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The coming global contraction

Slowly, almost inexorably, the gale forces of a terrifying global contraction (so we sidestep the unmentionable "D" word) advance upon us. As in a Greek play, the various actors remain absorbed in their own circumstances, hopeful in their predicament, but totally unaware that the die of the gods has already been cast. Tragically, they cannot sense their own demise. And just as tragically, the audience senses it but is impotent to do anything about it.

We do not mean to imply that this impending crisis is absolutely inevitable. We are of the firm belief that there is no room for fatalism in human affairs, provided, however, we understand the nature of the problem and the way to solve it. Sadly, neither condition is present. The governments of the leading industrial nations not only see no wrong in the present monetary arrangements, but continue to extol the virtues of their prudence and discretionary powers. Far – infinitely far from them – is the notion that they have been the main cause of the greatest credit orgy and concomitant speculative binge in modern history and its inevitable sequel – a full fledged debt deflation/credit collapse.

Given our present state of knowledge, tragedy is indeed inevitable.

Lest the reader think that we possess an unusually keen sense of divination or, even more flattering, an extraordinary ability to analyze economic events, we bid him to rest assured: It is neither. Before we let him in on our simple secret, we will confess that our natural predisposition and our training have something to do with our views, which is only natural, but only to the extent that they have allowed us to abstract ourselves from the ongoing euphoria and the pseudo-intellectualization that has accompanied this euphoria. In some way, we would like to think, it has made us more "objective."

Without further ado, we offer our secret: For just over one year, we have observed more and more "downward"

revisions to any number of disparate and seemingly unrelated economic and financial events. Below, we will discuss some of the more obvious ones.

Suffice it to say that downward revisions are the hallmark of incorrect data, or, more often, incorrect analysis and diagnosis. Rational beings should be able to discount certain type of events (with the exception, of course, of natural events such as drought and earthquakes – despite reasonable prognostications of the El Niño effects), sometimes erring on the optimistic and sometimes on the pessimistic side. The essential point, however, is that the bias is impartial. That events turn out worse than anticipated *all of the time* tells us that events are not being diagnosed correctly. Specifically, in the predicament of the 1998 global economy, it means that officialdom and the press have been too optimistic about the corrosive impact on real economic activity of easy money and excessive credit creation.

Month after month we are treated to downward revisions – and this is only a partial list – of economic activity in Southeast Asia, in accelerating deflation in Japan and China, in greater-than-expected fiscal problems in Brazil and Russia, in higher-than-expected inflation in the US and the UK, in worse-than-expected corporate profits in the US.

In this issue

- 4 Japan**
The reflation that never was
- 5 Observer**
Pax Americana

Contributions by Albert D. Friedberg, Steve H. Hanke.

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

From our earliest trading days, and ever since, we respected revisions as reliable indicators of future trends. Upward earnings revisions meant that a bull market was assuredly in progress, while upward supply revisions meant that a bear market in a particular commodity was just as assuredly in progress. Conversely, downward revisions to earnings spelled a bear market, while downward revisions to supply spelled a bull market for that particular commodity. The same was true about upward or downward revisions to inflation and their impact on interest rates or to revisions to economic activity and their impact on foreign exchange markets.

Interestingly, the denial of the implications of these revisions extended the life of the ongoing trend. Markets often reached their peaks and bottoms when the pendulum swung the other way, as expectations began to incorporate the revisions and used them to project new levels. We had moved from denial to acceptance and then to a wholehearted embrace; the extraordinary (but slow) power of adaptation of the human being had finally priced in – i.e., discounted – the future.

Our expectations do not move in tandem with events. They either lag them, very temporarily catch up with them, or surpass them. Expectations are a product of past experience: A boom creates optimism; a long boom wild optimism. Conversely with depressions. Empirical observations will change our expectations, but given our adaptive nature, only after some time. Revisions are the cues that cry out for a change in expectations. If we don't change them, it is because they have too much momentum, or because we don't want to change them (it is unacceptable to our well-being), or because we are at a loss to understand them. Or for all of these reasons.

There is one more element to this common sense analysis. Denial must be grounded on some theory, it must be rationalized. An impartial or dispassionate observer, the proverbial "man from Mars," should be able to gauge the logic and internal consistency of the argument: The greater the gap between the direction of expectations and the revisions, the weaker the logic of the denial. You are on to something important if the one who denies the new evidence is just "grasping at straws."

In sum, revisions that run contrary to expectations alert the "objective" observer to the possibility that a change in trend is in the offing (if it runs contrary to the existing trend), inviting him to assess the logic and inner consistency of those who refuse to believe in the implications of the revision. These types of revisions can also serve to accentuate the ongoing trend.

Consider the following: What was initially thought to be

merely a liquidity problem, albeit a severe one, has become a solvency issue: both South Korea and Thailand need enormous sums of money to capitalize their banking systems, sums that could easily exceed 30% to 40% of GDP. With it all, South Korea has as yet to tackle the insolvent chaebols, which have been kept alive by further loans, and Thailand has had to foreclose on seven new finance companies. The trough that was supposed to occur in the first quarter has now been postponed to the end of the year. No wonder! GDP has been contracting at almost 30% (!) per annum.

Consider: The trade and current account positions of the Asian Five have improved dramatically in recent months, but this was a result, primarily, of an extraordinary compression of imports. Over the 3 months to March, combined exports in dollar terms have actually *fallen* 5%. For example, South Korea recorded a monthly trade surplus in April of \$3.9 billion, up from \$3.7 billion in March, and a deficit of \$ 1.4 billion in April 1997. But this came from a 35.5% decline in imports and a mere 7% rise in exports. This still compares favorably with the \$1.7 billion February trade surplus for Indonesia, despite reporting a 5% *fall* in exports, and the \$980 million March trade surplus for Malaysia, despite the sharp 13.5% year-on-year *fall* in exports. The 8.2% drop in Thai exports in April from March was actually a third to a half worse than many analysts expected.

Even Chinese exports have been decelerating at a surprising rate: While export growth in January-April taken together was 15.8% year on year, March exports grew by only 9.2%, and April by a mere 7.9%. This unexpected shrinkage in regional (and soon, global) trade underscores the profound difference between this crisis and past ones, such as Latin America in the early to mid-'80s and Mexico in 1995: Relatively small countries or even regions can experience an export-led recovery when the rest of the globe is growing and liquidity is plentiful. This becomes far more difficult, and maybe impossible, when the affected countries represent a large proportion of world trade and an overwhelming proportion of the incremental growth in world trade in the recent decade. Projections for a recovery in Asian exports depend critically on a global economic recovery – they cannot be extrapolated out of thin air or out of alleged analogs.

Consider: Unsurprisingly to those who understand the workings of a fixed rate of exchange, there is statistical and anecdotal evidence that China has entered outright deflation. Its retail price index fell by 2.1% in April, some petrochemical prices are down by 15% year on year, and the prices of some steel products are down 20% over the last year.

Extremely high inventories in the face of falling prices is quite worrisome. Already, industrial production has decelerated to only 2.8% in April year-on-year. In the past, industrial production was a leading indicator of future currency realignment: There was a sharp dip in industrial production growth before the 1986, 1990, and 1991 devaluations – and early signs of deceleration before the 1994 realignment (courtesy of Chase research). Readers should note that the currency realignment of 1994 has been considered the proximate cause of the currency crisis in the rest of Asia. Without a doubt, a new devaluation would create havoc in that region of the world, forcing *inter alia* a much faster devaluation of the yen, and a new trade onslaught on the shores of the Western nations.

Downward revisions are confirming the severity of the Asian crisis. Why are Western markets so complacent?

Consider: Japan reported a trade surplus for April of ¥1.23 trillion, up from ¥0.80 trillion a year ago, and ¥0.90 trillion in March. This was the result of falling imports, as *exports fell* 1.7% from a year ago. Exports to Thailand and Korea were down by more than 40% and to Indonesia by more than 50%.

Consider: The US trade deficit, on the heels of the Asian crisis, was expected to increase to a monthly figure of \$12 billion by the end of 1998; the April trade gap already exceeded \$13 billion. Using real variables (to factor out falling petroleum prices), the trade adjustment in the first three months of the year alone was three times as large as the earlier consensus estimate for the year as a whole.

The US economy has become the earth's black hole, and its pillar of strength. But how long will it be able to carry the world on its shoulders? Eventually, the trade gap will overwhelm the US economy, already weakened by falling corporate profits and investments. What is the response of those who deny this upward trade-gap revision? They are not significant, they say. But if extrapolated, they can become extremely significant. And a US slowdown can only remove another peg from the collapsing world trade.

Consider: Russia and Brazil are fighting a desperate and losing battle to avoid a devaluation, default on international debt – and mayhem. This was not supposed to be. As late as last January, these countries were praised for having taken decisive action to rein in fiscal deficits and regain investor confidence.

In the Brazilian case, a massive rise in taxes and a huge rise in interest rates were decreed, but seemingly to no avail. Hot money flew in to take advantage of seemingly juicy

returns, enriching international reserves, but the economy creaked under the combined weight of these two actions. Hot money has once again begun to leak out; it will soon become an uncontrollable avalanche.

The deterioration is clearly visible in the monthly unemployment and fiscal deficit numbers, reports of widespread unrest in the civil service by unpaid workers in Russia (the easiest way to bring the books into balance), and so on. Have the bulls on the world economy thought through the implications for cross-border lending, trade finance, and world trade of capital flight cum devaluation cum default in these two countries? Have they taken note of their progressive weakening, so unforeseen just three months ago?

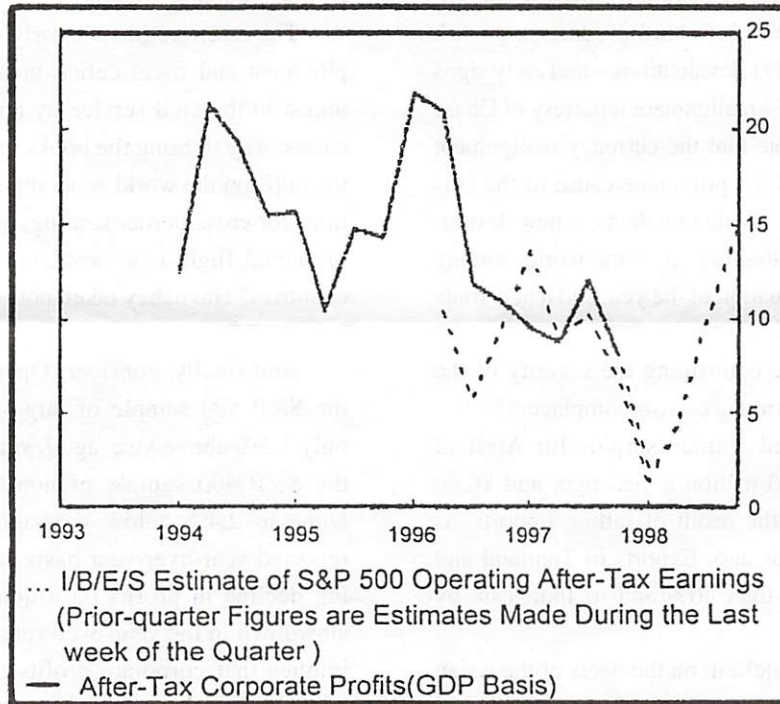
And finally, consider: Operating earnings per share of the S&P 500 sample of large corporations have come in only 1.5% above year-ago levels, and earnings per share of the S&P 400 sample of non-financial corporations have come in 2.4% below year-ago levels. The slowdown in reported year-over-year basis earnings masks a more striking decline in profits on a quarterly basis. A first-quarter slowdown in the year-over-year growth of corporate profits implies that corporate profits tumbled in the first quarter compared with the fourth quarter. This downward trend in profits was not supposed to occur, as profits were expected to show gains of 10% to 13% year-over-year just 3 months ago. The answer from the bulls? Watch for a sharp rebound in earnings in the next three quarters (see chart). This flies in the face of logic, as pressure on profit margins has come from the squeeze of weaker pricing (and wait for some more if and when exports from Asia ever recover) and escalating labor costs (with no sign of a letup in sight). Weaker growth, a dear objective of our Monetary Authorities, will compound the problem. Clearly, expectations are lagging reality, and by a wide margin.

Recent economic data have surpassed expectations, for the worse. Expectations are far from adapting to the new reality. The refusal to change has been buttressed by hopeful projections that are at best illogical and inconsistent. Ergo, a change in trend is imminent in the industrialized markets, and a worsening of the downtrend is a given in the Asian and emerging markets. The tragic lack of preparedness guarantees that the coming contraction will hit the globe with the force of a tidal wave.

“Who is wise?” asked the Talmud. And it retorts, “He who can foresee events.”

Chart 1

Corporate Earnings Forecasts
 Percentage change From A Year Earlier



Source: Bureau of Economic Analysis and I/B/E/S.

note: 1998 Q1 estimate by Chase Research using I/B/E/S estimates as a guide.

Chase Securities Inc.

JAPAN

The reflation that never was

Adding to our foreboding sense of impending doom is a clarification issued by the Bank of Japan in a letter to the editor of *The Financial Times* of London (April 30) and a further private communication from the manager of the International Department of the Bank of Japan dated May 15 (copies are available on request).

We will spare the reader the technicalities of the letters. Suffice it to say that the extraordinary expansion of the BOJ's balance sheet (reaching at one point more than 50% on a year-over-year basis) did not end up in a corresponding increase in currency and bank reserves. The bank does not publish figures for the monetary base, but analysts have estimated that it rose about 10% for the year. Meanwhile, the growth in banknotes was a more moderate 7%. These increases have clearly been insufficient to expand the broadest measure of money supply

(up only a measly 2.4% year-on-year), probably due to hoarding/leakages. While massive monetary reflation was not our preferred option (see last month's issue), it may just be the only way out at this late stage of the game in view of the gathering deflation and the drying-up of world liquidity (which two years ago could have supported a cold turkey approach). Little wonder that the JGBs kept rising and now yield an incredible 1.28%! Trading discipline, not brains, saved us from making significant losses.

In light of this new information, we strongly advise resisting the temptation to buy equities, even though we have identified a number of interesting value situations. Instead, remain short second-tier bank stocks, which should prove a rewarding strategy, and remain short yen, as Japan struggles to export its way out of depression.

OBSERVER

Pax Americana

By Steve H. Hanke

Pax Americana is alive and well. Indeed, the US is not only the world's superpower but also its most imposing imperial power. And the man calling the shots is Secretary of the Treasury Robert Rubin. Over the past few years, Rubin has cleverly taken over foreign policy from the State Department and done so without leaving many fingerprints. Just reflect on what's been going on in Indonesia during the past few months and the consequences.

The spinmeisters at the White House, US Treasury, and the International Monetary Fund have been working overtime on the Indonesian story. Indeed, they have had President Suharto, admittedly an inviting target, in their cross-hairs for months. As they spin it, the Indonesian economy is in shambles because Suharto failed to take the IMF's medicine.

This tale has little to do with reality. Now that Jakarta has entered a pre-revolutionary phase, it's time to set the record straight. With a high degree of self-righteousness and arrogance, the Clinton Administration, with Rubin at the controls, has used the IMF as a battering ram to reshape the political and economic landscape in Indonesia. And by the looks of things in Jakarta, this has worked wonders. How did the IMF policies inflict so much destruction?

Until the Thai baht collapsed on July 2, 1997, the Indonesian economy had registered over 30 years of spectacular growth and modest inflation. But the Indonesian rupiah was vulnerable. The Bank of Indonesia had managed the exchange rate and domestic monetary policy so as to keep the rupiah-dollar rate relatively stable. This pseudo-fixed exchange rate induced private enterprises to pile up about \$80 billion in unhedged foreign debt on the assumption that the rupiah would never be devalued. With the devaluation of the Thai baht, Indonesian companies worried about the fate of the rupiah and began to cover their short dollar positions. This put the rupiah under selling pressure and drained BI foreign reserves. Facing increased reserve drains, and not wanting to defend the rupiah, the BI floated it on Aug. 14. The currency didn't float. It sank.

In late October, the Indonesians called in the IMF. Little did the wily Suharto know that he had fallen into Rubin's trap. Indonesia was facing a potential currency crisis, but its first agreement with the IMF focused on breaking up cronyism. On Nov. 1, 16 banks were closed. This was a botched job of the first order and set off a financial panic. Money was pulled out of banks and took flight to Singapore. The rupiah and BI reserves fell further.

In an attempt to stem the tide, Indonesia signed a second IMF agreement on Jan. 15, 1998. This program was a large-scale structural adjustment program aimed at rooting out cronyism and opening the economy. Before the ink had dried on the second IMF agreement, the markets concluded that it did not address Indonesia's immediate problem, the unstable currency, and they took the rupiah down to new lows.

By the last week in January, Suharto had given up on the IMF, as the implementation of the first IMF program had caused a financial panic, and the prospect of a second one had caused the rupiah to melt down. Suharto knew that his days would be numbered if he couldn't stabilize the rupiah at a realistic level.

Consequently, he called me in to develop a comprehensive currency stabilization program. I presented such a program on Feb. 26. And Suharto embraced this home-grown program three days later. He called it the IMF-plus program, because it contained all the elements in the second IMF agreement, plus a currency board system, external debt rescheduling, bank restructuring and recapitalization, a bankruptcy law overhaul, and a large privatization program.

The IMF-plus program sent Rubin and the White House and the IMF into a full court press to force Suharto to implement the second IMF agreement. Indeed, President Clinton dispatched Walter Mondale to Jakarta with what amounted to an ultimatum and specific advice on how to shape a new cabinet. Suharto hung tough, and the IMF finally agreed to discuss all the issues raised in IMF-plus. But, in the end, Suharto caved in. On April 10, the third IMF agreement was signed. It included everything in my IMF-plus program, except the currency board lynch-pin. Instead of a currency board, a "smart" managed floating-exchange-rate system was installed. This half-baked setup required the BI to more than double short-term interest rates, a punishing blow to the economy.

The killer blow of the third IMF agreement came, however, with the untimely fuel-price increases of May 4. Whereas the first IMF agreement set off a financial panic and the second IMF agreement set off a currency collapse, the third agreement set off bloody rioting. This was enough to cause Suharto to pack it in after 32 years. And as was the case when the US pushed the Shah of Iran over the edge, no one knows exactly how the Indonesian story will end. However, one thing is certain: The Indonesian political and economic turmoil that has been set in motion by US imperialism will continue to unsettle Asia in the coming months.

Contrary to the spinmeisters, Thailand and South Korea are not out of the woods, thanks largely to US-inspired IMF policies adopted in those countries. Among other problems, both countries had built massive excess capacity before their currency collapses of last year. When the IMF rushed to the rescue, it prescribed the standard IMF medicine: fiscal austerity to cut domestic demand. This promises to make both countries even more vulnerable. Indeed, with excess capacity and weakened, policy-induced domestic demands, there is even more pressure for further currency depreciations and export-led growth in Thailand and South Korea.

Rubin has been busy dishing out misguided advice in Japan, too. The Japanese have a name for the type of shrill cajoling that Rubin and company permit themselves to engage in. They call it *gaiatsa*.

The Japanese economy is close to implosion. To solve the problem, Rubin wants more tax cuts and government spending increases. The fiscal stimulus approach will simply not work in Japan. Japan's comprehensive fiscal deficit is already over 6% of GDP and the gross debt-to-GDP ratio is nearly 100%. These statistics are by far the worst in the G-7 countries. This overly loose fiscal stance has already destroyed confidence in Japan and dramatically reduced fiscal multipliers. Consequently, Rubin's demands for even looser fiscal policies, which, incidentally, the Japanese are following, will fail to restart the economy.

What's needed in Japan is a massive loosening of the monetary policy, something that Milton Friedman has suggested. Rubin, of course, remained silent on Japanese monetary policy, because a looser monetary policy in Japan would send the yen-dollar rate toward 170 yen per dollar, its pur-

chasing power parity level. And this would send the US merchandise trade deficit with Japan soaring.

Rubin's position should not surprise anyone, as US-Japanese commercial tensions, including the threat of trade wars, determine the yen-dollar rate. And that exchange rate determines Japanese monetary policy. Japan has not operated an independent monetary policy since 1971. Indeed, the yen-dollar rate has been a forcing variable for Japan's monetary policy, with mercantilist pressure from the US determining the yen-dollar rate, which then determines Japan's monetary policy.

All this explains why Bank of Japan policymakers, while showing sympathy with the idea of cutting interest rates and stimulating monetary policy at the BOJ's April 9 policy meeting, indicated that monetary stimulation would be used only as a last resort. Alas, given Rubin's *gaiatsa*, this will probably be too little, too late, and will come only after Japan's economy sinks further into a deflationary slump.

Thanks to US-induced policies, Asia is going to remain in the tank. This will eventually hit US earnings and the Dow. And when the Dow finally ends its bull run, other vulnerable currencies, namely the Russian ruble and the Brazilian real, will take a tumble. When that day arrives, all emerging markets will come under pressure, and the repricing of risk (reflected in emerging market-Treasury spreads) will take its toll. In this environment, all I can say is, if cash isn't king, it soon will become so.

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