





the bright boys in the US Treasury, Japan will not be an Asian locomotive.

It's time to pull the plug on the Professors of Rotational Medicine. The Asian flu isn't going to be cured anytime soon. And it will infect the US. As David Dreman documents in his recent book, *Contrarian Investment Strategies*, analysts' earning forecasts are biased and consistently overoptimistic.

This bias coupled with overconfidence can be extremely dangerous, particularly when there is a virus in the air and stocks are highly valued.

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Chart 1

CHART 1 INTERNATIONAL BANK AND BOND FINANCE FOR ASIA\*

\$bn	Annual rates		Actual rates
	1995 Q1-1996 Q3	1996 Q1-1997 Q3	1997 Q4
Net interbank lending	43	11	-31
Bank lending to non-banks	15	11	-1
Net bond issuance	17	32	1
Total	75	54	-31
Memorandum item	1995-1996		1997
Net equity inflows	17		2

\* South Korea, Indonesia, Malaysia, Philippines, and Thailand

Sources: BIS, IIF

Chart 2

CHART 2 Bank Lending to Emerging Markets

	US\$b, end June '97				% of bank capital			
	US	Japan	Canada	EU	US	Japan	Canada	EU
Asian emerging markets	43.3	271.4	15.4	353.3	12.4	110	46.1	48.5
Five crisis countries*	23.8	97.2	3.9	98.1	6.8	39.2	11.8	13.5
China	2.9	18.7	0.9	28.1	0.8	7.6	2.6	3.9
Taiwan	2.5	3	1.7	14.4	0.7	1.2	5.2	2
Singapore & Hong Kong	14.1	152.4	8.9	212.8	4	61.5	26.6	29.2
Eastern Europe and Turkey	14.9	6	0.4	92.6	4.3	2.4	1.3	12.7
Russia	7.5	0.8	0.00	45.5	2.2	0.3	0.1	6.2
Latin America	60.3	14.5	9.8	125.7	17.3	5.9	29.4	17.3
Total Emerging Markets	119	291.9	25.6	571.6	34	118	76.8	78.5

\* South Korea, Indonesia, Malaysia, Philippines, and Thailand

Source: OECD Economic Outlook, June 1998



Chart 5

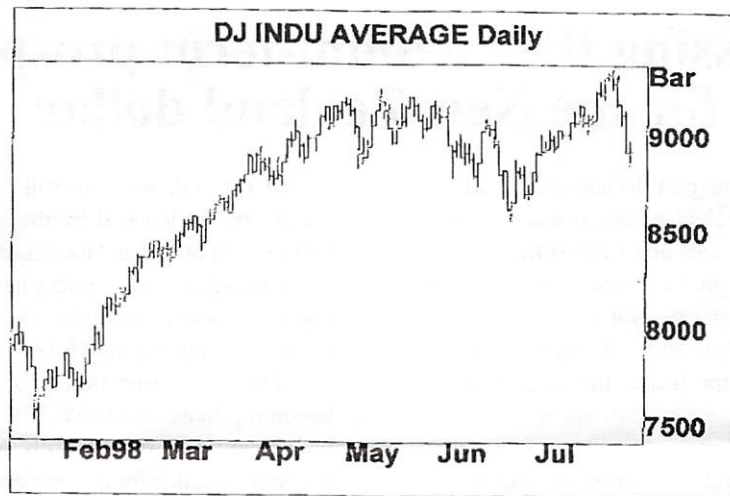
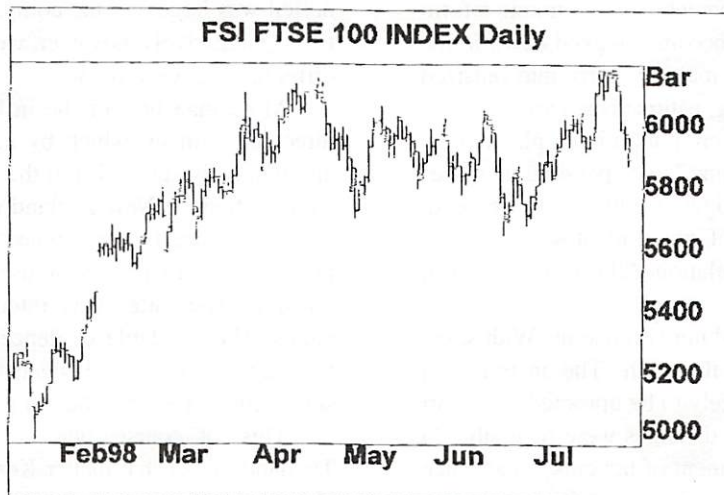


Chart 6



## BAILOUTS

### The too-large-to-fail doctrine: from banks to nations

The bailout of Russia's creditors and investors raises once more the highly disturbing issue of "moral hazard," an issue that was first raised in connection with countries, after the Mexican bailout in 1995. These bailouts foster excessive risk-taking by emerging-market investors.

The Mexican bailout fostered a wild lending and investing binge in Southeast Asian nations. Their bailouts have, in turn, sent investors to Russia, Brazil, and Poland, making sure at each step of the way the emerging country was large enough to cause serious consternation at the US Treasury (Estonia and Lithuania clearly would not pass muster, because their failure does not put the world at risk).

As more and more investors learn of the opportunities of investing in high-yield securities (like Russian

ruble T-bills yielding 150%) underwritten by the International Monetary Fund, the World Bank, and the US Treasury, the stakes grow exponentially. The dangers to the world economy, too, are growing exponentially, because of the dead weight of billions and trillions of ill-invested dollars and because IMF conditionality is highly contractionary. Thus, in the wake of its most recent rescues, the IMF has been spreading austerity and depression – an unworkable recipe in a world where trade is imploding.

In the end, the bailout requirements will overwhelm the resources of the IMF and its industrial backers, who will no longer be able or willing to come to the rescue. At that point, the losses will be absolutely staggering.



nations, pegged as they were to the US dollar, enjoyed enormous competitive advantage during the period of the strong yen, in particular in the first half of the '90s. Trouble began to brew when the yen commenced its long descent from the rarefied  $\text{\$/¥}80$  rate in early 1995. By mid-1997, with the yen back to 125, the regionals had "lost" or given back 35% to 40% of their advantage. It was only a matter of time before some sort of equilibrium was reestablished.

The enormous inflow of short-term capital into the region postponed the necessary adjustment, financing an ever-larger current account deficit. When the inflow turned into outflow, the exchange rates of the regional currencies dived, way overshooting their tentative equilibrium. Without having to make repayments on the debt, and therefore without having to build a large surplus on current account, it would be reasonable to expect Southeast Asia/yen rates to be slightly more expensive than the 1995 lows. With the need to make enormous debt-service payments, however, the rates may have to settle at just under their lowest point for the decade. This is in fact what is happening. The currencies of nations that are making serious adjustment efforts, such as Korea and Thailand, have recovered in recent months from their panic lows and are settling at levels just below those prevailing in 1995. (See Charts 9 and 10.)

Australia and New Zealand, on the other hand, not burdened with extraordinary debt servicing efforts, may settle somewhere between their best and worst levels of the past decade (see Charts 7 and 8), effectively where they trade today.

Please note that this assessment does not take a view of the NZ\$/US\$ rate, because it considers the NZ\$/yen rate to be primary, and the former only secondary, or derived. To obtain the former, one would have to first forecast a US\$/yen

rate and then derive accordingly the NZ\$/US\$ rate.

What could go wrong with this medium-term scenario?

- First, a continuous and more severe fall in its terms of trade. Since a high proportion of New Zealand's export sector is in primary commodities, a large drop in world prices of wool, timber, dairy products, and meat products could worsen the trade deficit. Given our world economic outlook, this is a reasonable probability.
- Second, an early election that sees (quite) left-of-center Labor form a government. Such an event would have a negative impact on capital flows. At this moment, this outcome appears to have a better than 50% chance.

Against these bearish influences, one can name at least two positive and bullish influences:

- An accelerated fall of the yen as the banking crisis unravels or as the BOJ takes a more aggressive easing posture (a very good chance).
- A new coalition in power, featuring the ruling party and ACT, the libertarian party of the original guru, Roger Douglas (less than 50/50).

Weighting all these factors leaves us (and we really don't mean to be that precise, knowing full well that we are dealing with probabilities and otherwise imprecise notions) with an expected 6-month spot rate of 71-75 yen to the kiwi. Six-month NZ\$/¥ forwards, trading at approximately 70.60, favor, if ever so slightly, the purchase of kiwi vs. the sale of yen. Interesting, but still not enough to initiate a full-scale trade.

In conclusion, we would like overseas investors in the New Zealand dollar to focus their attention in the months ahead on the critical NZ\$/¥ rate to the exclusion of the trade-weighted measure, the meaningless Monetary Conditions Index, and the US\$/NZ\$ rate.

Chart 7

NZD/JPY

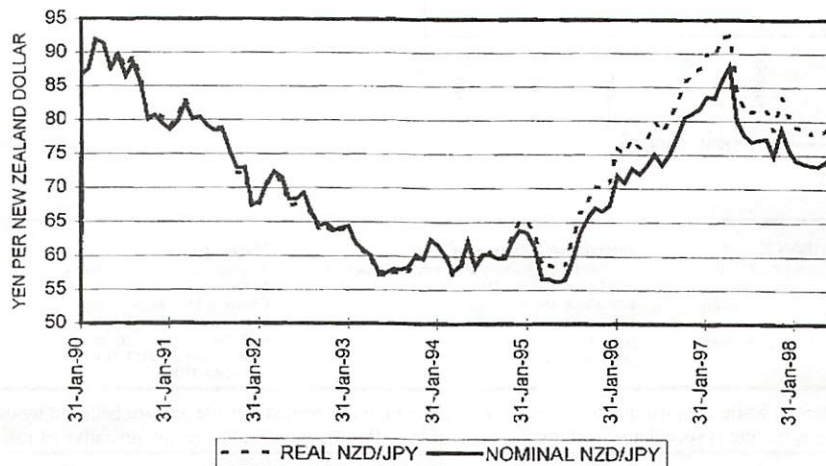


Chart 8 AUD/JPY

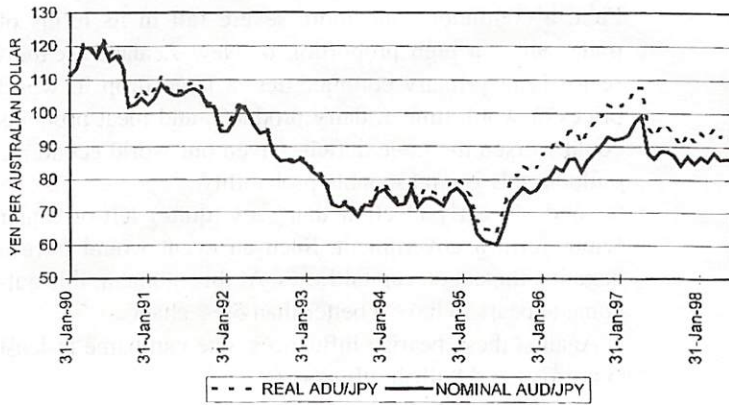


Chart 9 KRW/JPY

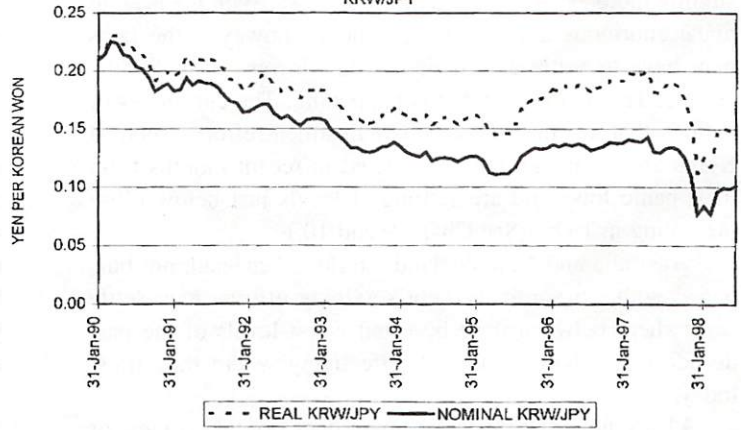
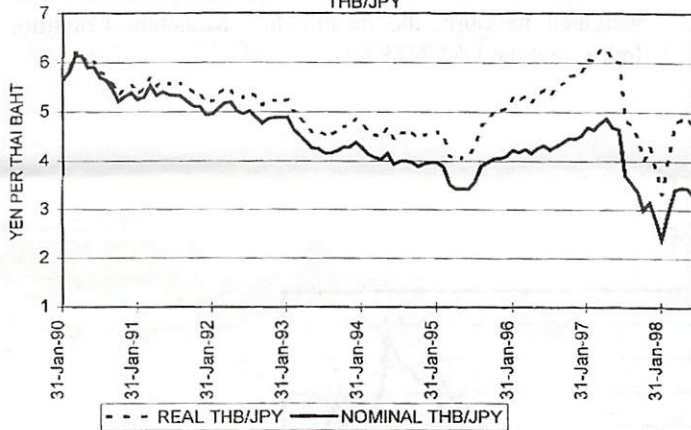


Chart 10 THB/JPY



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