

FRIEDBERG'S

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The lending trauma, or the continuous reliquification of the banking system

In a piece back in October 1989 (see "The coming (banking) reliquification: its impact on security prices and inflation"), we discussed three powerful reasons why the banking system — and the economy — would undergo a lending crunch.

The first reason was the Fed-induced growth slowdown in bank reserves, which has persisted to date: By the end of January 1990, reserves had increased a year-on-year *negative* 0.4%.

The second reason was the continuing uptrend in bank failures and the appearance of increasingly larger banks in the FDIC's problem list. Federal regulators are discovering horrendous black holes in bank balance sheets, thanks mostly to the real estate depression.

The final reason was the inexorable move towards the implementation of the new risk-based capital standard (see October article for a fuller description). The thrift industry is being hit on an almost daily basis by additional "guidelines," all of which tend to crimp new lending. Panicky regulators have become overzealous and will, no doubt, manage to cripple the banking industry. Curiously, the most important long term remedy has been avoided: the removal or scaling down of the \$100,000 federal deposit insurance (see our November 1989 issue: "More on the banking mess").

At the same time we concluded that "the reliquification process, i.e., loan liquidation and the build-up of bank investments, could take several months or several years, depending on the severity of the deflation/recession and the *damage done to lenders' psyches*." A short six months later, we have begun to witness a lending crunch.

A story carried by the Dow Jones Service this past Friday begins with "Fears are growing that a worsening credit crunch poses a threat to the US economy — and that it could push the nation into a recession." After cutting back to leveraged buyout borrowers and real estate operators, banks have become less willing to lend to small and medium-sized businesses. A recent Fed survey found that 60% of sampled banks had tightened standards for loans to "below investment-grade

commercial and industrial customers." The article concludes by saying that anecdotal evidence of a credit crunch worries John Laware, a Federal Reserve Governor.

He need not rely on flimsy anecdotal evidence. In November 1989, commercial banks' total loans fell by 4.1%, the *first* such drop since the expansion began in late 1982 (with the sole exception of November 1987, the month of the stock market crash, when loans fell 2.9%). In fact, a drop in total loans is an extremely rare occurrence — usually associated with a recession. Thus from the third quarter of 1974 to the third quarter of 1975, total loans fell 1%. During this time, bank investments increased at a staggering 26.2% annual rate. Again, the first and second quarters of 1980 saw a drop of total loans of 3.8%. Here, too, the economy was undergoing a concurrent recession. The more severe 1981-82 recession, on the other hand, was not accompanied by loan liquidation,

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With contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

possibly because the banks had already built up a large cushion of liquidity during 1980 and partly because of rate deregulation.

A look at Chart 1 indicates that the reliquification process has already begun. Bank investments are the preferred assets in bank portfolios and will become much more so in coming months.

A lending crunch can have a serious short- to medium-term recessionary impact on the economy. Firms and individuals "addicted" to credit will suffer "withdrawal pains," and many will most probably fail. But because money supply, at worst, will be kept constant and, at best, will continue to grow around 4% to 5% per annum, we are certain to avoid an outright deflation.

It is worthwhile to note that stocks have entered bull markets at the first signs of loan liquidation. The probable rationale and sequence is as follows: In the early stages of recession, firms' loan demand rises — typically called distress borrowing. In the latter stages of recession, as many of these firms have failed and/or adjusted their expenses to the lower level of revenues, loan demand falters and interest rates fall. Banks rebuild liquidity, i.e., run off loans and purchase high-grade, short-term securities, thus reinforcing the downward trend in rates. Securities' prices rise.

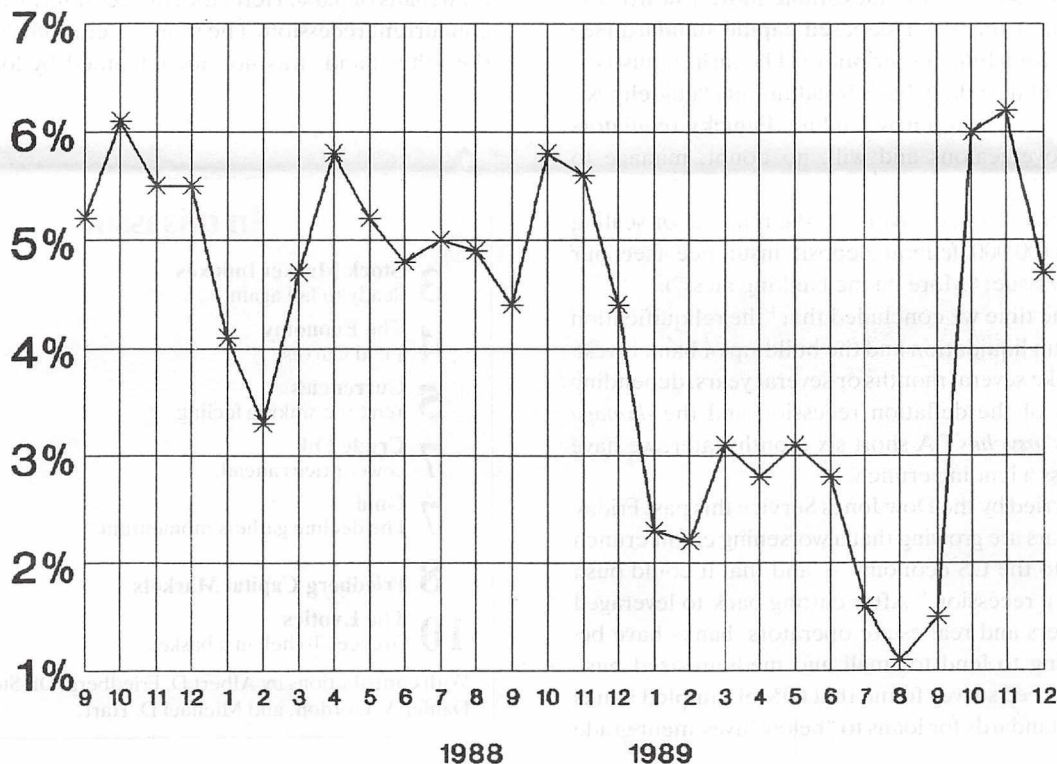
A drop-off in loans caused by drop-off in demand, as we demonstrated, is beneficial to security prices. What if, as now, the drop-off in loans is caused by the lenders' reluctance to undertake further risk, and, in fact, unsatisfied loan demand remains as strong as ever? Non-bank liquidity will continue to deteriorate, and interest rates are not likely to recede. If as a consequence, a recession does occur, then the beneficial effects on security prices eventually occur. On the other hand, if the economy does not undergo a recession, credit demands are merely postponed, and security prices suffer. Alternatively, a *prolonged* slowdown could weed out the weak borrowers and cause a slow-motion drop in loan demand. *Eventually* interest rates ease and security prices rise.

In sum, a prolonged period of banking reliquification not accompanied by a drop-off in loan demand is clearly bearish for stock prices. A recession, on the other hand, would accelerate such a reliquification process but would eliminate latent and unsatisfied loan demand and would thus bring down interest rates.

The predicted credit crunch has arrived, brought about by a lenders' trauma. It will operate as a supply-side restriction. As such, it will bring no relief to interest rates or security prices.

Chart 1

COMMERCIAL BANK TOTAL INVESTMENTS
9-MONTHS RATES OF CHANGE-ANNUALIZED



STOCK MARKET INDEXES

THE ECONOMY

Ready to fall again

The outlook for stock prices remains negative.

Interest rates will stay high for a variety of reasons: a) Rising rates in Western Europe and Japan; b) unsatisfied credit demand because of the developing credit crunch (see first article); and c) massive Treasury borrowings designed to raise hundreds of billions of dollars to bail out a very sick banking system.

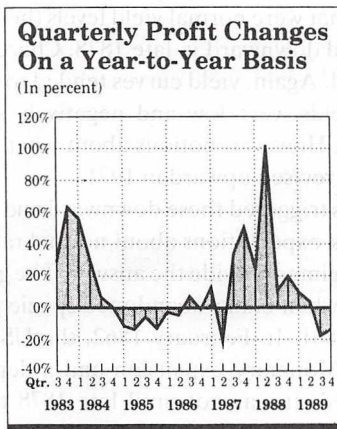
At the same time, the severe corporate profit squeeze (see Chart 2) promises to intensify if interest rates remain high in view of the relentless rise of net interest as a percent of pre-tax profits (see Chart 3).

The February-March rally served to correct the market's oversold condition. Volume and breadth, however, were relatively poor. Bearish sentiment (as measured by *Investors'*

Intelligence) has improved considerably since early February, with bulls moving up to 39.8% from 29.9% and bears falling to 47.8% from 57.3%, a swing of almost 20 percentage points. Technically, the market is once again ready to resume the primary, downward trend.

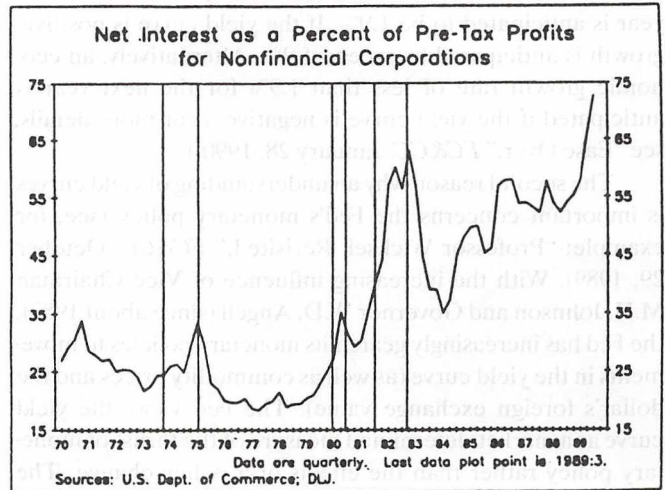
STRATEGY: On March 5, in a Flash Update, we advised hedging the short Value Line position with a long S&P 500 contract. On March 21 we advised liquidating such a hedge, because we felt that stock prices were once again heading lower. The "hedge" trade was profitable. On the same date, we advised purchasing June and September S&P 500 put options (see Hotline Update for March 21). Remain short June '90 Value Line, and long June and September 1990 S&P 500 puts.

Chart 2



THE WALL STREET JOURNAL

Chart 3

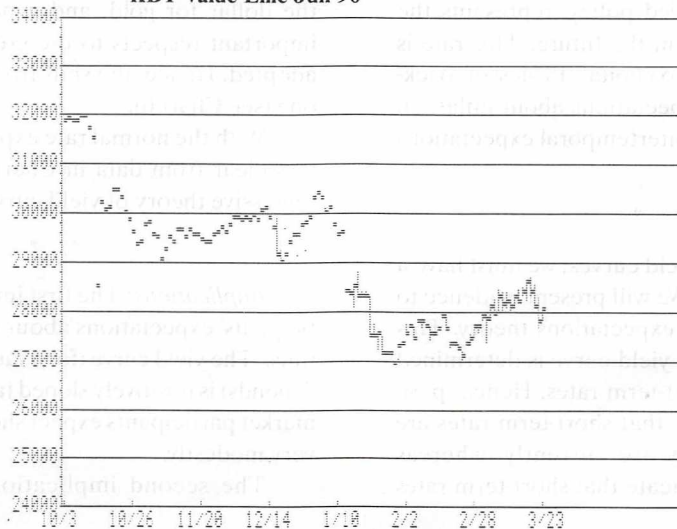


Data are quarterly. Last data plot point is 1989:3.
Sources: U.S. Dept. of Commerce; DWJ.

The Zweig Forecast

Courtesy: Eric Miller

Chart 4
KBT Value Line Jun 90



THE ECONOMY**Yield curves**

A yield curve is a plot of yields on fixed-income securities with the same default risks against their differing maturities. Hence, the yield curve represents a "snapshot" of returns available at a single point in time to an investor who can choose from among securities with different maturity dates. If a yield curve is positively sloped, long-term rates exceed short-term rates. A negatively-sloped yield curve occurs when short-term rates exceed those for longer-term maturities. If yields for all maturities are equal, the yield curve is flat.

* * * * *

Why is an understanding of yield curves important? For our purposes, there are two reasons. First, the shape of the yield curve is a reliable indicator of the future course of the economy. For example, when the yield curve (3-month T-bills vs. 10-year T-bonds) is flat, real economic growth for the next year is anticipated to be 1.9%. If the yield curve is positive, growth is anticipated to exceed 1.9%. Alternatively, an economic growth rate of less than 1.9% for the next year is anticipated if the yield curve is negative. (For more details, see "Ease Over," *FC&CC*, January 28, 1990.)

The second reason why an understanding of yield curves is important concerns the Fed's monetary policy (see, for example: "Professor Wicksell Revisited," *FC&CC*, October 29, 1989). With the increasing influence of Vice Chairman M.H. Johnson and Governor W.D. Angell (since about 1987), the Fed has increasingly geared its monetary policies to movements in the yield curve (as well as commodity prices and the dollar's foreign exchange value). The Fed views the yield curve as a market-determined measure of the thrust of monetary policy rather than the effects of a policy change. The short end of the yield curve (specifically, the Fed funds rate) is controlled by the Fed and is analogous to Professor Wicksell's "bank rate." The long-term bond yield, while not directly influenced by changes in Fed policy, represents the return to promises to pay dollars in the future. This rate is related to both long-term returns to capital (Professor Wicksell's "natural rate") as well as expectations about inflation. In consequence, the structure of intertemporal expectations is embodied in the yield curve.

* * * * *

To understand the shape of yield curves, we must have a theory that explains their shape. We will present evidence to support the traditional-regressive expectations theory. This theory holds that the shape of the yield curve is determined by expectations about future short-term rates. Hence, positively sloped yield curves indicate that short-term rates are expected to be higher than they are currently, whereas negatively-sloped yield curves indicate that short-term rates

are expected to decline. Flat yield curves, of course, indicate that short-term rates are expected to remain constant over time.

This isn't the end of the theoretical story, however. These traditional expectations are formed in a regressive manner. For example, if yields have been rising and are above "normal," they are expected to reverse course, or regress, towards what is considered normal levels. Alternatively, if yields have been falling and are below "normal," they are expected to regress and rise back to normal levels. In consequence, in high interest-rate periods, yield curves tend to be negatively sloped, and in periods of low interest rates, yield curves tend to be positively sloped.

Charts 5 and 6 present data that support the traditional-regressive theory. Chart 5 covers the 1862-1929 period. Yield curves tended to be positively sloped when yields were low and negatively sloped when yields were high. In addition, notions about what were normal yield levels (hence, high and low) were revised downward in late 1878. Chart 6 covers the 1900-1989 period. Again, yield curves tended to be positively sloped when yields were low and negatively sloped when yields were high. However, notions about what were normal yield levels were revised upward in 1971.

What events triggered these downward and upward revisions in investors' expectations about normal rates? Alternative monetary regimes provide the answer. The gold standard was abandoned when banks abandoned specie payments on December 30, 1861. In February 1862, the US entered the greenback era. Monetary expansion and a depreciation of the dollar ensued. It was not until late 1878 that the gold standard was restored. Hence, the shift from a high normal rate to a lower one (see Chart 5). Gold continued to play a role (although a reduced one) until August 1971. At that time, the US suspended the international convertibility of the dollar for gold, and a paper standard, identical in all important respects to the greenback era of 1862-1878, was adopted. Hence, the shift from a low normal rate to a higher one (see Chart 6).

With the normal rate explained by the monetary regime, it is clear from data in Charts 5 and 6 that the traditional-regressive theory of yield curves is valid.

* * * * *

Implications: The first implication concerns market participants' expectations about the future course of short-term rates. The yield curve (for example, 3-month T-bills vs. 10-year T-bonds) is positively sloped (at about 50 basis points). Hence, market participants expect short rates to stay firm or increase very modestly.

The second implication concerns future economic

growth. For the 1989.4 quarter, the yield curve was negatively sloped (at 23 basis points). This implied a 1990.1 - 1991.1 growth rate of 1.65%, which is slightly below the low end of the Fed's growth target (1.75%). If the 1990.1 quarter's yield curve remains positively sloped at its current level of about 50 basis points, 1990.2 - 1991.2 growth would be expected to be about 2.5%, which is a bit higher than the high end of the Fed's growth target (2.0%).

The third implication concerns Fed policy. Given the Fed's growth rate target range for the 1990.1 - 1991.1 period (1.75% - 2.0%) and the yield curve's implications for economic growth, the Fed's current policy (a positively-sloped yield curve at about 50 basis points) should be viewed as a bit too loose. The Fed would be more comfortable with a flat yield curve, which would bring economic growth in right on the high end of the Fed's target range. Indeed, given the Fed's Wicksellian propensities, this shouldn't surprise us. After all, Professor Wicksell's policy rule for stable prices (no inflation) is to set monetary policy so that the "bank rate" (Fed funds) is equal to the "natural rate" (the long-bond yield). In

other words, a Wicksellian policy rule is to target a flat yield curve.

The fourth implication concerns the possibility of an eventual shift in what investors consider a normal rate. If the Fed continues to follow a Wicksellian approach to monetary policy, we predict that the normal rate will shift down as it did when the US switched from a greenback policy to a gold standard in the nineteenth century. There is evidence to support our prediction, and it comes from Professor Wicksell's native land, Sweden. In September 1931, Sweden abandoned the gold standard and the Swedish central bank, the Riksbank, adopted a Wicksellian monetary policy to stabilize prices. This policy was retained until 1939. Sweden's price stability during the eight-year Wicksellian period was remarkable: The wholesale price index was rather stable on a year-over-year basis and trended upward modestly (+8.5% over the 8-year period); the consumer price index was even more stable on a year-over-year basis and trended upward even less rapidly (+3.7% over the 8-year period).

— Dr. Steve H. Hanke

Chart 5
Frequencies of Rising and Falling
Yield Curves, 1862-1929

Commercial Paper Yield (% per annum)	(Slope of Yield Curve)	
	Positive	Negative
1862-1878		
Above 7.57	0	5
Below 7.56	12	0
1879-1929		
Above 5.40	0	16
5.21 - 5.40	4	17
Below 4.21	14	0

Chart 6
Frequencies of Rising, Flat and Falling
Yield Curves, 1900-1989

One-year Corporate Bond Yield (% per annum)	(Slope of Yield Curve)		
	Positive	Flat	Negative
1900-1970			
Above 4.40	0	0	20
3.25-4.40	10	10	5
Below 3.25	26	0	0
1971-1989			
Above 9.00	1	0	3
Below 9.00	14	1	0

CURRENCIES

Yen for a sinking feeling

The one percentage-point rise in the Discount Rate, to 5¼%, came too late, as we predicted last month, to save the day.

The *real* problem is inflation, and the Japanese authorities refuse to face up to it, arguing that consumer prices are growing only at 3.7% per annum (and a good part of that, thanks to a rise in retail sales tax). They close their eyes to soaring asset prices, a falling yen, and a deteriorating current-account surplus (see Chart 7), all products of an unbridled monetary expansion.

Beyond ignorance lies fear. Fear of a market crash and fear of a breakdown of the cozy relationship between Big Business and LDP. Markets, like dogs, sniff fear and become

highly disturbed.

The "right" thing to do is to tighten, fearlessly and brutally. Only then will the convulsion end.

STRATEGY: We are short the 10-year 6% government bond traded on the LIFFE face value ¥ 100,000,000. Maintain stops at 96.75, basis June '90, close only. We remain short yen versus our long position on Swiss francs (see Chart 8) and Italian lire.

We remain long Nikkei put options, looking for eventual lows in the 15,000-16,000 area.

Chart 7

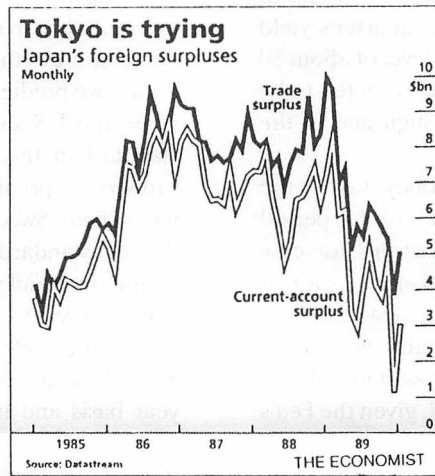


Chart 8
Swiss francs/Japanese yen

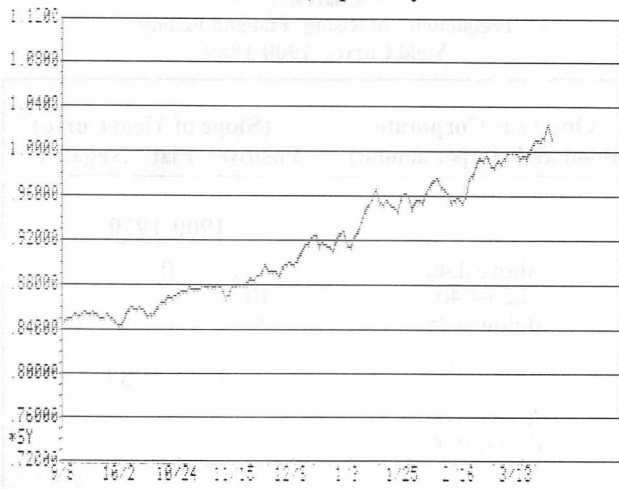


Chart 9
CME Japanese Yen Jun 90

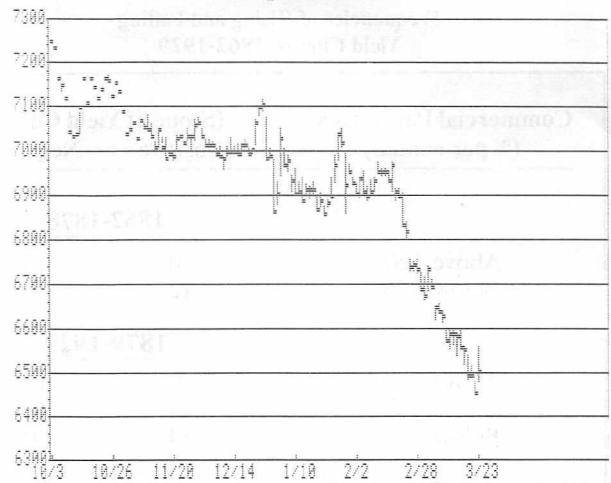


Chart 10
Nikkei 225 Index Spot

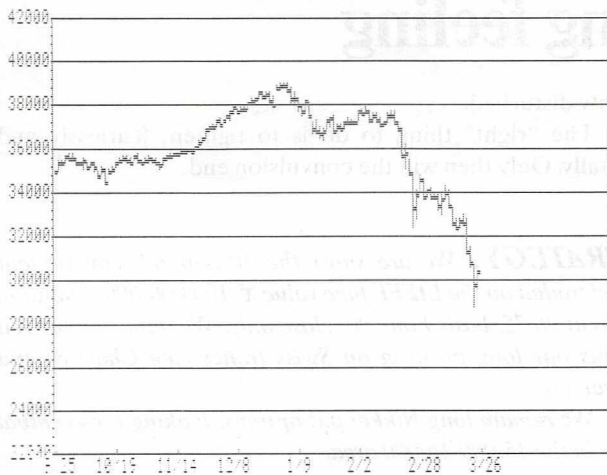
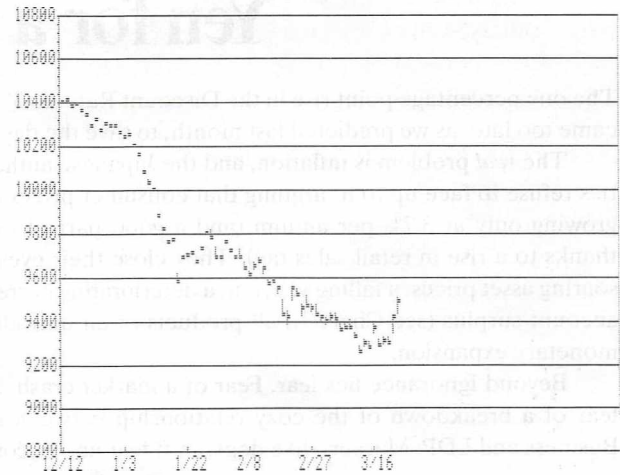


Chart 11
LIF Japanese Bond Jun 90



CRUDE OIL

Lower prices ahead

Over the past 30 days, crude oil prices have fallen dramatically (Chart 12). Perhaps even more indicative of the market's weakness is Chart 13, which depicts the spread between the expired April '90 contract and the six-month forward position; from a \$2.15/barrel premium the spread collapsed to a \$1.20/barrel spot discount.

Not since early 1986 have we witnessed such a spectacular swing from backwardation to contango. The speed and

magnitude of the reversal reveals a growing crude oil surplus and the likelihood of much lower prices ahead.

STRATEGY: We established timely short positions last month via the purchase of June and July 21 striking put options. Our initial target remains \$18/barrel. Ultimately, the market may be testing, once more, the \$12-\$13/barrel level.

Chart 12
NYME Crude Light May 90

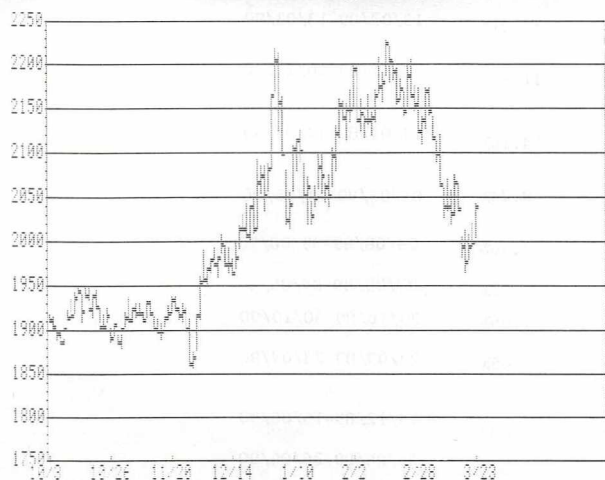
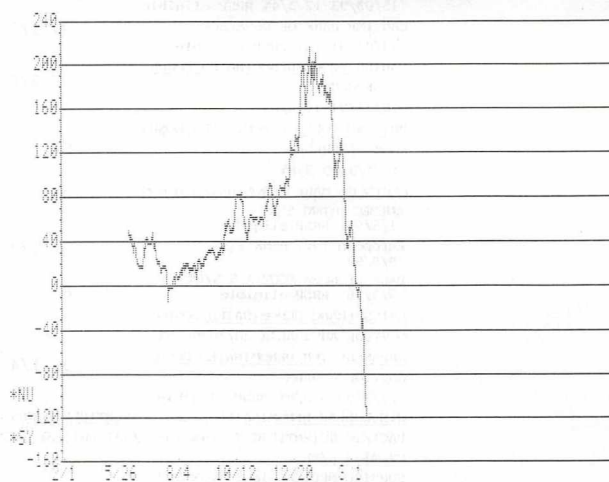


Chart 13
Oil: April 90 - 6-month forward



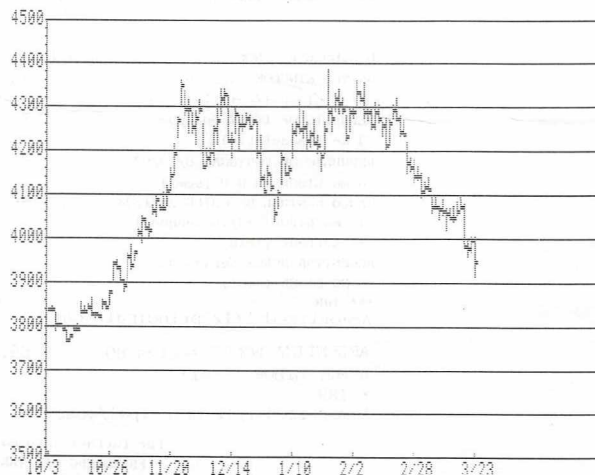
GOLD

The decline gathers momentum

The erosion in bullion prices has given way to a slightly more violent decline: In two sessions last week, prices intraday declined more than \$8/oz., denoting a special urgency on the part of sellers. And worried they should be. The decline from these levels portends new lows, possibly a challenge to the 1985 lows of \$280/oz.

STRATEGY: Retain short positions initiated February 9. Roll over April positions to June '90 and lower stops to 415, close only.

Chart 14
Comex Gold Jun 90



FRIEDBERG CAPITAL MARKETS

**Chart 16
Foreign Currency Bonds**

Date: March 20, 1990

We offer the following bonds subject to change without prior notice: Min. a/c US\$5000.

PAY ISSUER/MTY./DATE/COUPON	BID	OFFER	CURRENT ANN. YIELD TO MTY	LAST PAY DATE	NEXT PAY DATE
CANADIAN DOLLAR DENOMINATED BONDS:					
GOVERNMENT OF CANADA (semi annual) 10 3/4% 5/12/90	98.02	98.32	13.23%	05/12/89	05/06/90
NEW ZEALAND DOLLAR DENOMINATED BONDS:					
TORONTO DOMINION BANK 02/04/90 10% RRSP eligible	99 7/8	-	-	02/04/89	02/04/90
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	60	62	16.19%	matures	04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS:					
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	98 7/8	99 5/8	14.06%	01/07/89	01/07/90
WORLD BANK 15/03/93 12 3/4% RRSP eligible	98 3/8	99 1/8	13.11%	15/03/89	15/03/90
CAN. IMP. BANK OF COMMERCE 13/03/91 13% RRSP eligible	97 1/2	98 1/2	14.71%	13/03/89	13/03/90
DANISH KRONER DENOMINATED BONDS:					
STOCKHOLM 10/11/91 10 5/8%	97 3/8	98 1/8	11.87%	10/11/89	10/11/90
BRITISH POUND DENOMINATED BONDS:					
KGDM of SWEDEN 14/4/93 9 3/8%	88	88 3/4	14.16%	14/04/89	14/04/90
DEUTSCHE MARK DENOMINATED BONDS:					
QUEBEC HYDRO 5 1/2% 1/5/96 RRSP eligible	82 1/8	83 1/8	9.24%	01/05/89	01/05/90
European INV. BANK 5 1/2% 9/8/93	89 1/2	90 1/4	8.96%	09/08/89	09/08/90
Bank of NOVA SCOTIA 5 5/8% 7/5/96 RRSP eligible	83	83 3/4	9.22%	07/05/89	07/05/90
SWISS FRANC DENOMINATED BONDS:					
GOVT. OF AUSTRALIA 30/10/98 5%	85	87	7.06%	30/10/89	30/10/90
JAPANESE YEN DENOMINATED BONDS:					
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	96 1/4	97	6.65%	23/07/89	23/07/90
U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS:					
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) CV @ \$38 p/sh	69 1/2	71 1/2	12.50%	15/12/89	15/06/90
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV @ \$17 5/8 p/sh	73	78	12.51%	26/06/89	26/06/90
ALLIANT COMPUTER 7.25% 15/05/12(semi) CV @ \$39.75 p/sh	52 1/2	54 1/2	14.40%	15/05/89	15/11/90
COOPER CO'S. 10 5/8% 01/03/05(semi) CV @ \$27.45 p/sh call in 1995 @100	66 3/4	68 3/4	16.90%	01/03/90	01/09/90
DICEON ELECTRONICS 5.5% 1/3/12 (semi) CV @ \$39.50 p/sh	35	39	15.68%	01/03/90	01/09/90
U.S. DOLLAR DENOMINATED ZERO COUPON BONDS:					
KINGDOM OF DENMARK 6/8/98	46 1/8	47 5/8	9.28%	matures	06/08/98
U.S. DOLLAR DENOMINATED FIXED RATE BONDS:					
ALBERTA 7 3/8% 9/12/91 RRSP eligible	97	97 3/4	8.82%	09/12/89	09/12/90
SOUTHWEST CORP. 10 7/8% 1/11/89 (semi)	-	-	-	N/A	
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES:					
UNITED KINGDOM 24/9/96 3 mo. LIBOR-1/8 (qly)	99.83	100.13	8 1/4%	28/12/89	28/03/90
REPUBLIC OF ITALY 30/4/93 3 mo Limean(qly)	99.50	99.90	8 5/16%	31/01/90	30/04/90
REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P.(semi)	99.85	100.15	8.2375%	08/12/89	08/06/90
BANCO CENTRAL DE CHILE 20/1/94 12 mo LIBOR+ 13/16 (annual) ** current yield	62 3/4	-	10 11/16%	22/01/90	22/01/90
ARGENTINA BONEX series 82 6 MO LIBOR (semi) *** IRR Amortized 1/12 principal/year	66.85	68.35	8.4375%	15/02/90	15/08/90
ARGENTINA BONEX series 80 6**MO. LIBOR (semi) * IRR Amortized 1/12 principal/year	85.65	87.15	8 5/16%	27/11/89	27/05/90

For further information and current prices please call:
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F/MICICM

Recommended bond portfolio allocation

New Zealand dollar bonds	5%
US dollar high-yield convertible bonds	20%
Argentina Bonex	10%*
US dollar floating-rate notes	30%**
British pound fixed-rate bonds	17.5%
Danish krone fixed-rate bonds	17.5%

*Increased from 5%

**Decreased from 35%

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Chart 17
Breakeven exchange rates for US\$-based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DKr) or revalue (for DM, SF, JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **March 20, 1990.**

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND
2 year	8.41%		CIBC 13% 13/3/91, yields 14.71% (.714 A\$/US)				Stockholm 10%, 10/11/91, yields 11.87% (6.680 US/DK)	
3 year	8.65%	Tourist Hotel 0% 4/6/93, yields 16.19% (.476 NZ/US)*	World Bank 12¾% 15/3/93, yields 13.11% (.669 A/US)	Euro Inv. Bk. 5% 7/5/96, yields 8.96% (1.719 US/DM)		Canada 5% 23/7/93, yields 6.65% (145.79 US/JY)		Sweden 9% 14/4/93, yields 14.16% (1.380 BP/US)
4 year	8.72%		CBA 14% 1/7/94, yields 14.06% (.622 A\$/US)					
6 year	8.66%			Quebec Hydro 5½% 1/5/96, yields 9.24% (1.760 US/DM)				
8 year	8.59%				Australia 5% 30/10/98, yields 7.05% (1.357 US/SF)			
Spot Exchange Rate	N/A	.5825	.7555	1.7047	1.522	154.15	6.474	1.601

*For example, since a US\$-based investor would receive 754 basis points (1619-865) by holding the Tourist NZ\$ bond, the NZ\$ can depreciate to .476 NZ/US from the present spot exchange rate of

.5825 NZ/US over the next 3 years for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

THE EXOTICS

Greece: To hell in a basket

Greece's current account deficit for January '90 totalled \$534 million from last year's figure of \$13 million. For 1990 as a whole, it now looks as if the deficit will easily exceed 5% of GNP.

The main problem lies in the intractable and growing public sector deficit, which reached 21.5% of GDP in 1989 (see Chart 18). Total public sector debt now equals 100% GNP of which 63% is domestic and the balance is external. These staggering deficits crowd out private sector credit, raise real interest rates to usurious levels, and simultaneously put strong upward pressure on the drachma's foreign exchange rate (see Chart 19), a consequence of strong hot money inflows.

The loss of competitiveness resulting from the drachma's real appreciation has widened unsustainably the current account deficit. A host of expectational factors are now coming into play — mainly, the belief that a drachma devaluation and the restoration of competitiveness is inevitable and the belief

that eventually the public sector debt will be monetized.

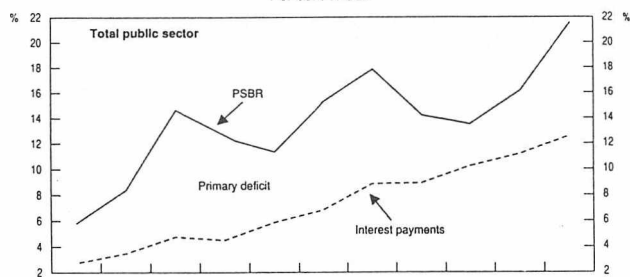
The caretaker government of Xenophon Zolotas was unable to introduce the necessary austerities required to bring public sector spending into line. At the same time, the underground economy has succeeded in continuously chipping away at the government's expected receipts (see Chart 20). More taxes can result only in less revenues. The only solution is a sharp reduction in expenditures.

Elections are due to take place April 8. It is unlikely that any party will obtain a sufficient majority to enable it to take decisive action on the fiscal front. Time is running out for Greece. We expect a very substantial devaluation during 1990.

STRATEGY: Add to existing short positions in Greek drachmas. Note that forward discounts are in excess of 16% per annum and that, therefore, the speculation is not costless by any means.

Chart 18

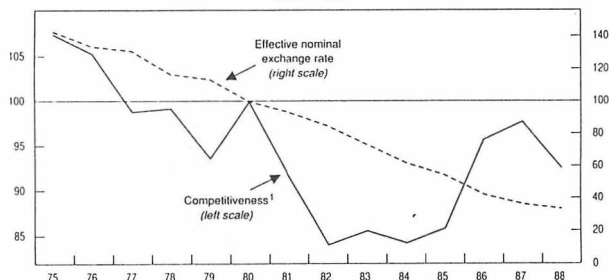
PUBLIC SECTOR BORROWING REQUIREMENT AND INTEREST PAYMENTS
Per cent of GDP



Sources : OECD, National Accounts and direct submission by national authorities.

Chart 19

INTERNATIONAL COMPETITIVENESS
1980 = 100



1. Relative manufacturing unit labour costs in a common currency. Competitiveness improves (deteriorates) when the curve rises (falls).
Source : OECD estimates.

Chart 20

Budget plans and outcome
(Administrative basis)
Drachma billion

	1987		1988		1989	
	Budget	Outcome	Budget	Outcome	Budget	Estimate
Receipts						
Ordinary budget	1 840	1 724	2 145	1 929	2 310	2 090
Direct taxes	492	440	616	523	616	568
Indirect taxes	1 216	1 156	1 393	1 266	1 532	1 372
Other receipts	132	128	136	140	162	150
Expenditure¹						
Ordinary budget	2 098	2 117	2 649	2 671	3 157	3 358
Wage bill	766	780	908	950	1 086	1 146
Other consumer expenditure	230	236	334	274	333	321
Interest payments	298	412	474	554	696	828
Other ²	754	689	888	893	992	763
Reserves	50		45		50	
Ordinary budget deficit ¹	258	393	504	742	847	1 268
Investment budget deficit	410	262	453	303	327	322
Deficit, total	668	655	957	1 045	1 174	1 590

1. Excluding debt repayment.
2. Mainly transfers and subsidies.
Source : Data submitted by the national authorities.

OECD

Chart 21

YEAR	GREEK DRACHMAS PER U.S. DOLLAR (PERIOD)	U.S.		BASKET	
		1973=1.00	1978 =1.00	1973=1.00	1978 =1.00
1967	30.00	0.9993	1.1284	0.8683	0.8877
1968	30.00	1.0370	1.1711	0.8483	0.8674
1969	30.00	1.0679	1.2060	0.8668	0.8862
1970	30.00	1.1002	1.2424	0.9081	0.9285
1971	30.00	1.1131	1.2570	0.8057	0.8238
1972	30.00	1.1028	1.2453	1.0175	1.0403
1973	29.62	1.0000	1.1293	1.0000	1.0224
1974	30.00	0.8853	0.9997	0.8799	0.8997
1975	32.28	0.9167	1.0352	0.9511	0.9724
1976	36.51	0.9695	1.0948	0.9498	0.9711
1977	36.83	0.9285	1.0485	0.9455	0.9667
1978	36.74	0.8855	1.0000	0.9781	1.0000
1979	37.04	0.8343	0.9421	0.9760	0.9979
1980	42.62	0.8728	0.9856	1.0489	1.0724
1981	55.41	1.0062	1.1363	1.0379	1.0612
1982	66.80	1.0637	1.2012	1.0080	1.0306
1983	88.06	1.2039	1.3595	1.0602	1.0840
1984	112.72	1.3570	1.5324	1.0880	1.1124
1985	138.12	1.4424	1.6289	1.1362	1.1617
1986	139.98	1.2122	1.3689	1.1225	1.1477
1987	135.43	1.0437	1.1786	1.0773	1.1015
1988	141.86	1.0019	1.1315	1.0706	1.0946
1989 (1Q)	154.73	1.0461	1.1813	1.0886	1.1130
1989 (2Q)	165.02	1.0898	1.2306	1.0853	1.1096
1989 (3Q)	166.25	1.0813	1.2210	1.0674	1.0914

Above 1.00 = Undervalued Below 1.00 = Overvalued

----- BASKET -----
 U.S. 7% GERMANY 3%
 FRANCE 13% ITALY 23%
 UK 10% NETHERLAND 10%

Chart 22

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	356	-4.15	-1048
1971	396	-3.05	-1127
1972	853	-3.09	-1166
1973	771	-7.08	-1933
1974	543	-5.89	-2732
1975	165	-4.06	-3209
1976	-418	-3.99	-2949
1977	-822	-3.98	-2881
1978	-1347	-2.93	-2959
1979	-1615	-4.74	-3916
1980	-1319	-5.32	-5050
1981	-1768	-6.32	-6503
1982	-2386	-4.80	-6509
1983	-2486	-5.32	-6178
1984	-2242	-6.31	-5902
1985	-1919	-9.87	-7286
1986	-2502	-4.33	-7084
1987	-2717	-2.67	-6175
1988	-2420 (June)	-1.84	-3857
1989	-	-4.70	-4926

Chart 23

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

Reserves * + Previous 12-months curren Account *** = 3978
 (Reserves + 12-months C/A) / M1 ** = 3978/6,940 = 57.3%
 (Reserves + 12-months C/A) / Broad Money ** = 3978/32,099 = 12.4%

*As at Dec. 1989 ** June 1988 *** 1989

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1978	6338	18,516
1988 June	6,940	32,099
% Increase (decrease)	9.4%	73.3%

Corresponding %
increase in the
United States

(a) 1988 Imports as percentage of GNP 24.17
 (b) 1979 - 1988 Imports as percentage of GNP 23.04%
 1988 /1979 - 1988 average) = (a)/(b) = 104.72

Source: IFS

FOREX RATES & UPDATE

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM: 1.7150)</i>
Australian dollar	.7485-.7495	.7360-.7675	.7065-.7085	Neutral	Neutral
Belgian franc	35.37-35.42	35.48-35.63	35.74-36.14	Remain long	Neutral
Danish krone	6.5150-6.5200	6.5640-6.5735	6.6750-6.6930	Remain long	Remain long
Dutch guilder	1.9170-1.9180	1.9175-1.9190	1.9200-1.9220	Remain long	Neutral
Greek drachma	1.6355-1.6365	1.6685-1.7145	1.7655-1.9115	Remain short	Remain short
Hong Kong dollar	7.8135-7.8145	7.8200-7.8225	7.8345-7.8425	Neutral	Neutral
Irish punt	1.5590-1.6010	1.5440-1.5410	1.5000-1.5060	Remain long	Neutral
Italian lira	1255-1256	1267-1270	1303-1309	Remain long	Remain long
Kuwaiti dinar	.29430-.29460	.29420-.29490	.29320-.29480	Neutral	Neutral
Malaysian ringgit	2.7230-2.7240	2.7130-2.7160	2.6830-2.6930	Neutral	Neutral
New Zealand dollar	.5786-.5796	.5712-.5726	.5521-.5551	Remain long	Neutral
Norwegian krone	6.6030-6.6080	6.6595-6.6685	6.7805-6.7980	Remain long	Neutral
Portuguese escudo	150.75-150.85	153.75-154.25	162.75-166.85	Neutral	Neutral
Saudi Arabian riyal	3.7495-3.7505	3.7460-3.7480	3.7400-3.7440	Remain short	Remain short
Singapore dollar	1.8785-1.8795	1.8730-1.8745	1.8535-1.8615	Neutral	Neutral
Spanish peseta	109.20-109.30	110.70-110.90	115.45-115.75	Remain long	Neutral
Swedish krona	6.1590-6.1630	6.2510-6.2585	6.5110-6.5250	Remain long	Neutral

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, February 27:

1. As per Friday's update we liquidated long May sugar positions at market.
The market letter is in the mail. It includes a recommendation to buy June and July \$21 crude oil put options at market.

Friday, March 2:

The market letter was mailed Tuesday. It includes a recommendation to buy June and July \$21 crude oil put option at market.

Flash Update, Monday, March 5, 8:00 am:

The recent stock market advance looks likely to continue, at least temporarily.
1. Buy S&P futures to hedge short Value Line position.
2. Sell long put options at market.

Tuesday, March 6:

As stated in our flash update yesterday, we believe the recent stock market advance looks likely to continue at least temporarily, therefore we advise:
1. Buy S&P futures to hedge short value line position.
2. Sell long put options at market.

Friday, March 9:

As per our flash update Monday, we recommended to:
1. Buy S&P futures to hedge short Value Line position.
2. Sell long put options at market.

Tuesday, March 13:

Buy May sugar at market, risking 1470, close only.

Friday, March 16:

One new recommendation. As of Tuesday, we recommended to buy May sugar at market, risking 1470, close only.

Tuesday, March 20:

No changes or new recommendations.

Flash Update, Wednesday, March 21, 9:30 am:

Reinstate net short position in the stock market by liquidating long S&P hedge. Thus you will remain short Value Line. You may also purchase June and September 330 S&P put options at market.

Friday, March 23:

A review of new recommendations still outstanding since the last market letter.
1. You are long May sugar at around 1590 as per our update March 13.
2. You are long June S&P 330 S&P put options as of March 21 9:30 am.

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