

FRIEDBERG'S

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On gold and the dollar: a reappraisal

The great bull market in gold has been a disappointment. A better description, perhaps would be to say that it never happened — that it was a mirage.

Measured in terms of a collapsing currency, gold did manage to rise 59% since early 1985. Measured in terms of a hard currency, gold fell nearly 25%. Again in terms of hard currencies, since early 1986, gold has merely marked time, moving in a range between Sfr 600 and Sfr 740 (Chart 1), DM720 and DM890, and ¥ 5400 and ¥72,000, while in dollar terms it has risen from around \$350/oz. to the present \$445/oz.

What does it mean? Which measure is most reliable? In a world of wildly gyrating currencies, it would be a brave man who states categorically which currency or group of currencies is the "anchor," the one that represents constant value, and which is the "satellite." Lacking the capacity to discover the true solution (and perhaps there is none), we simplistically submit that gold should be measured against all of them. Not necessarily quantitatively, as say, against a US dollar index or SDRs, but rather "behaviorally."

Let us explain. From the second half of 1982 to early 1983, gold staged its second major bear market rally (the first one, it should be recalled, took place in mid-1980 and could be characterized as merely a technical bounce, after the formidable compressed collapse from \$875/oz. to \$460/oz.). This rally was fuelled by 1) fears of Mexican default and its implications for the *global* banking system and 2) the initial spurt coming out of the global 1981-82 recession and its implications for *global* inflation.

What we are implying is that *global investors* were reacting (justifiably, in view of the circumstances) in unison with global concerns, that is an LDC default followed by a worldwide bank holiday and a worldwide, synchronized boom that would relieve the inflation of the '70s.

As a result, gold prices, measured in dollars, Swiss francs, deutschemarks, and yen, rose rather significantly (see Chart 2). As neither of those two fears materialized, gold prices — once again measured in *all* the major currencies — began a long decline that was to challenge the earlier 1982 lows.

In early 1985 the US dollar reversed course and began a

long decline. Not coincidentally, gold prices, *expressed* in US dollars, stopped declining in early 1985. Expressed in the other major currencies, however, gold prices continued to decline until mid-1986, finding support at *exactly* the 1982 lows.

Standing in mid 1986, one would have had to conclude (something that *we did not* do) that it was more correct to say that gold was still in a downtrend and the dollar had been falling than to say that gold had been rising.

The above discussion may *seem* highly theoretical and of no practical use. It is not so. In a floating currency regime, it is very difficult to discuss commodity price trends. We believe that we have, however, discovered a useful rule: Gold must show a trend when expressed in all the major currencies. Any divergence must be attributable to the value of the currency rather than to the inherent price of gold. We will return to this rule in our conclusion.

What about the large and growing US current account deficit? US external liabilities are mounting, and sooner or later, the US's only liquid international asset must rise in price sufficiently to offset this rise in external liabilities. As Chart 3 shows, gold must now trade at well over \$900/oz. to balance the books (see *FC&CC* June 24, 1987, Gold: the best is yet to come).

While this conclusion probably is true, a rise in the dollar price of gold can occur, as we have seen, as a result of 1) gold's rising in price against all currencies and/or 2) the US dollar's falling further. This latter possibility is logical — after all, the growing current account deficit is a US dollar problem. But why should the first possibility ever take place? Phrased more elegantly, *why should gold rise, measured in constant terms*, just because the US financial condition is deteriorating?

In this issue

We look at platinum, and like what we see. CRB is erratic but we retain our spread. We're long EMS currencies and the yen, and we're short T-bonds. We look for ways to make a buck from the bear in the stock markets, and we stay short crude oil. Also, we reassess the kiwi. Contributions by Albert D. Friedberg, Steve H. Hanke.

Clearly, trends in gold production and costs of mining as well as gold consumption are more pertinent to the price of gold, measured in constant terms, than the external financial condition of the US. Yes and . . . no.

To the extent that US balance of payments outflows end up swelling other central banks' international reserves and thus their monetary base, and to the extent that these increases are not sterilized, the US exports monetary inflation. Eventually, worldwide inflation raises the price of gold measured in all currencies.

There is strong evidence that the first step in this complex mechanism has already occurred. Chart 4 shows the trend of international reserves, expressed in US dollars, and its year-over-year rate of growth. At almost 40% per annum, the growth in international reserves has already exceeded the pace recorded in the early and mid '70s.

What is different now is the far greater adherence to monetarism and the much greater efforts being made to sterilize these inflows. As a result, money supply growth in West Germany, Japan, or Switzerland is a great deal more subdued than the one experienced in the early to mid '70s. This tends to blunt somewhat the worldwide inflationary implications of the growing US international indebtedness. And tells us that most probably, *gold is likely to break out only in dollar terms* — which is equivalent to saying that the US dollar will con-

tinue to fall.

We have now come full circle and have arrived at some rather surprising conclusions. Gold, when expressed in some major currencies (specifically, Sfr, DM and yen), has been stabilized for the past two years and is not likely to be bid up unless inflation in these countries rises well above current rates. A combination of sterilization and upward flotation has allowed these countries to blunt the inflationary implications of swollen international reserves.

As well, a possibility exists that gold, expressed in these currencies, will resume its downtrend in view of the mounting production and the increased use of gold loans (see *FC&CC*, Feb. 21, 1988). By contrast, the dollar price of gold probably will continue reflecting in almost mirror image the falling value of the US dollar.

Considering the negative carrying costs of gold and the positive "carry" of an investment in foreign currencies, one would have to conclude that foreign currency bonds and money market instruments will represent a better alternative than gold — at least in the near term.

STRATEGY: *We have been stopped out of our long Comex positions. There are, at this time, and in line with our comments above and elsewhere in this issue, three superior alternatives to gold: foreign currencies, CRB index, and platinum.*

Chart 1

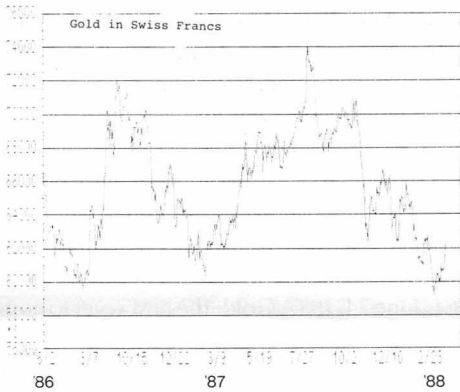


Chart 2

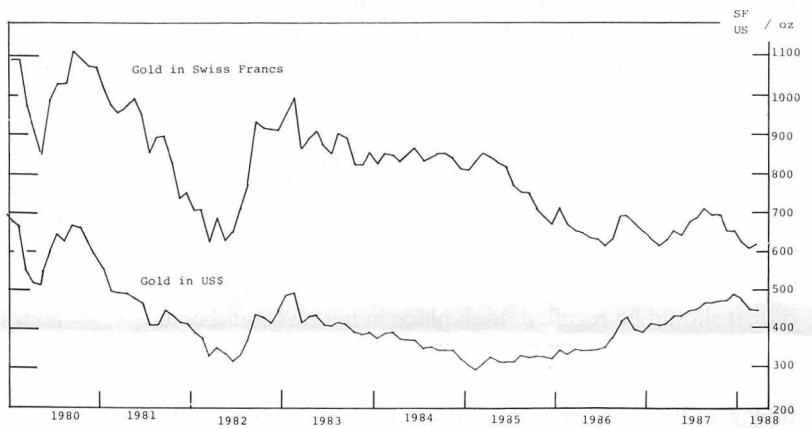


Chart 3

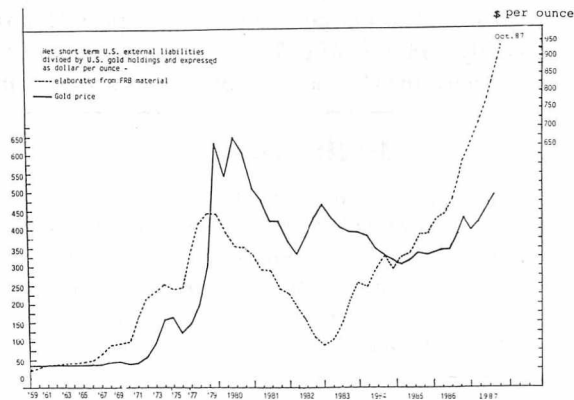


Chart 4

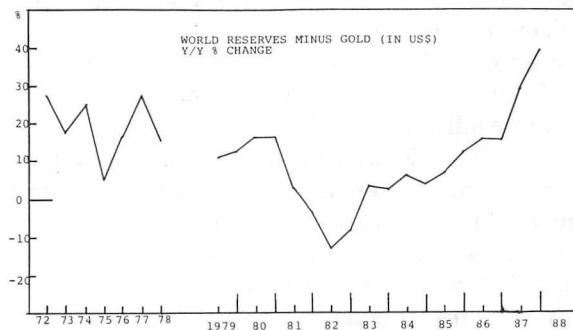
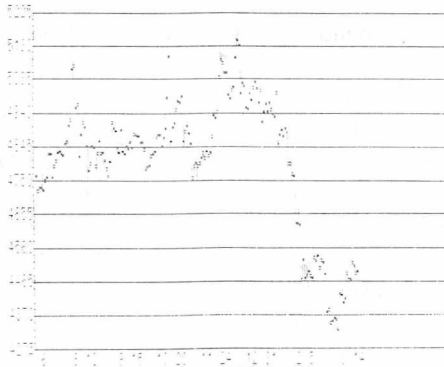


Chart 5 — COMEX GOLD JUN 88



PLATINUM

Made in Japan

While most are well aware that South Africa is the dominant supplier of platinum, they are unaware that Japan is the dominant demander (see Chart 6). To understand the demand-side of the platinum market — which is, after all, the most volatile side of the markets — we must pay particular attention to the Japanese.

* * * * *

We believe that most analysts have not incorporated the proper economic dynamics into their demand forecasts for the Japanese market. As evidence of this fact, note that actual 1987 Japanese platinum imports were 1.672 million ounces. This number exceeds recent estimates made by Drexel, Burnham, Lambert (DBL) for 1987 Japanese imports. For example, DBL's January 1988 estimate for 1987 was 1.2 million ounces, and their most recent estimate, which was made in February 1988, was 1.6 million ounces (see Chart 6).

Other respected analysts also have been revising their 1987 Japanese import numbers upward, but they still remain much too low in relation to what we now know were the real imports. For example, Johnson Matthey's most recent estimates (November 1987) for 1987 Japanese imports ranged from a low of 1.24 million ounces to a high of 1.475 million ounces.

All the analysts have misread the Japanese market and are still playing catch-up. Perhaps this is why a piece that ran in the March 11, 1988, edition of Johannesburg's *Financial Mail* quotes a spokesman from Johnson Matthey as saying: "there is a lot of doubt about the real supply-demand situation."

* * * * *

What the analysts, as well as the market participants, have failed to incorporate into their supply-demand balances is the proper Japanese demand elasticity for platinum. Specifically, the demand elasticity appears to be much higher than that implied by traditional forecasts. Hence, as the yen-price of platinum has fallen (see Chart 7), the demand for jewelry and 500 gram and 1 kilogram platinum bars has soared.

This price stimulation has been complemented by a rapid economic expansion, which pushed Japan's 1987 per-capita GNP above that of the United States for the first time. This growth in income — coupled with higher platinum income elasticities than are implied in traditional forecasts of Japanese platinum demand — have added unanticipated fuel to the platinum demand.

If this weren't enough, the increased liquidity in Japan has generated a good bit of speculation. For example, the Tokyo stock market now is trading at levels that are higher than they were just before the October crash. This speculative fever has not missed the platinum market. Hence, another stimulant to the Japanese demand.

* * * * *

To put the explosive Japanese demand for platinum into context, consider the following: We estimate that Japanese platinum imports, for the first quarter of 1988, will average, on an annualized basis, about 2.315 million ounces. Hence, if imports were to be sustained at this level for 1988, the Japanese would import about 72% of the world's entire 1988 supply. Clearly, these import levels are not sustainable at present prices. If the Japanese demand should continue at these levels, prices will explode to ration the world's supply and stimulate more production.

If we put the Japanese demand into a realistic supply-demand balance, we must carefully consider the demand for jewelry, which is the largest Japanese platinum demand sector (see Chart 8). Note that the Japanese jewelry demand not only constitutes over 50% of Japan's demand but also is a significant portion of the total world platinum demand. With lower yen prices for platinum and higher Japanese incomes, the demand for jewelry has surged since 1983.

The Platinum Guild International has informed us that they anticipate that jewelry demand will continue to grow in 1988, with estimated use at about 965,000 ounces, or a 9.2% increase over 1987. Now, if Japanese industrial and investment demand remain static at 1987 levels (a conservative as-

sumption), this would mean that total Japanese demand for 1988 would be about 1.77 million ounces.

If we place this demand figure in the supply-demand balance in Chart 6, we increase the 1988 DBL estimate for Japanese demand to 1.77 million ounces from 1.30 million. This causes total world demand to increase from 2.75 million ounces to 3.22 million, which is almost exactly the DBL forecast for total 1988 world supply. In consequence of including a more realistic estimate for Japanese jewelry demand, the estimated 1988 surplus available for investors would fall to 15,000 ounces

from 485,000 ounces. This would be an extremely tight supply-demand balance, when viewed in an historical context (see Chart 6).

STRATEGY: From a risk-reward point of view, we recommend establishing the following spread (see Chart 9): Purchase July platinum and sell June gold at a ratio of 2 platinum/1 gold. Place stops at \$15/oz. platinum premium on close only.

— Steve H. Hanke

Chart 6
Worldwide platinum supply-demand (thousand oz.)

	1970-79 Average	1980	PLATINUM		SUMMARY					
			1981	1982	1983	1984	1985	1986	1987p	1988f
Demand										
USA	680	950	745	665	675	875	1025	985	700	800
Japan	920	945	1155	1055	950	1160	1245	1030	1600	1300
Europe	410	335	380	310	305	355	350	385	420	500
Others	240	110	125	160	135	125	130	130	140	150
Total	2250	2340	2405	2190	2065	2515	2750	2530	2860	2750
			+3%	-9%	-6%	+22%	+9%	-8%	+13%	-4%
Production										
S. Africa	1805	2320	1800	1960	2070	2280	2320	2345	2450	2550
Canada	170	165	155	90	90	130	135	115	140	160
Others	35	35	30	25	20	30	30	35	60	75
Total	1710	2520	1985	2075	2180	2440	2485	2495	2650	2785
			-21%	+5%	+5%	+12%	+2%	+1%	+6%	+5%
Secondary										
Scrap	135	225	275	275	190	180	140	140	200	200
CPEs	525	320	345	340	285	230	205	255	350	250
SUPPLY	2360	3065	2605	2690	2655	2850	2830	2890	3200	3235
BALANCE	+110	+725	+200	+500	+590	+335	+80	+360	+340	+485
NYMEX Prices		\$682	\$446	\$327	\$426	\$359	\$293	\$466	\$559	

Source: Drexel, Burnham, Lambert

Chart 7 — Platinum price (Yen/oz.)

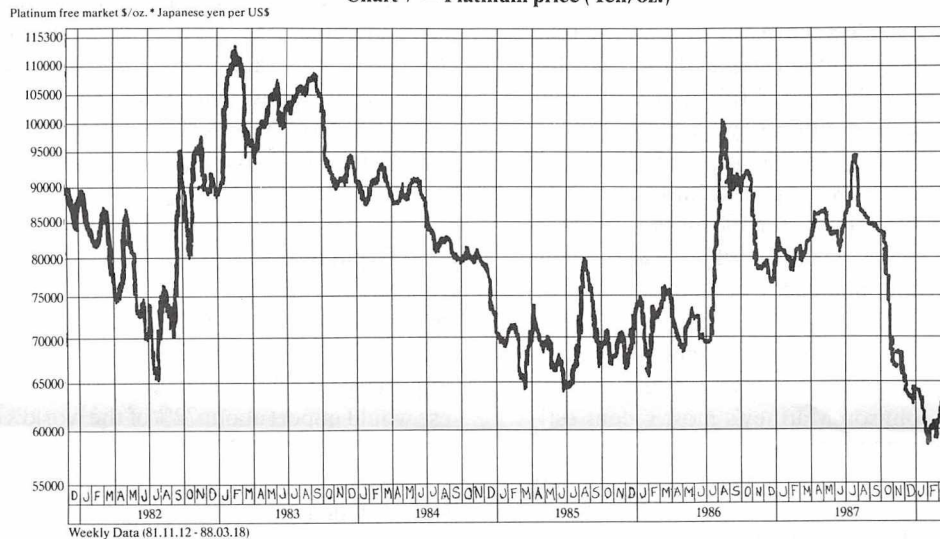


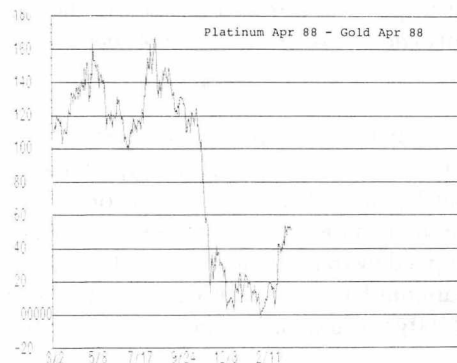
Chart 8 — Japanese Demand, Platinum Jewelry

Year	Demand (000 oz)	% Change yr/yr	% World Demand*
1977	840		31.7%
1978	835	- 0.6%	30.9
1979	590	-29.3	20.7
1980	440	-25.4	18.9
1981	625	+42.1	25.7
1982	620	- 0.8	26.7
1983	560	- 9.7	25.7
1984	625	+11.6	23.8
1985	675	+ 8.0	23.9
1986	740	+ 9.6	26.0
1987	884	+19.5	
1988	965 est.	+ 9.2	

Sources: Johnson Matthey; Platinum Guild International

*Note: To keep a consistent data series, Johnson Matthey world demand data were used. These are somewhat different than those used in Drexel, Burnham, Lambert's "Worldwide Platinum Supply-Demand Balances."

Chart 9



CRB INDEX

Erratic behavior

We were stopped out of our long positions on a close below 225, basis cash index. Breadth continues positive, but price action of individual components remains lethargic.

STRATEGY: Reenter long side on a close above 233.00, basis cash index.

Retain spread

Long CRB/short gold spread. While a one-year-long down-trend in the CRB index versus gold came to an end earlier this year, commodity prices still have not gathered enough momentum to make a decisive upside breakout. As a result, the spread at around 0.51 is still not out of the base (see Chart 11). This will require a move beyond .545.

STRATEGY: Retain spread long 1 CRB/short 2.5 gold contracts, risking 0.46.

Chart 10 — CRB INDEX, SPOT

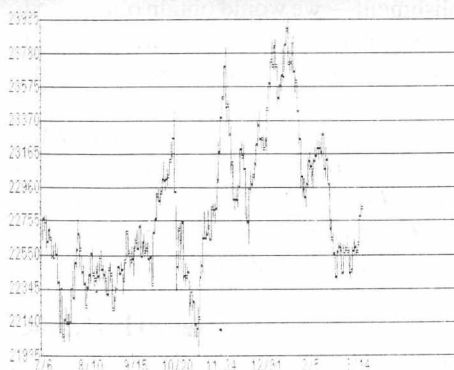


Chart 11

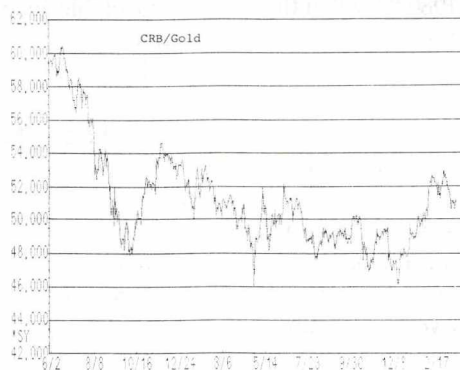


Chart 12



CURRENCIES

Exports, imports and relative prices

Market participants, particularly those engaged in trading foreign exchange, have become hostage to the monthly trade statistics. We anticipate that this will continue, at least for the next few months. This will make trading hazardous, because the monthly trade data are notoriously volatile — particularly data for the United States, because they are not seasonally adjusted.

That said, we must ask whether underlying trends can be discerned from the monthly data. Notwithstanding the decline in January exports, the longer-term signs for exports are encouraging: Both the volume and value of exports have turned upward. This result is consistent with common intuition. After all, the dollar has fallen in value; this makes US exports cheaper and stimulates them.

To understand the boom in exports, however, we must look beyond common intuition. For price changes to favor exports, the price of US exports (measured by the foreign currency price of US exports) must fall relative to substitutes produced in foreign countries. Indeed, the relative price of US exports has fallen dramatically since the Plaza Agreement

of September 1985. For example, the relative price of non-agricultural exports has fallen about 40%.

If exports were the end of the story, we could conclude that the trade deficit should be improving. But the 1987 trade deficit deteriorated and hit a record of about \$170 billion. How could this occur?

To answer the question, we must look at the all-important import picture. In 1987, both the volume and value of US imports increased. How could this occur? After all, intuition tells us that a lower-valued dollar should make imports more costly and this should act to reduce imports.

To understand the counter-intuitive results obtained on the import side of the merchandise trade balance, we must analyze relative import prices. Although the dollar price of imports has increased, so have the domestic prices of goods produced in the US. In consequence, some of the cutting edge of higher import prices, which should act to reduce US imports, has been knocked off by increases in prices of substitute products produced in the US.

To grasp this, observe Chart 13, which is up-dated from

our first analysis of this issue ("The trade gap: turning the corner or rounding the bend," *FC&CC* July 26, 1987). Although the effective dollar exchange rate has fallen steadily since the first quarter of 1985, the relative price of imports has increased very little. Hence, the price mechanism, while operating in a sharp fashion on the export side of the market, is operating in a dull manner on the import side of the market.

Our general analysis of relative import prices recently has been confirmed in a more disaggregated study. Mr. Jack L. Hervey of the Federal Reserve Bank of Chicago analyzes three sectors (capital goods, autos, and consumer durables) that make up about 60% of the total US imports. Chart 14 shows that when measured in 1982 dollars, capital goods imports have continued to surge, even in the face of the dollar's decline, while autos and consumer durables imports have stabilized.

Charts 15, 16, and 17 show domestic prices, import prices, and relative import prices over the period 1980-84, when the dollar was appreciating, and from the first quarter of 1985, when the dollar was depreciating. Since the dollar began to fall, import prices relative to domestic prices have risen. However, they have not risen dramatically. Moreover, with the exception of autos, import price levels, relative to where they were in 1980, are below domestic prices.

Implications: The dollar's decline has been accompanied by a significant decline in the relative price of US exports, and by only a very small increase in the relative price of imports. Hence, the depreciating dollar has worked to stimu-

late exports. As a result, exports should continue to show improvement, unless economic growth in the rest of the world turns sour. On the other hand, the dollar's decline has not worked to retard imports. As a result, imports will continue to register strength *as long as the US economy displays strength*.

Since imports currently are about 50% greater than exports, an outright reduction in imports is required before a large dent can be made in the nominal trade deficit. Such a reduction in imports, however, can occur only *if relative import prices increase dramatically or if the US economy dips into a recession*. At this time, we do not anticipate a marked reduction in the merchandise trade deficit in the near future.

To appreciate this conclusion, consider the following arithmetic: If import volumes were to fall 2% in 1988 — which would be a significant accomplishment — and import prices would rise 7%, the nominal value of imports would rise by 5%. Now, if the value of exports rose by 13% — which would be a respectable accomplishment — we would obtain only a moderate decrease in the merchandise trade deficit: from \$170 billion in 1987 to about \$155-\$160 billion in 1988.

STRATEGY: *We have reinstated long positions in the EMS currencies and the Japanese yen (see Hotline Update for March 8). Short of a severe recession (which will come someday), the US balance of trade will not show the desired improvement. Retain stops at 71.65 and 58.95, basis June SF and June DM, respectively, close only.*

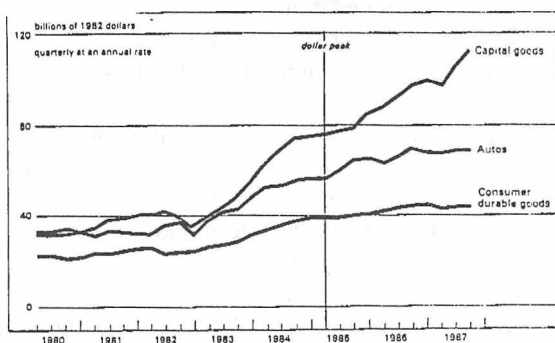
— Steve H. Hanke

Chart 13
Percentage change in exchange rates and relative prices

Time period	Effective dollar* exchange rate	Ratio of US import prices to US GNP deflator
I/1977 - II/1980	- 11.5%	+ 9.0%
II/1980 - I/1985	+ 45.3%	- 29.4%
I/1985 - II/1986	- 25.6%	- 0.8%
II/1986 - I/1987	- 10.7%	+ 1.2%
I/1987 - IV/1987	- 7.3%	+ 1.3%

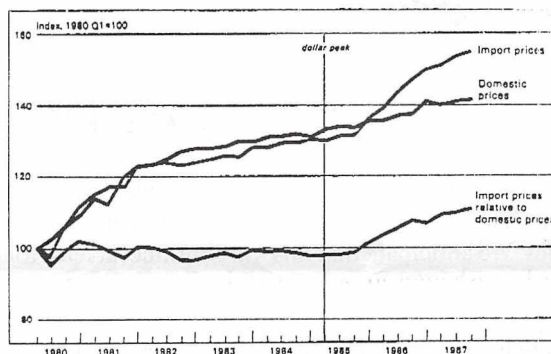
*Effective exchange rate changes are an indicator of the extent to which the external value of a country's currency has moved relative to other currencies. Effective exchange rate changes are computed as an index, combining the exchange rates between the currency in question and 17 other major currencies with weights derived from the International Monetary Fund's "Multilateral Exchange Rate Model." Each weight represents the model's estimate of the effect on the trade balance of the country in question of a change of one percent in the domestic currency price of one of the other currencies. The weights, therefore, take account of the size of trade flows as well as of the relevant price elasticities and the feedback effects of exchange rate changes on domestic costs and prices. The measure is expressed as an index based on average exchange rates during 1980.

Chart 14 — US Imports (1982 \$)



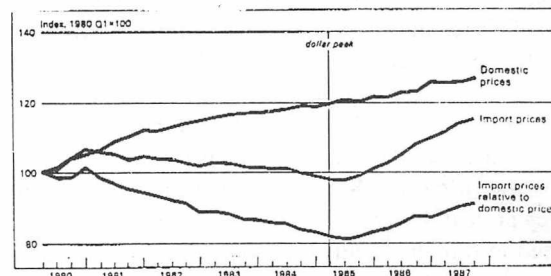
Source: Chicago Federal Reserve Bank

Chart 15 — Auto prices



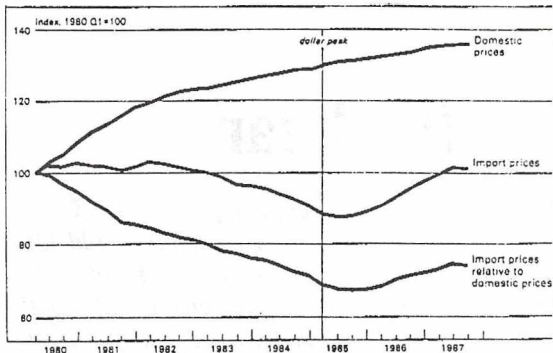
Source: Chicago Federal Reserve Bank

Chart 16 — Consumer durable prices



Source: Chicago Federal Reserve Bank

Chart 17 — Capital goods prices



Source: Chicago Federal Reserve Bank

Chart 18 — CME SWISS FRANCS JUN 88

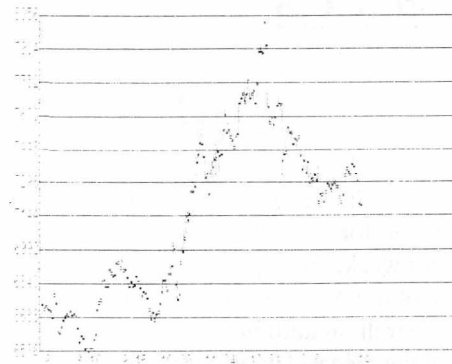


Chart 19 — CME DEUTSCHE MARK JUN 88

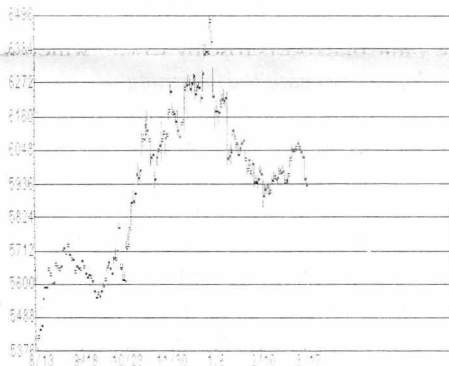
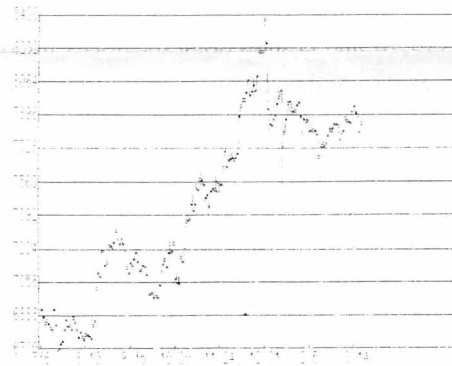


Chart 20 — CME JAPANESE YEN JUN 88



T-BONDS

Better short than sidelined

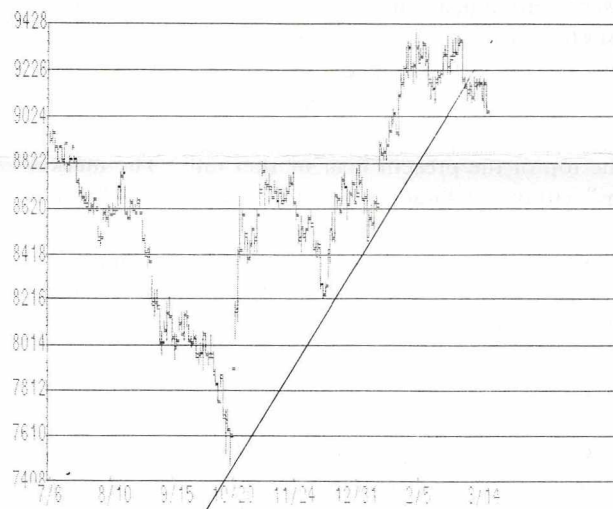
A steady stream of positive economic news, demonstrating that earlier recession fears were still premature, sent bond prices down to finally break the uptrend that dates back to October 19. Technically, the retracement just exceeded two thirds of the previous bear move, reaching, as we said last month, the "outer limit of a counter-trend correction."

This bearish interpretation and the fact that T-bond futures were unable to penetrate their early February highs, thus forming an enormous double top, did not prevent us from (stupidly) jumping the gun and covering short positions (Hotline Update for Feb. 26) in anticipation of further weakness in the CRB index.

After all is said and done, we are far more comfortable being short T-bonds than being sidelined.

STRATEGY: Sell June T-bonds at market, place initial stops at 94.10, close only.

Chart 21 — T-BONDS (DAY) JUN 88



STOCK INDEXES

Pulling bucks from the bear

Buoyed by the frantic pace of "deal" activity and the renewed institutional yen for ignored secondaries, the stock market inched up last week, coming very close to completing a 50% retracement of the August-October bear plunge.

While overall breadth has remained impressive — a direct result of the renewed interest in junior issues — the list of new 12-month highs remains pathetic. On Friday's move to new recovery highs, a mere 27 companies appeared on the honors list, most of them involved in some way in takeover activity.

There are a number of other disturbing signs: market letter writers have become much more optimistic, margin debt continues to contract (a phase that normally occurs during bear markets), IBM, a bellwether issue, languishes well below its January and October post-crash recovery highs, utilities are behaving extremely sluggishly, and so on.

The late stages of an economic upswing provide a bleak background for equity prices. On the one hand, capacity utilization in labor and various industries spells potential inflationary problems; on the other, they are followed, quite inexorably, by a recession. The severity of this downturn is qualified by the credit excesses incurred over the preceding expansion.

A credit-free economic expansion, just like a rise in stock prices unaccompanied by margin debt and leverage, is less likely to stumble badly when the inevitable correction takes place. The 1982-1987 expansion witnessed the largest real increases in credit in a generation. The weaning out process promises to be spectacular. As a result, stock prices, selling at multiples in excess of 15 times earnings are extremely vulnerable to a changing economic climate.

For the following reasons we believe that the S&P 500 is near the top of the present bear market rally: The market "churns" without making significant progress. It has formed a near-classic bearish wedge (see Chart 22). And finally, the deeply oversold condition existing in October-November has been corrected as the indexes have reached (and kissed) their descending 30-week moving averages.

STRATEGY: *There are no easy ways to deal with this market's extraordinary volatility. In the first place, outright short positions require \$20,000 per contract. Moreover, reasonably close stops are nearly always useless given this unusual volatility.*

Option premiums are expensive (as they justifiably should be) but perhaps within the realm of the reasonable if (and that is a crucial "if") our trend and target assumptions are correct. We look for the bear market to last a maximum of another 30 months, making the S&P drop a simple 1.66% per month to reach 135 by the third quarter of 1990. A shorter bear market,

that is, 24 months, would yield a simple drop of 2.5% per month.

Obviously, conservative speculators would like to buy six-month put options if (1) they are bought after the market has "realigned" itself with the projected monthly path and (2) the cost of the option does not exceed, in any case, 60% of the projected drop.

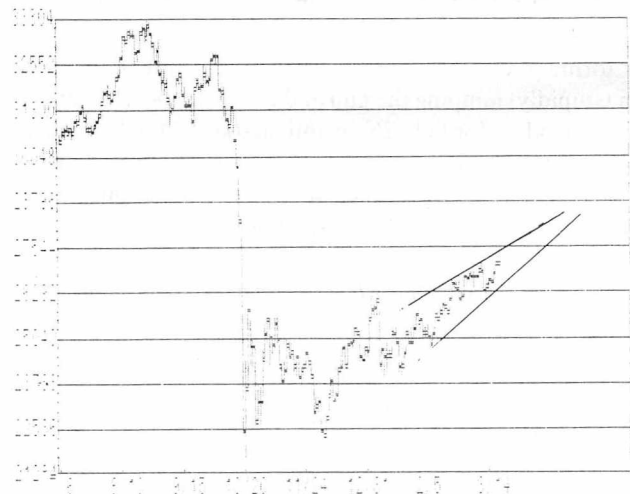
At this time, the September 270 put, at \$15.70, is fairly priced, even using the more conservative projection. A further rally in points and/or in time would, of course, make this option even more attractive, provided that a rise in implied volatilities does not negate the advantage.

As an example, if the S&P 500 remained above 270 by the third week of April, the same September 270 option would trade at \$13.10 (unchanged implied volatility). Given our strategy, we should be willing to pay as much as \$14.00 and still be better off than paying \$15.70 one month earlier.

In short, a conservative speculator should concentrate on projecting a probable path and measure the cost of the option — not in terms of implied volatilities — but rather in terms of the probable path.

Short of establishing an outright bear position breaking 263.00, the support line of the wedge (Chart 22), we advise purchasing a partial line of Sept. 270 S&P 500 put options at \$15.70 (Friday's close), with the intention of adding to this position over the coming weeks, we hope at a slightly lower cost.

Chart 22 — CME S&P 500 INDEX



CRUDE OIL

The destiny of the Kingdom

Word that Opec had called a meeting to cope with falling prices caused some spirited short-covering late in the week, pushing quotes almost \$1/barrel off their 15-month lows. Bulls are once again crowing about \$18-\$20/barrel prices by the end of 1988.

What these hapless souls don't realize is that Opec's *only* source of strength in the past was Saudi Arabia's willingness unilaterally to cut production and act as a swing producer — a role that it has firmly vowed not to repeat.

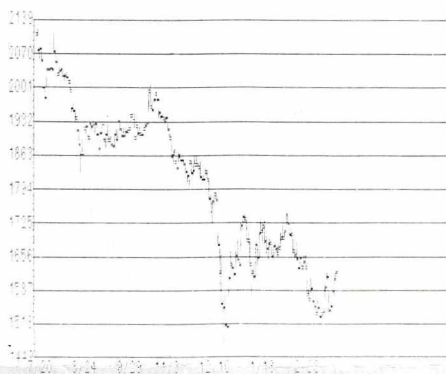
While admittedly Saudi output has fallen somewhat to 3.9 million barrels per day (b/d) from the 4.3 million b/d quota, mostly a result of Saudi reluctance to follow prices down, steps already have been taken (in the form of 30¢-40¢/barrel discounts below Brent levels, a bit under \$14/barrel) to restore full production. In addition, over 20 million barrels have been moved into storage, ready to be unloaded at any moment. Precarious Saudi finances do not allow the Kingdom to play the role of savior.

Moreover, it would appear that the Saudis prefer to main-

tain Opec output at slightly over 17 million b/d — and thus their own output at 4.35 million b/d — than to cut Opec's overall production by 5%-10%, even if an agreement could be reached. It may be that the Saudis have finally understood that 1) maintaining price and production targets simultaneously is an impossibility, 2) that therefore, production targets are better revenue maximizers, especially since 3) the Saudis believe that consumption is on an uptrend. When (3) is finally proven false, the Saudis will arrive at the only, inescapable, conclusion that their long-term best interest is served by moving to full production, allowing prices to collapse, capturing market share, reversing non-Opec gains in production and exploration, and providing the groundwork for rising consumption.

STRATEGY: *We do not believe that the Saudis will go along with overall Opec production cutbacks. Even if they do, prices are unlikely to recover beyond \$17.50, basis WTI. Remain short, leaving stops at \$17.60, basis May '88 crude, close only.*

Chart 24 — NYME CRUDE LIGHT MAY 88

**NEW ZEALAND DOLLAR**

Abandoning the kiwi

On March 1 we put out a sale advice on long NZ dollar positions (and NZ dollar-denominated assets), reversing the relatively favorable stay-on-course review of last month.

We had three reasons for this sudden about-face: 1) the currency had advanced further, now to a new recovery high of 67¢, going well beyond reasonable parameters of valuation, even while little progress had been made on the external front; 2) exporters' howls about their loss of competitiveness (note the violent remarks made by the chairman of the Fletcher-Challenge Group), and the pressure it is likely to bear on a

left-wing cabinet that has only one right-thinking individual; and 3) the potential top forming in the NZ \$/Aussie \$ cross, an indication that the game was shifting to the neighbors.

In the following article we reproduce from *The Economist* a review of a most important World Bank study on economic and financial liberalization and the insights it brings to bear on the New Zealand situation (which agrees with our coverage of the kiwi ever since we first recommended it on May 18, 1986, in "The kiwi turnaround").

ECONOMICS FOCUS

Free markets: out of order

The benefits of freer markets — whether for labour, trade or foreign capital — are more widely accepted today than they have been for many years. Yet the success of liberalisation depends partly on the order in which deregulation is applied.

Economists have long trumpeted the benefits of eliminating restrictions and distortions. Away with inter-rate ceilings, trade barriers, subsidies and foreign-exchange controls, which slow down economic growth. That is the message preached by the IMF and the World Bank, and practised by a growing number of developing countries. Until recently the order in which different markets should be deregulated has received scant attention. But programmes of economic liberalisation can flop if politicians get their sequencing wrong.

Too often, governments tackle the easiest tasks first. Experience suggests some wiser rules on how economics should best be unswaddled.

- In general, it is best to start by freeing those markets where prices tend to be least responsive — eg, an arthritic labour market rather than the financial markets. A rigid labour market will stifle adjustment to freer trade. If wages are too inflexible to encourage workers to shift out of declining industries into expanding ones, unemployment will rise.
- Controls on the movement of capital in and out of the country should not be relaxed until the domestic financial sector has been fully liberalised. If capital controls are scrapped while real interest rates remain at low or even negative levels, capital will immediately flee the country seeking higher yields elsewhere.
- If inflation is high, it is unwise to loosen financial markets until the government has got its budget deficit under control. Soaring inflation and high real interest rate could otherwise jeopardise the programme. Argentina's failure to control its budget deficit was partly to blame for the abandonment of its liberalisation scheme in the late 1970s.
- The trade account of the balance of payments should be freed before the capital account, or the resulting inflow of capital may be destabilising. If tariffs remain in place when capital controls are lifted, more resources may flow into the protected import-substitution sector, magnifying rather than reducing the distortion.

Worse still is the effect on the exchange rate. For trade liberalisation to succeed — ie, for industry to shift from an inward-obsessed to an outward-oriented strategy — the real exchange rate needs to fall in order to shift resources out of protected industries into exporting ones. If capital controls are lifted too soon, the real exchange rate is more likely to rise than to fall, as higher real interest rates and the more bullish image of the economy (on the back of free-market reforms) suck in foreign capital.

This higher exchange rate will squeeze the profitability of the traded-goods sector at the very time when import-competing sectors are losing their protection, and thus when export industries need to expand. Exporters and producers of import substitutes will therefore be discouraged from investing. Deregulation will have freed resources from inefficient activities, but failed to show where they should be redeployed. It would be better to keep a grip on capital flows until producers have adjusted to freer trade.

The two developing countries where the sequencing of liberalisation has been most closely examined by economists are Argentina and Chile. Both carried out wide-ranging liberalisation and stabilisation programmes in the 1970s, but in different orders. Argentina, which started its reforms in 1976, freed its capital account before it tackled trade. Chile freed its trade account first, and only started to relax capital flows several years later. Both their free-market experiments came under threat in the late 1970s as their real exchange rates rose sharply, pushing their current-accounts deeper into deficit. But, as the chart shows, while most of Chile's trade liberalisations remained in place, most of Argentina's were reversed.

The trade-liberalisation index used in the chart is taken from a World Bank study of 19 countries. The indicator reflects the value judgements of different researchers and so can only be used to monitor changes over time within a country, not for comparisons between countries. For this reason, its scale has been omitted.

The premature liberalisation of Argentina's capital market left its industry vulnerable to destabilising capital flows. And so, as the World Bank puts it, "trade liberalisation was still-born". A widening current-account deficit, and capital flight, forced the government to slam the doors shut again. By contrast, earlier trade liberalisation gave Chile's industry time to adjust, leaving it in better shape.

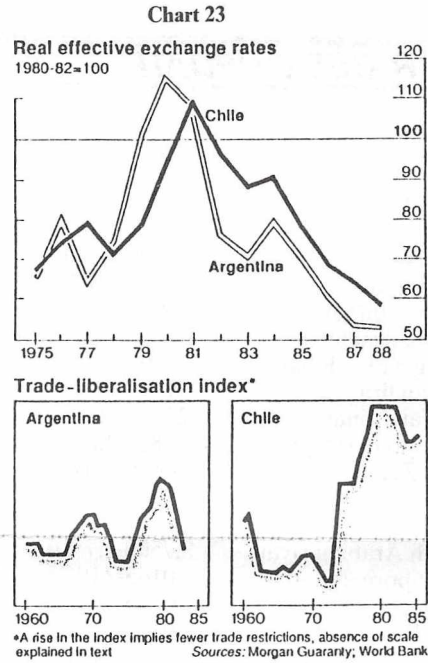
These four rules suggest that the ideal sequence is: first, cut the budget deficit; second, reform the labour market; third, liberalise goods markets (ie, cut subsidies and tariffs); fourth, tackle domestic financial markets; finally, liberalise the external capital account.

Upside down down under

How does New Zealand's bold dash for economic freedom stand up to this test? The far-reaching economic reforms of Mr Roger Douglas, the country's finance minister, won admiration from far and wide, but critics claim that he got the order wrong. He has pursued liberalisation in almost exactly the opposite order, while leaving trade barriers and the labour market till last.

The freeing of capital controls and the exchange rate were originally expected to lead to a fall in the New Zealand dollar, thereby compensating farmers and producers for their loss of protection. Instead, heavy government borrowing and financial deregulation have driven up interest rates, and, in turn, the exchange rate — by more than 30% in real trade-weighted terms since the end of 1984. This has probably led to some unnecessary adjustment-costs for industry. There is a risk that, by starting with the pudding rather than the hors d'oeuvre, Mr Douglas has invited a severe attack of indigestion.

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COPPER

Time for profit-taking... and caution

Taking advantage of the most recent 13¢ rally, we advised liquidating (profitably) long May '88 positions with a view towards repurchasing positions at lower levels. At this time, the downtrend in the backwardation (see Chart 26) signals caution ahead.

STRATEGY: *Remain sidelined, but keep in close contact with Hotline Update messages.*

Chart 25 — COMEX COPPER MAY 88

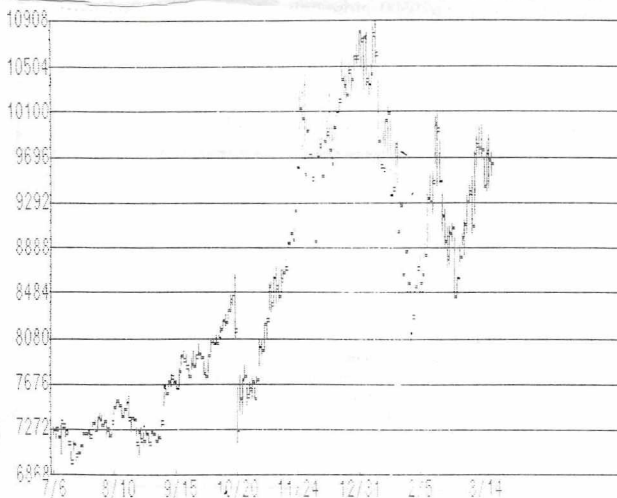
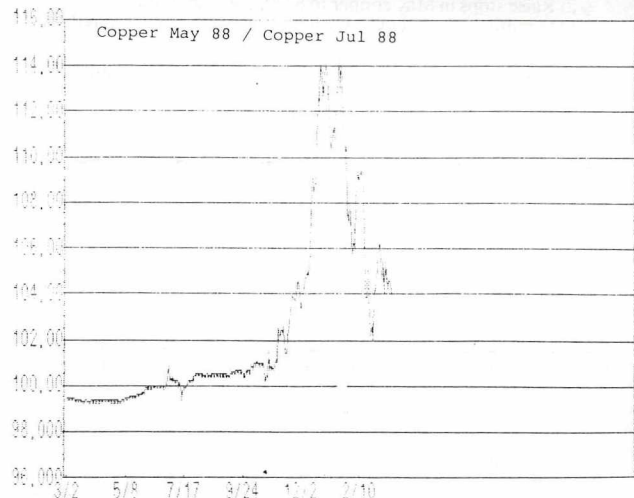


Chart 26



FOREX RATES & UPDATE

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.6950)
*Belgian franc	35.35-35.40	35.27-35.36	34.94-35.11	Remain long	Neutral
*Danish krone	6.4840-6.4870	6.5160-6.5590	6.5940-6.6230	Remain long	Neutral
*Dutch guilder	1.9015-1.9025	1.8883-1.8896	1.8465-1.8490	Remain long	Remain short
Greek drachma	135.40-135.50	138.80-140.85	148.95-157.80	Remain short	Remain short
Hong Kong dollar	7.7990-7.8000	7.7420-7.7460	7.6240-7.6550	Remain short	Neutral
*Italian lira	1252-1256	1264-1268	1292-1304	Remain long	Remain short
Kuwaiti dinar	.27530-.27550	.27396-.27459	.26895-.27076	Neutral	Remain short
Malaysian ringgit	2.5800-2.5815	2.5615-2.5650	2.5150-2.5265	Neutral	Neutral
*New Zealand dollar	.6685-.6695	.6630-.6650	.6235-.6295	Neutral	Neutral
*Norwegian krone	6.3725-6.3775	6.4870-6.4950	6.7925-6.8100	Remain long	Neutral
*Portugese escudo	113.00-113.50	140.25-141.25	145.00-150.50	Remain long	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7500-3.7525	3.7545-3.7605	Remain short	Remain short
Singapore dollar	2.0165-2.0175	1.9993-2.0013	1.9515-1.9575	Neutral	Neutral
*Spanish peseta	113.45-113.55	112.45-112.70	116.70-117.30	Remain long	Neutral
*Swedish krona	5.9800-5.9850	6.0190-6.0275	6.1215-6.1390	Remain long	Neutral
Venezuelan bolivar	Owing to the lack of a forward market, we will no longer be commenting on the Bolivar.				

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, February 23: Market letter is in the mail. For the benefit of subscribers, the one change in the new letter is: Raise stops in gold to 437.00, basis nearest contract, close only.

Flash update, Friday, February 26, 2:55 p.m.: Cover short T-bonds position at market, cancelling 9410 stop, basis June, close only. This message will remain on the tape should there be no further changes.

Tuesday, March 1: Two changes:

- 1) Liquidate long NZ dollar positions at market.
 - 2) Raise stops in May copper to 8730, good anytime.
- One reminder. As per our flash on Friday, we have covered short bond positions.

Friday, March 4: There are no changes or new recommendations. A repeat of the two messages from Tuesday, March 1.

- 1) Liquidate long NZ dollar positions at market.
- 2) Raise stops in May copper to 8730, good anytime.

Flash update, Tuesday, March 8, 10:45 a.m.: Sell US dollars against purchase of European currencies and the JY. Place stops on IMM currencies at 7165, basis June SF, and 5895, basis June DM, good anytime.

Friday, March 11: A recap of the week's activities:

- 1) As of Tuesday's flash update, we are long the European currencies and JY. Place stops on the IMM currencies at 7165, SF June, and 5895, June DM, good anytime.
- 2) Raise stops in May copper to 9500, close only.

Tuesday, March 15: No changes or new recommendations.

Friday, March 18: No changes or new recommendations.

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