

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

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## Let it fall, gently

All attempts to stave off the coming global depression will come to naught. Like a terminally ill patient, the best the G-7 and its associated institutions can do is to ease the pain, smoothing out the violent and recurrent spasms that will occur on the way to demise.

For well over one year, central bankers and international lending institutions misjudged the depth of the problem. There are now signs that the gravity of this economic crisis – the most ominous one since the '30s – is being perceived. In fact, a sense of quiet panic has begun to take a hold of policymakers around the major financial centers. Unfortunately, there is little or no agreement of what to do. The reason is simply that there still is no understanding of the true cause of the problem.

There is no great mystery. Easy money and credit lie at the root of the biggest speculative boom in recorded history. Easy money financed highly dubious projects. Easy money financed reckless securities and real estate speculation, here and abroad. Easy money lured naive investors to search for higher yields without taking notice of the attendant risks. Easy money allowed shrewd, well connected operators, working primarily with other people's money, to leverage imprudent financial bets to the point of absurdity.

The fatal policy error of easy money was compounded by yet another mistake: moral hazard. The too-big-to-fail doctrine gained increasing acceptance over the past 30 years. Its hazy beginning traces back to the bailouts of Chrysler, and Lockheed in the early and mid-'70s. It was invoked around the time of the failure of Continental Illinois Bank in 1984 and is widely thought to have been the motivation for the easy money policy of the early '90s (to bail out the US money center banks).

The doctrine came to its full blossom just a few short years later in the now famous "rescue" of Mexico. The Mexican bailout, as we pointed out at the time, was to underwrite the greatest and most reckless transfer of private resources in memory to the global periphery. The fallout from the Mexican rescue did not take long in coming. Just two years later, the Western powers saw themselves obligated to bail out creditors in Southeast Asia, lured there by the implicit guarantees signaled by the Mexican White Knights.

Significantly, every bailout involved progressively larger sums of money. This is not surprising because human nature

will continuously push and probe the limits of tolerance and forbearance, in much the same way a child will do with a permissive parent. The natural limits are the very size of the rescue package and the willingness of the debtor to endure some sacrifice in the servicing of the debts. In the case of Russia, the rescue was thankfully (and hopefully) aborted because the latter condition – the unwillingness of the debtor to demonstrate some semblance of debtor responsibility. We are rapidly approaching (although perhaps not rapidly enough) the limits imposed by the first constraint: the Brazilian cliffhanger may easily overwhelm the readily available resources of Western governments (which, incidentally, are still acting as if they need not be accountable to their legislative bodies and to their taxpayers).

It is easy to see that each one of these two policy errors by themselves – easy money and the bailout of bankrupts and imprudent creditors – has disastrous long-term consequences. The combination is leading to nothing less than an economic holocaust.

These comments do not come as a surprise to our readers, long accustomed to our rambling jeremiads. What is surprising is that Dr. Greenspan, of all people, has come to recognize and admit (?) the problem. Such is the media and Wall Street's myopia and their obsession with a rate cut that the true import of his comments to the House Banking

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Funny, the banks never mentioned it

Contributions by Albert D. Friedberg, Steve H. Hanke, and Holman W. Jenkins, Jr.

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

Committee on the 16th of this month was entirely missed (eliciting to our knowledge only one observation of note – an analyst who remarked that Greenspan had gone off into some abstruse comments about nineteenth century banking!). Following, we quote some of the more revealing passages of his prepared remarks:

"The key question is obviously how do private sector entities and governments and, by extension, economies as a whole allow themselves through currency mismatches to reach the edge of insolvency? Indeed, where was the appropriate due diligence on the part of foreign investors?"

"Investors will, on occasion, make misjudgments, and borrowers will, at times, misread their capabilities to service debt. When market prices and interest rates adjust promptly to evidence of such mistakes, the consequences of the mistakes are generally contained and, thus, rarely cumulate to pose significant systemic risk.

"There was some evidence of that process working in the latter part of the nineteenth century and early twentieth century when international capital flows were largely uninhibited. *Losses, however, in an environment where gold standard rules were tight and liquidity constrained were quickly reflected in rapid increases in interest rates and the cost of capital generally.* This tended to delimit the misuse of capital and its consequences. Imbalances were generally aborted before they got out of hand. But following WWI such tight restraints on economies were seen as too inflexible to meet the economic policy goals of the twentieth century. In the late twentieth century, however, fiat currency regimes have replaced the rigid automaticity of the gold standard in its heyday. *More elastic currencies and markets, arguably, are now less sensitive to and, hence, slower to contain the misallocation of capital.*" [Our emphasis is – Ed.]

The above comments about the "elasticity" of fiat currency regimes almost hits the nail on the head. Fiat currency regimes are "elastic" in the sense that they accommodate the demand for money. They are unable, even as they try, to "fix" the precise rate of interest that will equate genuine savings with demand for these savings. In short, fiat currency regimes are far more prone to cause severe bouts of booms and busts through alternating periods of easy and tight money than the good old gold standard, in much the same way as a socialist economy is far less efficient than a free market one. Price tampering leads to capital misallocation; fine-tuning interest rates is such a form of price tampering.

That was not all. Greenspan further touched upon the issue of moral hazard and how it came to play such a prominent role in the present crisis. He said, "The tendency to downplay the risks of lending in emerging markets, reinforced by the propensity of governments explicitly or implicitly to guarantee such investments in a number of cases, doubtless led to an excess of lending that would not have been supported in an earlier age."

There it is. One of the leading culprits of the coming economic collapse – and perhaps the leading one – has

admitted that an "elastic currency" (i.e., easy money) and the moral hazard created by "explicit and implicit government guarantees" created the preconditions for this crisis. And yet, in his most recent testimony, he was widely thought to have hinted at the possibility that, at its next meeting, the Federal Reserve may be forced to lower rates to pre-empt a serious, systemic breakdown! Why? Has the Fed Chairman become so scared that he would rather temporize than face the music now? Or does he not realize that an accommodative posture in the face of growing inflationary (yes, inflationary; see next article) pressures can only be taken to mean that the Fed wants to avoid a stock market drop – in effect, exacerbating the already serious, by his own admission, moral hazard problem? How many systemic risks can the authorities invent to justify an ever-increasing amount of intervention? Will the Fed be forced to lower rates the next time Citibank, Chase, or Merrill Lynch stand to lose \$200 million in reckless loans to go-go, heads-I-win tails-you-lose hedge funds, foreign gangsters, or rogue operators.

Every credit expansion is inevitably followed by a credit contraction that leaves in its wake bankruptcies, defaults, and depression. It is perhaps nature's way of reestablishing equilibrium. Tampering with this process, by, say, easing money and bailing out insolvent entities can only: a) prolong the agony, in the process sucking more innocent people into the maelstrom; b) waste valuable resources, pouring good money after bad money; c) transfer resources from law-abiding taxpayers to criminals (as an example, Russian "oligarchs") and greedy and unethical bankers (see for example the attached article by Holman Jenkins); d) diminish the capacity of democracies to withstand economic sacrifice as the crisis wears on, producing demands for protectionism, minimum wages, and other forms of damaging governmental intervention; and e) continue to encourage reckless lending and investing.

In the following article, we will make the case that the Fed is slowly but inevitably losing room to maneuver, a favorable circumstance. In the interim, however, a great deal of damage can still be inflicted. Moreover there are other White Knights waiting in the wings – some more constrained, some less – ready to do incalculable damage.

What can be done to help us overcome as quickly as possible the inevitable contraction and help set the foundations for a healthy and lasting recovery? Specifically, what should the Fed, the Treasury, the IMF, and the G-7 ministers do?

- Ignore the stock market, just as they ignored it on the way up, fueling the insane bull market.
- Allow lenders and speculators who have made poor decisions to fall, regardless of their size. In other words, disavow explicitly and resolutely, the doctrine of too-big-to-fail. Protect only innocent bystanders, those that did not attempt to earn a profit by following imprudent behavior (such as for example checking account depositors in uninsured systems).

- Allow emerging countries to renegotiate and reschedule with their private creditors under the their implicit threat of default. Allow defaults. They are private matters.
- Combat illiquidity, not insolvency: Lend to banks freely and frequently, but only against good collateral. Mop up excess liquidity, leaving money supply unchanged.  
Reform the present fiat currency regime (one good way

to start is to abolish central banks – no joke). Finally, as the recession sets in, cut one dollar of government expenditures for every two dollars of taxes.

We cannot, and ought not to resist the developing credit contraction. The powers that be can only minimize the pain in an intelligent and nondiscriminatory manner. They must let it fall, gently.

Chart 1

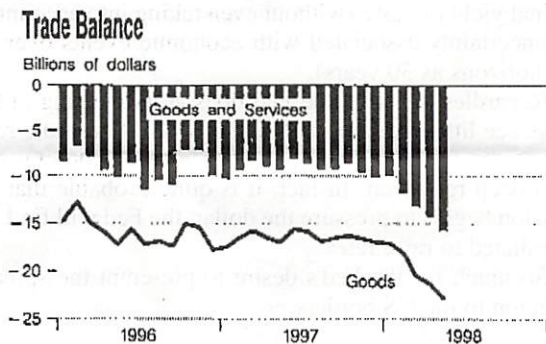


Chart 2

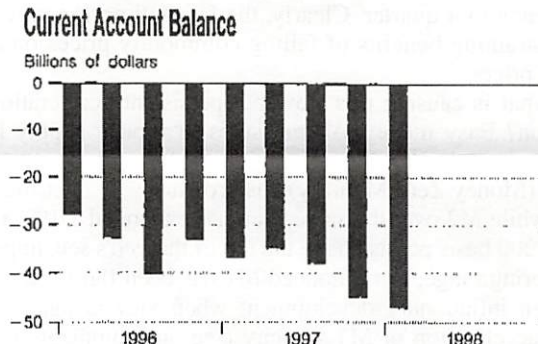


Chart 3

Journal of Commerce – Industrial Price Index

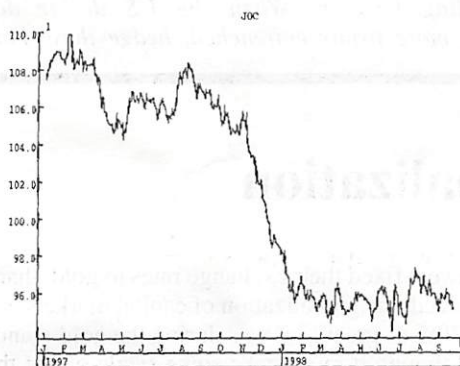
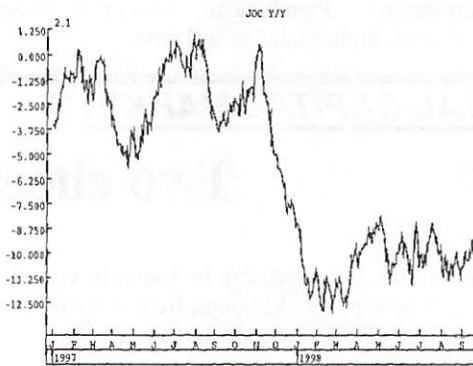


Chart 4



## US MONETARY POLICY

### Losing room to maneuver

As strange as it may seem, the US Federal Reserve does not have all that much room to maneuver, i.e. ease rates, even if it thought it was absolutely necessary to do so (which, of course, we do not).

For one thing, the US dollar has already come under some pressure in recent weeks, dropping 6% in trade-weighted terms since Aug. 26, 1998. More importantly, it has fallen in this same period 7.61% against the currencies constituting the soon-to-be-launched Euro, recording this past Friday a 17-month low. US inflation has benefited mightily from the 14% rise in the dollar's trade-weighted value in the past year; without it, inflation would have been much higher given the prevailing boom conditions.

It should be remembered that a fixed, and even more a

rising, dollar is a restraining influence on inflation at the expense, of course, of a widening trade and current account deficit given inflationary monetary policies (certainly the case, as we shall soon see). Charts 1 and 2 clearly show a progressive deterioration in both the trade and the current balance, a phenomenon that can be primarily attributed to domestic inflationary pressures. In the future, a weakening dollar will help close these deficits but at the expense of accelerating inflation.

Secondly, US core inflation (consumer prices ex the volatile energy and food components) has accelerated to 2.5% this year from 2.2% last year, despite one of the most dramatic falls in commodity prices in recorded history. Our studies indicate that falling commodity prices, measured on a year-over-year basis, are a powerful restraining force on ever

upward-creeping consumer prices. Chart 3 shows that the nadir of the downside momentum curve in industrial commodity prices occurred as far back as the first quarter of 1998, easily explaining the subdued rise in CPI of only 0.1% for that period. Since then, the quarterly reading has risen to 0.5% for the unadjusted CPI and 0.7% for the core measure, exceeding and matching, respectively, year-ago levels. Even if commodity prices continue to fall, a reasonable conclusion on the assumption of a deep global recession, momentum is unlikely to see the -12.5% year-over-year fall registered in this year's first quarter. Clearly, the US will no longer enjoy the restraining benefits of falling commodity prices on consumer prices.

What is causing this slow but persistent acceleration of inflation? Easy money. All measures of money supply have exceeded prudential rates of expansion for quite some time: MZM (Money Zero Maturity) has grown 11.3% over the past year, while M2 over the same span has expanded 7.1%, a rate that is 200 basis points above the top of the Fed's self-imposed monitoring range. Little-noticed M1 has been flat for the past year, an inflationary development when viewed against the sharp acceleration of M1 velocity (see our comments in our February 1998 issue) in recent years. Assuming real economic growth of 3% over the coming 2 years, these money measures spell inflation rates of close to 4%, a substantial acceleration from the present pace. Paradoxically, lower rates of economic growth spell even higher rates of inflation.

Accelerating inflation in the US over the next 24 months is possibly the least expected economic event in anyone's mind. Proof of it is the pricing of the 30-year Treasury bond, now yielding an absurdly low 5.12%. Here is a quick test; inflation-linked Treasuries with similar maturity yield 3.8%. The difference between 5.12% and 3.8% – specifically 1.32 percentage points – is the market's inflation expectation for the next 30 years! As we pointed out earlier, core inflation is still running at 2.5%, even after the most savage commodity bear market in recent memory, which suggests a rock bottom nominal yield of 6.3% (without even taking into account normal uncertainty associated with economic events over such long horizons as 30 years).

Regardless of what the Fed does at its meeting of Sept. 29, we see little likelihood of subsequent interest rate reductions in the following months, even as the economy slides into a deep recession. In fact, it is quite probable that once recession begins to pressure the dollar, the Fed will find itself necessitated to raise rates.

So much for the Fed's desire to pre-empt the spread of contagion to the US borders.

**STRATEGY:** *Only belief in the Greater Fool Theory could justify the purchase of long-term nominal interest rate Treasuries. Conversely, inflation-linked Treasuries are an outstanding bargain. When the US dollar downtrend becomes more firmly entrenched, hedge these bonds back*

## GLOBAL CAPITAL MARKETS

# Two cheers for globalization

by Steve H. Hanke

Globalization, the "G" word, can be found in virtually every magazine and newspaper. Although frequently used, the "G" word is rarely defined. Indeed, its true meaning is usually buried under polemics.

Globalization, or market integration, results from freer trade in goods, services, and capital. The degree of globalization in the markets for goods and services can be measured by the ratio of the country's international trade to its GDP. Capital market integration can be measured, too. A country's current account balance is the difference between its domestic savings and investment. If the balance is positive, some of a country's savings are invested abroad, and if the balance is negative, some of its domestic investment is financed by foreigners' savings. To measure the degree of capital market integration, the plus and minus signs on a country's current account balance must be erased and then the ratio of absolute value of the current account to GDP should be computed.

One aspect of globalization that has aroused the international chattering classes concerns the integration of capital markets. This, they claim, has allowed for large, volatile capital flows, which have sparked financial crises.

Just how integrated have the capital markets become? Most of the pundits imply that the globalization of capital markets has reached heights never before attained. This is not the case, however. Capital markets were more integrated during the classical gold standard period (1870-1913), when the

major powers fixed their exchange rates to gold, than they are today. Indeed, the globalization of capital markets is still only roughly 70% as great as it was during the gold-standard period. Even though it might take some sizzle out of their globalization stories, the pundits should look at the numbers and attempt to put present developments into perspective.

When this is done, we can give two cheers for globalization, particularly since the freer movement of capital internationally is beneficial. It allows for savings to be channeled into the investments that yield the highest prospective risk-adjusted rates of return. This benefits investors, because they can obtain higher rates of return on their savings and so at lower risks because they can pool risks by diversifying their investment portfolios internationally. It also benefits countries that import capital, because they can grow more rapidly than if they were dependent solely on domestic savings. In particular, developing countries with low capital-to-labor ratios stand to benefit from the globalization of capital markets. Globalization of these markets also introduces a discipline on policymakers, because local capital is no longer held captive and exploited by politicians. Indeed, policymakers must "do the right thing" if their countries are to compete successfully in integrated capital markets.

This brings us to the contemporary debate about potential downside of capital market globalization. Many argue that the benefits of globalization are not worth the costs

because capital market integration creates large, volatile capital flows, and these cause financial crises. This line of argument misses the point. While globalization might be a proximate cause of financial crises, it is not the ultimate cause. Indeed, the ultimate cause is faulty exchange-rate regimes.

There are three types of exchange-rate regimes: floating, fixed, and pegged rates. Each type has different characteristics and generates different results (see Chart 5). Although floating and fixed rates appear to be dissimilar, they are members of the same family. Both are free-market mechanisms for international payments. With a floating rate, a monetary authority sets a monetary policy, but has no exchange-rate policy – the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a monetary authority. Whereas, with a fixed rate, a monetary authority sets the exchange rate, but has no monetary policy – monetary policy is on autopilot. In consequence, under a fixed-rate regime, the monetary base is determined by the balance of payments. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa.

With both floating and fixed exchange-rate mechanisms, there cannot be conflicts between exchange-rate and monetary policies, and balance of payments crises cannot rear their ugly heads. Indeed, under floating and fixed-rate regimes, market forces act to automatically rebalance financial flows and avert balance of payments crises. While both floating and fixed-rate regimes are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries, because these countries usually have weak monetary authorities and histories of monetary instability.

Fixed and pegged rates appear to be the same. However, they are fundamentally different. Pegged rates are not free-market mechanisms for international payments. Pegged rates require a monetary authority to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components.

Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange rate and monetary policies. For example, when capital inflows become "excessive" under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. And when outflows become "excessive," an authority attempts to offset the decrease in the foreign component with an increase in the domestic component of the monetary base.

Balance of payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it's only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies and force a devaluation. This is what happened in Europe's Exchange Rate Mechanism in 1992 and 1993, and in Mexico and Turkey in 1994. It is also exactly what happened during the summer of 1997 in Thailand and in the other Asian countries with pegged exchange rates, and most recently in Russia.

Pegged exchange rates are the ultimate cause of the recent financial crises. Indeed, every major financial crisis in

the 1990s has been set in motion by currency crises in countries with pegged exchange rates. In the past, the inherent flaws of pegged rates were often concealed by exchange and capital controls. But with the liberalization of capital markets and increased globalization, the flaws of the pegged systems have been unmasked and exposed to market discipline.

What does the future hold? One group advocates turning back the clock on globalization by introducing capital controls to protect exchange-rate regimes. The other group advocates the continued liberalization of capital markets and the scrapping of pegged rates. At present, the latter group, although under threat, still has the upper hand. Indeed, Europe will abandon pegged rates (ERM) on Jan. 1, 1999, when the EU-11 irrevocably fix their exchange rates and form a unified currency area. This promises to be one of the biggest monetary events of the century, and will motivate many emerging market countries to unify their currencies with a strong anchor currency via currency boards and fixed exchange rates, as did Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia (1998).

As we enter the 21st century, the globalization of capital markets will continue to accelerate. This promises to change the world's currency geography dramatically, with more currencies in Europe becoming unified with the Euro and more currencies in the Americas become unified with the US dollar. Consequently, there will be at least two large unified currency areas: the Euro and the dollar blocs.

How will the countries in the Mercosur fit into the world's new currency geography? There are two ways in which the countries in Mercosur could unify their currencies with the dollar and become part of the dollar bloc. The first method would be for the members of Mercosur to do what Argentina did in April 1991, when it established a currency board and unified the peso with the dollar. Under this method, each country in Mercosur would retain its own national currency, and each currency would be unified with the dollar bloc via a separate currency board. Consequently, each country would give up its monetary policy sovereignty while retaining its political sovereignty.

The second method would be more ambitious, because it would require each country to yield both monetary policy and political sovereignty. Each member of Mercosur would join in a Mercosur-wide monetary union, with one common currency and no individual national currencies. To unify this new Mercosur currency with the dollar, the Mercosur monetary authority would have to operate as a currency board.

President Carlos Menem proposed a Mercosur monetary union in January 1998 at the World Economic Forum meetings in Davos. However, a study by Brazil's Banco Nacional de Desenvolvimento Economico e Social (BNDES) concluded that the Mercosur countries would not be ready for a full-blown monetary union for another 15 years. This suggests that the countries in Mercosur will probably retain their unique national currencies and unify each national currency with the dollar via a currency board. This would eliminate the need to have a formal Mercosur monetary union.

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Chart 5

Exchange Rate Regimes					
Type of regime	Exchange rate policy	Monetary policy	Source of Monetary Base	Conflict between exchange rate and monetary policy	Balance of payments crisis
Floating rate (1)	No	Yes	Domestic	No	No
Fixed rate (2)	Yes	No	Foreign	No	No
Pegged rate (3)	Yes	Yes	Domestic and foreign	Yes	Yes

Notes:

1. Floating rates are employed in developed countries.
2. Fixed rates are employed in several developed countries or regions: Hong Kong (1983), Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia (1998).
3. Pegged rates are employed in most developing countries and also among the countries that are member so Europe's Exchange Rate Mechanism.

Source: Steve H. Hanke. "How to Establish Monetary Stability in Asia," *The Cato Journal*, Vol. 17, No. 3, Winter 1998 (a).

## CURRENT COIN

# The siren song of exchange controls

by Steve H. Hanke

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Paul Krugman, professor of economics at MIT, recently completed an Asian tour during which he sang the praises of exchange controls. Asian leaders should be wary of his flawed advice.

Currency convertibility is a simple concept. Essentially it means residents and nonresidents are able to exchange domestic currency for foreign currency. However, there are many degrees of convertibility, with each denoting the extent to which governments impose controls on the exchange and use of currency.

The idea of exchange controls can be traced back to Plato, the father of statism. Inspired by Sparta, Plato embraced the idea of an inconvertible currency as a means to preserve the autonomy of the state from outside interference. It's no wonder that the so-called Red-Brown (communist-fascist) coalition in the Russian Duma has, in recent weeks, rallied around the idea of exchange controls and an inconvertible ruble. This also explains why the leadership in Beijing finds the idea so user-friendly.

The temptation to turn to exchange controls in the face of disruption caused by "hot money" flows is hardly new. Tsar Nicholas II first pioneered limitations of convertibility in modern times, ordering the State Bank of Russia to introduce in 1905-06 a limited form of exchange control to discourage speculative purchases of foreign exchange. The bank did so by refusing to sell foreign exchange, except where it could be shown that it was required for imports; otherwise, foreign exchange was limited to 50,000 German marks per person. The tsar's rationale for exchange controls was to limit

hot money flows, so that foreign reserves and the exchange rate could be maintained. The more things change, the more they remain the same.

But before Asia's politicians come under the spell of exchange controls, they should ponder the following footnote in Nobelist Friedrich von Hayek's 1944 classic, *The Road to Serfdom*: "The extent of the control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges. Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty. It is in fact the complete delivery of the individual to the tyranny of the state, the final suppression of all means of escape not merely for the rich, but for everybody."

Hayek's message about convertibility has regrettably been overlooked by many contemporary economists. Exchange controls are nothing more than a ring fence within which governments can expropriate their subjects' property. Open exchange and capital markets in fact protect the individual from exactions because governments must reckon with the possibility of capital flight.

From this it follows that the imposition of exchange controls leads to an instantaneous reduction in the wealth of the country, because all assets are worth less. To see why, let's review how assets are priced.

The value of any asset is the sum of the expected future installments of income it generates, discounted to the present value. For example, the price of a stock represents the value to the investor now of his share of the company's future profits, where issued as dividends or reinvested, stretching out over time. The present value of future income is calculated using an appropriate interest rate that is adjusted for the various risks that the income may not materialize.

When convertibility is restricted, risk increases, and so the risk-adjusted interest rate employed to value assets is higher than it would be with full convertibility. That's because property is held hostage and subject to a potential ransom through expropriation. As a result, investors are willing to pay less for each dollar of prospective income and the value of property is less than it would be with full convertibility.

This, incidentally, is the case even when convertibility is allowed for profit remittances. With less than full convertibility, there is still a danger the government will confiscate property without compensation. This explains why foreign investors are less willing to invest new money in a country with such controls, even with guarantees on profit remittances.

So investors become justifiably nervous when it seems a government is considering imposition of exchange controls. At that point, settled money becomes "hot," and capital flight occurs. Asset owners liquidate their property and get out while the getting is good. Contrary to popular wisdom, restrictions on convertibility do not retard capital flight, they promote it.

This type of capital flight (and dollarization) has been occurring on a grand scale in capital-starved Russia. Indeed,

Russians swapped \$13 billion worth of rubles for greenbacks in 1997, a year in which the dollar-ruble rate was stable and inflation was falling rapidly. This dollarization amounted to a capital export that exceeded all capital imports to Russia that year. Clearly, the Russians have better memories than the IMF technocrats. The actions of the Russian people in 1997 indicate that they anticipated the great Duma exchange control debate of 1998.

Restrictions on convertibility also promote other noxious activities. For example, if capital account convertibility is restricted or limited and convertibility on the current account is allowed, a two-tier currency market will be either formally or informally established. In that case, the "investment currency" will trade at a premium over the price of the relevant foreign currency on the official market for current account transactions. With two prices of the same currency, there are profits to be derived from having capital account transactions "reclassified" as current account transactions. That ad hoc reclassification can usually be bought by crony capitalists, for a price.

Full convertibility is the only guarantee that protects people's right to what belongs to them. Even if governments are not compelled by arguments on the grounds of freedom, the prospect of seeing every asset in the country suddenly lose value as a result of exchange controls should give them pause.

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## **OBSERVER**

# Russia a deadbeat? Funny, the banks never mentioned it

*by Holman W. Jenkins, Jr.*

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Now that Russia has defaulted on its debt to big domestic and foreign banks, finally the dog is wagging the tail again.

As per always, there has been huffing and puffing among the big boys of international finance about how "those guys" can forget ever coming back to the market. "Their" credit is shot. Whom these pronouns might refer to is problematic. It can't be the Russian people, since lenders never had any dealings with the Russian people. And whether it's the same or different faces at the top of the Russian hierarchy, once somebody emerges with hands on the nation's cash flow, lenders can be counted on to return.

But some big players have been burned in Russia, people like George Soros and his Quantum Fund, out \$2 billion, and Credit Suisse First Boston, out \$250 million. They kept

pouring cash in, wagering that the IMF or somebody would come up with money – and keep coming up with money – to save the Yeltsin government from insolvency.

That idea has now been shown to be wrong. Should this realization take hold of men's minds, we could all be less ambivalent about the advance of global markets. Lenders would become less giddy to lend. Borrowers would find it harder to run up unsustainable debts.

But where did investors get these misguided ideas in the first place? One place might have been Goldman Sachs. In June, the Russian stock market was collapsing, the ruble was under siege, when we opened our paper to find Russia had miraculously pulled \$1.25 billion out of a hat, thanks to a bond sale put together overnight by Goldman.

The firm threw a glamorous party at a Moscow landmark, with George Bush in attendance, to formalize its triumphant return to the market. Four years earlier, Goldman had abandoned Moscow out of "fear that its reputation could be tarnished in Russia," as *Institutional Investor* magazine said at the time.

Now Goldman was back. Its most notable alum was Treasury Secretary Robert Rubin. This was surely a sign that Russia was too big to fail. The bonds sold out in less than an hour. Conveniently the proceeds retired a \$500 million bridge loan made by Goldman and Deutsche Bank from their own funds.

Oops. Today the buyers of the bonds are sharing in the estimated \$40 billion in losses on Russia's defaulted debt, while a Goldman spokesman snappishly told reporters last week that its own losses were "absolutely minimal."

We shouldn't pick on Goldman Sachs. First Boston was the most committed of all, in a single year earning half its global profits in the Russian market. Yet last week, Andrew Ipkendanz, its global head of emerging markets, let slip the truth about reform: "Russian elites have plundered the country's capital and funneled most of the proceeds offshore."

Now he tells us.

It was once said that the only thing worse than being exploited by capitalists is not being exploited by them. Banks like Goldman and CSFB are supposed to be the gatekeeper, making sure financing goes only to those who will employ it well. Did the fact that Russia was drowning in cronyism and capital flight figure in any prospectuses?

Its reforms were a sham. Its mass privatization was a lie. The public got worthless paper, and a handful of oligarchs got the valuable mineral and media resources. Seven years after the Soviet collapse, the land remains in thrall to the collectives. The country survives on food imports and whatever vegetables Russians can grow in their gardens.

By the middle of last year, the trade publication *Global Finance* was reporting capital flight of \$2 billion a month, a total of \$150 billion since Russia was born, in return for foreign investment of a piddling \$6.5 billion.

Goldman can spin its motives any way it wants. When the firm started advertising its plan to return last year, the only conspicuous opportunity in Russia was the accelerated looting of the state by seven politically manipulative empire builders, known as the "seven boyars."

Vladimir Potanin, a banker and government official, had

engineered the so-called loans-for-shares scheme, by which he and the chosen few walked off with most of the country's oil, minerals, and factories for a minuscule fraction of their true value. Had they paid a reasonable price, at least they would have been under pressure to upgrade the companies in order to generate a return on their investment. Now they collect state subsidies and let their holdings decay, while scrambling to amass more stolen properties.

No wonder many of the deals Goldman has touched since its return seem only to have left smudges and dents on its valued reputation.

Its bond offering for Gazprom, the ex-Soviet gas monopoly and tax cheat, sparked a revolt in the US Senate because of Gazprom's dealings with Iran. Its merger of two crony-owned oil producers, Yukos and Sibneft, turned into mystery meat for six months before being canceled. Its \$500 million bank loan for Yukos went into technical default in April, then was repackaged by Goldman and dumped off on investors just before the meltdown.

Its work on the sale of another oil company, Eastern Oil, ended with Western minority shareholders complaining that their new Russian parent was robbing them by paying lowball prices for their oil. Amoco is howling about a broken development agreement. Like most energy deals in Russia these days, Goldman's only seems to help the kleptocrats tighten their control while avoiding Western ownership or accountability.

Now there are grumbles about the bond deals it did for the Russian government just before the Russians stopped honoring their debts.

The losers were all grown-ups so we'll save the tears. But the promise of global capitalism is not being fulfilled. Goldman, First Boston and the like have sold themselves a bill of goods, believing that if they kowtow early enough in places like Moscow and Beijing, their "loyalty" will be remembered at some later date.

Goldman's hastiness seems especially odd given its imminent plan to float shares to the US public. Just as there will always be lenders, there will always be borrowers. These banks can afford patience – and might show some if certain no more bailouts were forthcoming. Far from being the end of the world, Russia declaring bankruptcy is a reasonable way of sharing the costs between lender and borrower of their common blunder. Maybe the gatekeepers of global capitalism will do their jobs right next time.

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