953 (with the sole exception of 1928 and 1929). In 1959-60 prices reached, for the very first time, the 1929 levels and exceeded them by a wide margin in 1965-66. Further, one notes how the bear market of the '70s brought prices back to the stable range of the first half-century.

The 1953-65 period needs an explanation. If stock prices represent the present value of an expected future stream of dividends or earnings, only two factors can affect valuation: a lower (or higher) discount rate and/or a lower (or higher) forecast of future earnings. In the post-war period one could argue that *real* rates of interest were lower than in the previous 50 years. Although this cannot be easily corroborated given the difficulty of *measuring* inflationary expectations, we believe that there is *some* validity to this line of reasoning.

A lower (real) discount rate meant higher present values. As to the second possibility, there is little reason to believe that investors were more confident and more euphoric about the upcoming '50s and '60s than about, say, the '20s for them to have raised significantly the *estimate* of future earnings.

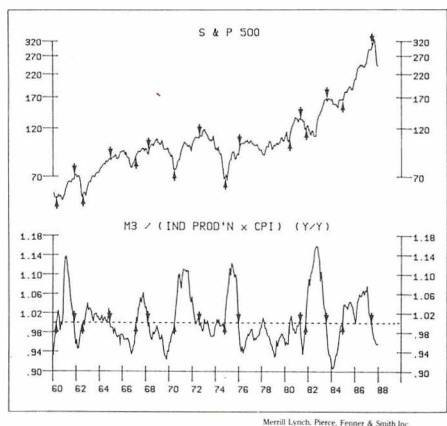
The explanation of a lower real discount rate, however, fails to explain the 1982-87 bull market: After all, nearly everyone agrees that the '80s have seen the highest real rate of interest in recent memory. What, then can explain this anomalous situation?

We believe that the true explanation lies in the concept of credit. Easy credit periods lead to maniacal buying of pledgeable assets, primarily securities and real estate. In the first post-war period (1953-65), credit far outpaced inflation and became the engine for *irrational overvaluation*. Easy credit led to highly mobile valuations because it led to higher prices. A perfectly vicious circle. In the second period, inflation "consumed" the increases in credit, and in real terms, credit contracted. Prices fell to their long-term equilibrium range. From 1982 to 1987, credit facilitated the greatest splurge of takeovers, leveraged buyouts, and whatnots. Profit-maximizing lenders and borrowers played the most leveraged game of all: securities and real estate credit. Once again, as long as credit was plentiful, overvaluation could be ignored.

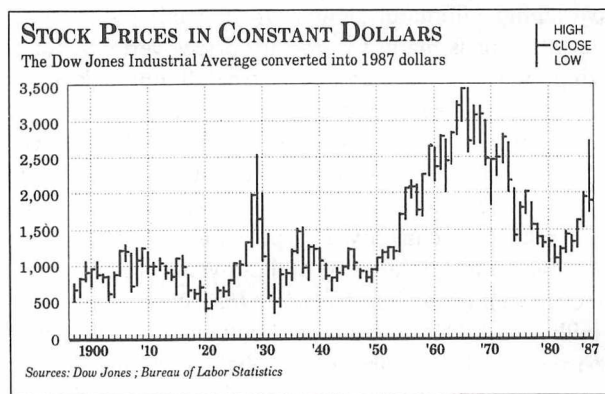
The 2000 level on the Dow in Chart 13 is no bargain. It is being supported by still excessive dosages of credit. Either overall credit begins to contract because we may not be able to continue servicing it (as was the case with credit to the LDCs in the early '80s) or inflation "consumes" it. Either way, stock prices have a long way to go, on their way to Dow 1000 (in 1987 dollars).

**STRATEGY:** Remain short against long March 240 calls.

**Chart 12 — Money Supply/GNP Relationships Often Determine The Primary Direction of Stock Prices**



**Chart 13**



THE WALL STREET JOURNAL

**SUGAR**

# Gorby's statistical noise

Since the Jan. 24, 1988, issue of *FC&CC*, sugar prices have broken down (see Chart 14). In consequence, we were stopped out of the March 1988 contract at 8.95¢.

The motivation behind the sharp price drop was a report on the world sugar balance, which was issued by F.O. Licht, the respected West German statistical firm. F.O. Licht's second estimate of world production for the 1987-88 market year was revised upward by 1.3 million tons, with the bulk of the increase coming from an increase in the estimate for the USSR's production. Specifically, F.O. Licht now estimates Soviet output for 1987-88 to be 9.7 million tons, up from 8.7 million tons in the 1986-87 market year.

As a result of the Licht report and other data made available since our January estimates, we have revised our world sugar balance (see Chart 15). The most significant revisions were an increase in the Soviets' output to that reported by F.O. Licht and a reduction in the Cuban estimate. Of note is the fact that we did not change our estimate of Soviet imports. The bottom line is that our new estimate for ending stocks, and ending stocks as a percent of consumption, have been revised upward slightly. In consequence, our world sugar balance remains essentially the same as it was in January. With unaltered fundamentals, we continue to remain friendly towards the sugar market.

To appreciate our position, we offer some thoughts on the Soviet production numbers. We have noticed that since Mr. Mikhail Gorbachov (Gorby) instituted economic reforms in the USSR, Soviet reported production figures, across a wide array of commodities, have begun to show a systematic improvement. Most recently, new estimates of reported production for sugar, grains, meats, and sunflower seed oils have come in at levels that were higher than the highest estimates that had been made by market participants.

Two hypotheses are consistent with these higher production figures. The first is that the economic reforms are working already and production has increased. If this hypothesis is correct, it would imply that the Soviets' import requirements might be reduced because the USSR's economy is actually

producing more internally.

The second hypothesis, and the one that we subscribe to, is as follows: Before to Gorby's reforms, producers (producing entities) were not rewarded on the basis of the amount of output they produced. Moreover, there was light and/or corrupt monitoring on the part of the state authorities. Hence, producers had an incentive (a pay off) to skim off some of the actual output they produced so that it could be sold in the black markets. In consequence, the official production statistics were lower than the real production. Since Gorby's reforms, there is a linkage between the amount producers produce and their compensation. In addition, state monitoring has increased and corruption has been reduced. Hence, the incentive (pay off) to skim for the purpose of black market sales has been reduced.

We should expect, therefore, that a higher percentage of actual production now flows through official channels and is officially reported than was the case before Gorby. The bottom line is that reported output should be higher after Gorby than it was before, even if actual output has remained stable. If this hypothesis is correct, it would imply that import requirements will remain about the same, even in the face of higher reported output numbers, because actual production has remained about the same.

At present, we subscribe to this latter hypothesis. In consequence, even though we have used the revised Soviet production figures reported by F.O. Licht in our world sugar balance (see Chart 15), we have not altered our estimates for the Soviets' 1987-88 sugar imports (see Chart 16). We have estimated imports at 5.1 million tons, which is the same level as those for the 1986-87 market year. After all, if reported production increases are due to "better reporting" and not actual production increases, why should Soviet import requirements be reduced?

**STRATEGY:** Reestablish long positions in October 1988 contract. Place stops at 7.90, close only.

— Steve H. Hanke

Chart 14 — N.Y. #11 SUGAR OCT 88

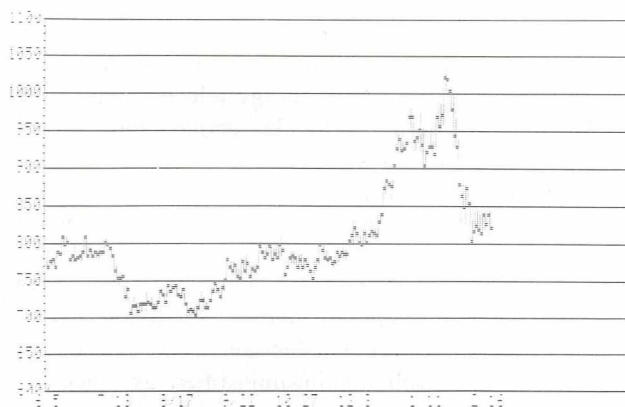


Chart 15 — World sugar balance

Mkt. Yr.	Production	Consumption	Net Trade			Ending Stocks	
			Imports	Exports	Net	Quantity	% of Cons.
85/86	98,940	100,290	28,415	29,399	-0,984	37,934	37.82
86/87	103,962	104,175	27,825	29,559	-1,734	35,987	34.54
87/88 (est.)	103,044	105,759	27,109	26,831	+0,278	33,550	31.72

Note: All figures in millions of tons, unless otherwise specified.

Chart 16  
USSR sugar production and imports (millions of tons)

Mkt. Yr.	Reported Production	Imports
84/85	8.685	4.9
85/86	8.260	5.4
86/87	8.700	5.1
87/88 (est.)	9.700	5.1

**NEW ZEALAND DOLLAR**

## As goes Rogernomics, so goes the kiwi

When New Zealand's Labour government took office in 1984, the economy was in deep trouble. Not surprisingly, its troubles stemmed from heavy intervention in all markets, a huge welfare state, and irresponsible monetary and fiscal policies.

With the new government came a set of policies designed to tighten monetary and fiscal policies, deregulate markets, trim the sails of the welfare state, and "corporatize" and "privatize" state-owned enterprises. These policies have been dubbed "Rogernomics," after their architect, Mr. Roger Douglas, New Zealand's hard-charging Minister of Finance.

We presented a detailed analysis of Rogernomics in "The Kiwi Turnaround" (*FC&CC* May 18, 1986). In that report, we concluded that if Mr. Douglas could implement Rogernomics, the economy would show new life, international investor confidence in New Zealand would be given a boost, and the Kiwi would strengthen. We also emphasized that our conclusion carried a significant, well-defined risk, namely the risk that Mr. Douglas would not be able to deliver the goods. However, in the end, we counseled that the risk-reward ratio was favorable, and recommended investments in the New Zealand dollar and high-yielding kiwi bonds. To date, the implementation of Rogernomics has begun, the economic results have been in the direction that we anticipated, and most importantly, the New Zealand currency and kiwi bonds have proven to be excellent investments (see Chart 19).

\* \* \* \* \*

With the reelection of the Labour government in August 1987, one of our original concerns (risks) has been eliminated. However, questions still remain. Hence, it is time to once again analyze New Zealand's economic prospects.

Shortly after Labour's reelection, Mr. Douglas had his civil servants at Treasury prepare a rather long, technical report. This impressive report is simply titled: "Government Management." It lays out a detailed blueprint for the future course of Rogernomics. The report's key elements are as follows:

**Implementation.** "The credibility of reforms can be enhanced by making the direction of policy clear and unequivocal; adopting consistent and mutually reinforcing policies; avoiding policy reversals (and, if they do occur, ensuring that policy reversals are obvious); and clearly explaining the benefits of change." (p. 193)

**Privatization.** "There is general agreement internationally that when non-commercial functions have been separated off from SOEs (State Owned Enterprises) and their regulatory environment has been reformed, their ownership should be transferred to the private sector. For efficiency reasons this policy should be implemented as soon as possible." (p. 112)

**Disinflation.** "Progress in reducing inflation, though un-

even, has been greater in the past three years than since the first oil shock in 1973. Nonetheless, a projected inflation rate of 7 percent is still far too high. Government must maintain its strong disinflationary stance and price stability must consistently take priority over other objectives in the formulation of monetary policy. Mitigating the costs of adjusting to low inflation can weaken the credibility of the Government's commitment to disinflation and reinforce inflationary expectations. In contrast, a clear reaffirmation now that there will be no reversal on disinflation, and that, if anything, its pace will be accelerated would reinforce the improving trend of inflation expectations evident since April. Holding down government spending, reducing import protection and further labour market reform will all assist achievement of lower inflation and act to ease the overall adjustment costs." (p. 201)

**Industry assistance.** "It is neither feasible nor sensible to attempt to extend assistance to our domestic producers on a level comparable to that received by our foreign competitors. At the same time it is important to recognize that there are major economic benefits to be gained from *unilateral trade liberalization*." (p. 244)

**Regulation.** "Although regulatory reform has generally resulted in lower prices, greater efficiency and improved quality and consumer choice, the programme to date has been uneven, and large areas of regulation have as yet not been exposed to critical scrutiny. The priorities for further reform should be determined by the likely gains in economic efficiency or equity from that regulation alone and the extent to which this policy interacts with other policy changes being undertaken.

"Next to the reform of industry assistance, the reform of labour market regulation including occupational licensing offers the greatest efficiency gains of any reform measure. The reform of capital market regulation has been a major achievement, and continuing improvements will bring further gains. Some areas still need attention such as earthquake insurance, taxation of superannuation and life insurance, the stock exchange and the role of the Rural Bank and the Housing Corporation. In the market for services major reforms are needed in the broadcasting, transport, energy, telecommunications, construction, distribution and social service sector." (p. 261)

**Taxes.** "Although substantial progress has been made in reform of the tax system over the last three years, much remains to be done to reduce its efficiency costs and to improve its overall fairness. The big issues relate to the breadth of the tax base and the rates of tax. Future reform should focus on combining the broadest practicable bases with low and relatively uniform rates of tax. The income tax base needs to be broadened further by eliminating unjustified tax concessions

and by continuing to correct deficiencies in present tax law and practice which lead to an erosion of the base. Greater reliance should be placed on indirect tax and this would require an increase in the rate of GST (value added tax) in due course, while maintaining its base and uniform rate. This would take some pressure off the income tax system, reduce disincentives to invest and save, and lessen the distorting impact of inflation on the tax system. The additional revenue from these moves should be used to lower and reduce disparities in personal marginal rates of tax; to lower company tax; and to phase out those selective indirect taxes which cannot be justified by 'social cost' arguments. In addition, the operation of the tax system needs to be strengthened." (p. 293)

\* \* \* \* \*

Needless to say, this is the stuff that tough economic policies are built on. Moreover, it is the type of hard-hitting analysis that is atypical of civil service staffs. But, in New Zealand, there is Mr. Roger Douglas, and his fingerprints are on each page of the report.

Armed with the Treasury's heavy artillery, New Zealand's one-man gang sold another dose of Rogernomics to his colleagues in the cabinet. And on Dec. 17, 1987, Mr. Douglas announced an economic package that followed the script of the Treasury report.

With the holiday season, the wheels of government slowed, and among other things, Mr. Roger Douglas went to Davos, Switzerland to attend the World Economic Forum. In Mr. Douglas' absence, on Jan. 28, 1988, Labour's prime minister, Mr. David Lange, without consulting his colleagues, applied the brakes to Rogernomics. Specifically, Mr. Lange announced that Mr. Douglas' flat tax plan would have to be put on hold. This announcement caused Mr. Douglas to rush home from Davos to defend his policies in a protracted cabinet meeting. Not surprisingly, participants in the foreign exchange markets and the New Zealand Stock Exchange did not take too kindly to Mr. Lange's maneuver: the kiwi was put under a bit of downward pressure and the stock market fell in nine straight sessions. Investors were obviously worried that Rogernomics and perhaps more importantly Mr. Douglas were in jeopardy.

The next act in this drama was played out on Feb. 10, 1988: Messrs. Lange and Douglas reached an acceptable compromise and both issued similar press statements. As Mr. Lange said, "Highlights of the Government's latest decisions are:

- not to proceed with the implementation of a single nominal rate of income tax for the 1988-89 financial year;
- there will continue to be a progressive structure of income tax. Two marginal rates will apply from 1 October 1988: 24 percent on incomes up to NZ\$30,875 per annum, and 33 percent above that level;
- the rate of tax for resident companies will be 28 percent and for non-resident companies 33 percent;
- not to proceed with the proposal to enhance the Guaranteed Minimum Family income put forward in the economic statement.

"The fiscal impact of the revised package of taxation measures will be positive. They do not depend on an increase in the rate of Goods and Services Tax or reductions in Government expenditure on the social services.

"Cabinet affirmed its support for the following measures set out in the economic statement of 17 December 1987:

- reform of public sector management
- reform of regional and local government
- expenditure reductions
- regulatory reform
- reform of occupational regulation
- deregulation of telecommunications
- long term tariff policy
- fiscal objectives and debt management"

At this point, it appears that Rogernomics has been left intact. After all, on Dec. 17, 1987, Mr. Douglas had announced that New Zealand would adopt a flat, single rate income tax on Oct. 1, 1988. Although Mr. Douglas did not specify the rate, speculation at that time was that the rate would be set between 25% and 30%. The so-called compromise — a two-rate scheme of 24% and 33% — is not too bad. This, plus the fact that virtually all the other parts of the Dec. 17 economic program were left unaltered, leaves Mr. Douglas with much more than a half a loaf.

If this weren't enough, on Feb. 15, 1988, the government announced that it intended to sell its 70% stake in Petroleum Corp. New Zealand Ltd. to British Gas. The New Zealand dollar and kiwi bonds both moved up smartly on this announcement.

\* \* \* \* \*

The tax flap episode brings us to the real issue concerning the prospects for New Zealand's economy. In a word, it is *confidence*. As Lord Keynes wrote in his *General Theory*: "the state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analysed it carefully..." Of course, confidence is difficult to define and insert into a formal model. Lord Keynes admitted as much. However, it is a cardinal sin to confine analysis to clearly definable and quantifiable magnitudes, and to ignore an important determinant of behaviour simply because it cannot be encapsulated in a neat definition or be measured.

An analysis of confidence is of particular importance in the case of New Zealand because the superb performance of the kiwi has been the result of confidence and high expectations about the nation's economic prospects. And these economic prospects have been built on the prospects for Rogernomics, if not Mr. Douglas himself.

As Charts 17-21 show, New Zealand has been headed in the right economic direction. Yes, even the explosive money supply growth, as measured by M1, doesn't cause us undue concern (see Chart 20). To understand this, consider that when inflation and interest rates exceeded 20% per annum, the cost of holding cash and non-interest bearing checking accounts (the two components of M1) was very high. This high cost

caused New Zealanders to economize on cash and checking accounts. As the cost of holding these assets has fallen, the demand for cash and checking accounts has increased. Hence, the money supply (M1) has risen rapidly, when compared with other credit aggregates. In short, the strong growth in M1 has been the result of falling inflation and interest rates. The growth reflects, in part, the increased demand for cash and checking accounts, and the fact that the New Zealand economy is, as we would expect, being remonetized (that is, the ratio of money supply (M1) to gross national product (GNP) is increasing).

We should mention that the Reserve Bank of New Zealand accommodated and to some extent motivated the increased demand for money by easing somewhat the big monetary squeeze that existed before April 1987. Charts 18 shows that beginning in late April 1987, the spread between the short-term and long-term interest rates began to narrow (that is, since April 1987, the inversion in New Zealand's yield curve has become less pronounced). To put it in other words, while monetary policy remains tight, as measured by an inverted yield curve, it is not as tight as it was prior to April 1987. All this is not to say that New Zealand's economy is out of the woods, however. The problems discussed in the candid Treasury report are real and in need of more Rogernomics.

The economic data in the charts show general improvement. For example, the consumer price index (CPI) for the December 1987 quarter shows that the inflation rate was 9.6% (see Chart 17), which is the first time that the rate has fallen below 10%, without price controls, in the past 14 years. However, the kiwi (see Chart 19) has outperformed what the historical economic data *per se* might suggest. This result has been obtained because of international confidence in Mr. Douglas and Rogernomics. Hence, expectations about an improvement in *future* economic data have been high. If confi-

dence is reduced, high expectations will be dampened, and the New Zealand dollar will fall to a level that can be supported by the historical economic data *per se*.

To put it in other words, if expectations are that Mr. Douglas will continue to show no signs of battle fatigue and will be able to keep Rogernomics on the rails, the kiwi will hold, if not move higher. However, if confidence and expectations are reduced, then the kiwi will move more closely in line with the movements in historical economic data *per se*.

This brings us to the major risk associated with the New Zealand dollar and kiwi investments. The risk is that Rogernomics will not move forward as planned and international investors will lose confidence. Mr. Douglas has been able to move forward, in part, because the left-wing of the Labour party has been preoccupied with the nation's rather bizarre antinuclear, "peace" policies. Now that those policies are in place, there is a risk that Labour's left-wing will focus its attention on Rogernomics. During the most recent tax flap, we had a taste of the potential damage that the left-wing could inflict. Hence, if the left-wing begins to dig in its heels to defend the welfare state against Mr. Douglas' responsible, free-market policies, we will observe more "tax flap-type" confrontations. In consequence, we will see a drop in international investor confidence and a fall in the kiwi. Although we aren't forecasting such a drop, we are aware of this possibility and are monitoring the situation and this risk closely.

**STRATEGY:** For now, Rogernomics is alive and well. Remain long the New Zealand dollar vis à vis the US dollar and neutral vis à vis the deutschemark. Retain positions in kiwi bonds.

— Steve H. Hanke

Chart 17  
Macroeconomic indicators

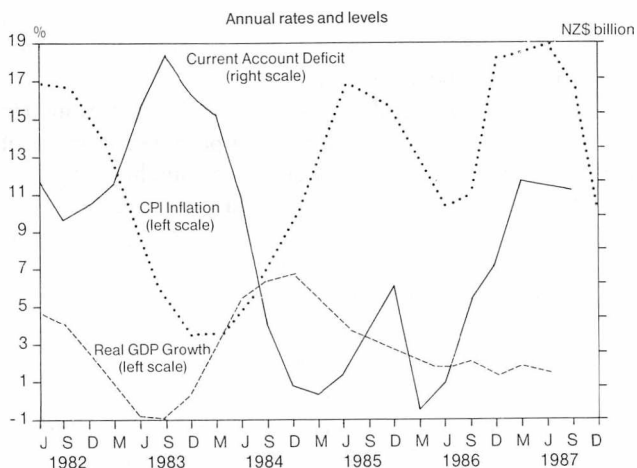


Chart 19 - Exchange rates

	20 Jan '88	16 Dec '87	21 Oct '87	15 July '87	15 Apr '87	21 Jan '87	Annual percentage change
US dollars	0.6623	0.6463	0.6455	0.6002	0.5814	0.5368	23.38
Australian dollars	0.9307	0.9067	0.9049	0.8515	0.8025	0.8147	14.23
Yen	85.337	82.274	92.868	90.870	82.053	81.862	4.25
Deutsche-mark	1.1103	1.0522	1.1693	1.1119	1.0442	0.9855	12.66
Sterling	0.3730	0.3524	0.3907	0.3729	0.3555	0.3527	5.76
Trade Weighted Index (June 1979 = 100)	66.8	64.5	68.2	64.6	60.5	59.8	11.71
US dollar per Australian dollar	0.7116	0.7128	0.7133	0.7049	0.6442	0.6589	7.99

Source: NZI Bank

Chart 21  
Balance of Payments Current Account Forecasts

SM (Prepared in October 1987)

March Years	Actuals			Forecast	
	1984/85p	1985/86p	1986/87	1987/88	1988/89
<b>MERCHANDISE TRADE</b>					
Exports:					
Meat	2,006.0	1,926.3	2,138.8	2,164.6	2,380.3
Wool	1,405.9	1,305.6	1,520.3	1,596.0	1,610.7
Dairy Products	1,686.3	1,721.9	1,663.0	1,913.0	2,280.0
Other Animal Products	593.0	711.0	817.3	831.9	924.0
Forest Products	724.1	670.7	720.2	767.9	928.8
Other Primary Products	1,065.5	1,173.4	1,464.4	1,765.7	2,105.5
Manufactured Goods	2,505.9	2,612.9	2,542.4	2,651.1	2,913.4
Base Minerals, Other	533.3	771.3	731.6	837.3	890.9
Adjustment to BOP basis	(130.0)	(121.0)	(-107.0)	(54.9)	(67.5)
Total Export Credits:	10,390.0	10,772.0	11,491.0	12,473.2	13,966.1
Total Import Debits:	10,756.0	11,164.0	10,500.0	11,253.0	12,322.0
<b>MERCHANDISE TRADE BALANCE</b>					
	-365.0	-392.0	978.0	1,220.2	1,644.1
<b>INVISIBLES</b>					
Services Credits:	2,723.0	3,050.0	3,358.0	3,717.0	4,115.0
Services Debits:	3,754.0	3,774.0	4,190.0	4,554.5	5,010.0
Services Balance:	-1,031.0	-724.0	-832.0	-837.0	-895.0
<b>International Investment Income</b>					
Credits:	400.0	458.0	583.0	786.0	779.0
Debits:	2,459.0	2,657.0	2,966.0	3,340.0	3,440.0
Balance:	-2,059.0	-2,199.0	-2,257.0	-2,554.0	-2,661.0
Transfers Credits:	653.0	710.0	847.0	926.0	1,041.0
Transfers Debits:	442.0	524.0	608.0	643.0	709.0
Transfers Balance:	211.0	186.0	239.0	283.0	332.0
Total Invisibles Credits:	3,776.0	4,188.0	4,788.0	5,429.0	5,935.0
Total Invisibles Debits:	6,655.0	6,956.0	7,764.0	8,537.5	9,159.0
<b>TOTAL INVISIBLES BALANCE</b>					
	-2,879.0	-2,768.0	-2,976.0	-3,108.5	-3,224.0
<b>BALANCE ON CURRENT ACCOUNT</b>					
	-3,224.0	-3,160.0	-1,998.0	-1,888.3	-1,580.0
% GDP	8.4	7.0	3.8	3.2	2.5

FRIEDBERG CAPITAL MARKETS

Chart 22

Foreign Currency Bonds

Date: February 18, 1988

We offer the following Bonds subject to change without prior notice:  
Minimum amount US\$5,000 (Cdn.\$ 7,000).

ISSUER MTY DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO MTY.	LAST PAY DATE	NEXT PAY DATE
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
COCA COLA 16/6/89 18%	102 3/4	- 103 1/2	14.63	16/6/87	- 16/6/88
HONDA INT'L 20/9/89 16 3/8%	101	- 101 3/4	14.83	20/9/87	- 20/9/88
HONDA INT'L 28/5/90 16%	101 3/4	- 102 1/2	14.51	28/11/86	- 28/5/88
TOURIST HOTEL CORP. (N.Z.) 4/6/93 zero coupon	49	- 50	14.04	matures 4/6/93	
BANK OF NOVA SCOTIA 15/9/89 18 1/2 RRSF eligible	104 1/4	- 105	14.45	15/9/87	- 15/9/88
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	100 7/8	- 101 5/8	15.08	12/11/87	- 12/5/88
KODAK (semi-ann.) 15/2/89 17%	102 1/4	- 103	14.04	15/8/87	- 15/2/88
TORONTO DOMINION 2/4/90 18% RRSF eligible	104 3/4	- 105 1/2	14.70	2/4/87	- 2/4/88
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
CAN.IMP.BANK OF COMMERCE 13/3/91 13% RRSF eligible	101 3/8	- 102 1/8	12.11	13/3/87	- 13/3/88
<b>DANISH KRONE DENOMINATED BONDS</b>					
WORLD BANK 20/11/92 9 3/4% RRSF eligible	98 3/4	- 99 1/2	9.86	20/11/87	- 20/11/88
STOCKHOLM 10/11/91 10 5/8%	100 1/4	- 101 1/2	10.09	10/11/87	- 10/11/88

Chart 20  
Primary liquidity, money supply and domestic credit aggregates

1. (a) Monthly Aggregates (NZ\$ Million)

Month End	Primary <sup>1,2</sup> Liquidity	Average Holdings of Currency by Private Sector	M1	M3	Domestic Credit	Private Sector Credit
<b>1986</b>						
Sept.	909	858	4560	34497	42577	32956
Oct.	368	878	4667	35488	43420	33527
Nov.	344	901	4820	36062	43919	34156
Dec.	372	1019	5077	37160	45103	34720
<b>1987</b>						
Jan.	384	974	4756	37690	45454	34939
Feb.	991	945	5127	38651	46197	35492
Mar.	1308	981	4958	37793	44831	36172
Apr.	434	1140	5993	38471	45370	36844
May	377	1125	6212	38811	46374	37267
June	354	1114	5997	39499	47476	37887
July	340	1078	6290	39352	47489	37653
Aug.	443	1059	6733	39971	47995	37600
Sept.	561	1050	6773	40431	48840	38852
Oct.	385	1055	7096	41555	49928	39748
Nov.	601	1077	6787	41544	50164	40385

1 - Monthly average figures.  
2 - From 16 April 1986 the definition of PL changed to include only settlement cash and those securities with 30 days or less to maturity.

(b) Changes in Selected Monetary Aggregates

Month End	M1 % change		M3 % change		Domestic Credit % change		Private Sector Credit % change		Average Currency Holdings by Private Sector % change	
	Ann.	Seas. Month	Ann.	Seas. Month	Ann.	Seas. Month	Ann.	Seas. Month	Ann.	Seas. Monthly
<b>1986</b>										
June	17.7	4.1	20.0	0.4	21.4	0.5	27.5	0.5	9.6	2.2
July	17.6	0.3	16.2	0.3	20.4	1.4	24.5	0.8	11.3	3.3
Aug.	23.0	3.1	17.1	1.2	18.9	0.8	22.6	0.8	10.6	1.5
Sept.	29.0	6.3	18.0	2.2	18.8	2.1	22.8	1.9	10.7	1.4
Oct.	20.4	-1.1	20.2	2.4	20.2	1.5	23.9	1.7	9.1	0.9
Nov.	27.3	5.6	19.2	1.7	16.0	1.3	21.6	2.0	8.9	1.1
Dec.	16.0	-4.8	19.3	1.0	15.3	1.6	22.1	2.1	11.6	2.4
<b>1987</b>										
Jan.	21.7	3.1	20.2	2.8	16.1	2.0	20.6	1.4	15.5	4.7
Feb.	26.9	3.7	21.1	0.8	15.3	1.5	19.4	1.3	12.8	-2.5
Mar.	20.9	0.8	17.8	3.1	12.0	4.0	17.6	3.2	16.5	3.1
Apr.*	48.1	17.3	17.6	-0.4	13.9	-0.1	17.9	-0.1	34.8	11.4
May	50.8	5.0	17.6	0.9	15.2	1.6	18.2	1.5	32.8	-0.2
June	41.8	-2.4	18.2	0.9	16.3	1.4	19.6	1.6	30.4	0.3
July	48.6	5.2	17.8	0.1	15.0	0.3	18.3	-0.3	25.6	-0.5
Aug.	50.8	4.3	17.3	0.9	15.7	1.4	17.9	0.6	24.0	0.2
Sept.	48.5	4.3	17.2	1.9	14.5	1.1	17.9	1.8	22.4	0.1
Oct.	52.0	1.1	17.1	2.2	15.0	1.6	18.6	2.2	20.2	-0.9
Nov.	40.8	-1.5	15.2	0.2	14.2	0.7	18.2	1.8	19.5	0.6

\*EFTPOS (Electronic Funds Transfers) accounts were included in the aggregate for the first time.

1. Data are monthly averages (excl. weekends) of notes on issues from the Reserve Bank plus end-month coin in circulation. Unlike the monetary aggregates, the data includes the till money of the registered banks.

2. The sudden increase in the series in April 1987 is due to the abolition of the notes trust system around that time.

Source: RBNZ

**FOREX RATES & UPDATE**

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.7070)
Belgian franc	35.68-35.73	35.59-35.69	35.33-35.53	Neutral	Neutral
Danish krone	6.5135-6.5185	6.5405-6.5820	6.6110-6.6410	Neutral	Neutral
Dutch guilder	1.9140-1.9150	1.9010-1.9125	1.8590-1.8610	Neutral	Remain short
Greek drachma	136.36-136.46	139.46-141.56	153.16-159.86	Remain short	Remain short
Hong Kong dollar	7.7850-7.7900	7.7075-7.7175	7.5850-7.6400	Remain short	Neutral
Italian lira	1255-1256	1264-1268	1294-1305	Neutral	Remain short
Kuwaiti dinar	.27692-.27712	.27536-.27599	.27067-.27249	Neutral	Remain short
Malaysian ringgit	2.5850-2.5870	2.5670-2.5730	2.5210-2.5290	Neutral	Neutral
New Zealand dollar	.6610-.6620	.6455-.6475	.6110-.6180	Place stops at .6490, basis cash	Neutral
Norwegian krone	6.4260-6.4310	6.5390-6.5480	6.8585-6.8760	Neutral	Neutral
Portugese escudo	139.50-140.00	141.80-142.80	144.80-149.30	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7525-3.7550	3.7600-3.7660	Remain short	Remain short
Singapore dollar	2.0180-2.0210	2.0008-2.0043	1.9540-1.9620	Neutral	Neutral
Spanish peseta	114.55-114.65	115.85-118.80	119.15-119.65	Neutral	Neutral
Swedish krona	6.0650-6.0700	6.1025-6.1115	6.2100-6.2275	Neutral	Neutral
Venezuelan bolivar	29.75-30.25	Not available	Not available	Commercial hedgers remain short	

**Explanatory Notes**

- \*Indicates change in recommendation from last issue
- Currency expected to firm against both currencies. Buy Buy
- Currency expected to strengthen against US \$ and weaken against DM. Buy Sell
- Currency expected to weaken against both major currencies. Sell Sell
- Currency expected to weaken against US \$, but strengthen against DM. Sell Buy
- Term used to liquidate short position but does not imply a new buy recommendation Cover
- Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation. Liquidate

**HOTLINE UPDATE**

**Tuesday, January 26:** No changes or new recommendations. The market letter is in the mail.

**Friday, January 29:** The market letter was mailed Tuesday, January 26. Some subscribers have called this afternoon not having received the market letter and asking for stops in gold and CRB. For the benefit of these subscribers, we point out that gold was stopped out as of Wednesday's close at 467.00, basis February, on a revised 468.00 stop, close basis nearby contract.

Also the CRB contract triggered our revised stop today of 231.50, basis cash index, on close. We now have one new recommendation. Buy US dollars against the sale of all European currencies and the Japanese yen, using the DM as our main yardstick for all the above currencies. Place protective stops at 6060, basis March, close only.

**Tuesday, February 2:** No changes or new recommendations.

**Flash update, Friday, February 5, 9:00 a.m.:** Buy May copper at market, risking 7890, basis May, close only. (repeat for Friday night wrap-up.)

**Tuesday, February 9:** One recommendation. Lower stops on April NY crude oil to 1770, close only.

**Flash update, Thursday, February 11, 10:40 a.m.:** Cover all short currency positions at market. (7246 SF, 5936 DM, 7771 JY.)

**Flash update, Friday, February 12, 9:10 a.m.:** Two new recommendations: 1) Buy gold at market, risking a close below 439.00, basis June. 2) Sell June T-bonds at market, risking 9410, close only.

**Friday, February 12:** A recap of the week's activities. Four recommendations:  
 1) We have lowered our stops in crude oil to 1770, basis April, close only.  
 2) We have covered all our short currency positions, accepting profits.  
 3) We are long June gold with a stop at 43900, close only.  
 4) We are short June T-bonds with a stop at 9410, close only.

**Tuesday, February 16:** Old tape was left on, no new changes or recommendations.

**Friday, February 19:** No changes or new recommendations.

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