

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 20, No. 1 January 31, 1999

The great monetary debate *over* Japan

What it means for Japanese interest rates and the yen

Stacked on one side are prominent Western economists, the likes of Paul Krugman, Milton Friedman, and John Greenwood, all advocating a sizeable monetary reflation as a way out of Japan's recession/deflation. Stacked on the other, the governors and staff of the Bank of Japan and the unsinkable Mr. Yen, Eisuke Sakakibara, calmly rejecting the ever more strident calls for aggressive quantitative targets.

Who is right, and who is wrong? Can both be right? Wrong? Can we decide *a priori*, or must we wait to see what actually transpires?

Following, we offer our modest two cents' worth to this great monetary controversy, not in the hope of showing our prowess (the Lord knows, we cynically add, that this has never been our intent) but rather in the hope of extracting an "excess return." In muddy waters, says a well known Spanish refrain, fishermen are the winners.

To prescribe a solution properly, we must first diagnose the problem. It is widely acknowledged that Japan's sorry economic condition today is the result of the bursting of the Great Monetary and Asset Bubble of the '80s – a bursting process that was not and has not, as yet, been allowed to proceed in its most natural way. The misguided credit expansion of the last decade, partly the result of a mistaken foreign exchange policy, saw banks extend hundreds of billions of dollars to finance reckless land and securities speculation. This credit binge misallocated resources, creating enormous economic distortions.

The losses have been there for everyone (or almost everyone, but surely for the governmental agencies and in particular the Ministry of Finance) to see, but tragically, the powers-that-be, in an attempt to protect the banks, saw no evil. Ten years of extreme forbearance, now coming to an end, allowed the banks to hold back from biting the bullet. Credit inflation was never followed by credit *deflation*, its natural and healing sequel: Land and security prices remained too high, bankrupt deadbeats remained alive. Economic imbalances restrained consumption and unne-

essarily raised savings, the wheels of commerce came to a standstill. Asset price imbalances created idle resources in much the same way as artificially high wages create unemployment. *Therein lies the real problem: Japan has as yet to experience sufficient asset price deflation.*

There will be those who fear that asset price deflation – the forced and massive liquidation of bad loans – will aggravate the present deflation. This is the equivalent of saying that the collapse of the price of oil or of computer chips causes deflation, which is of course nonsense. In a smooth-running economy, relative price changes do not affect the overall price level. Instead, they help the economy to function more efficiently, allocating resources to their most productive destination.

If our diagnosis is correct, it is foolish to argue that Japan needs another round of credit inflation when it is precisely the opposite that is required. Viewed in this light, even the "modest" 3.5%-4% broad money supply annual expansion preferred by the Bank of Japan is excessive. The monetarists, tub-thumping for aggressive monetization, are wrong. What is more, the banks need to liquidate more loans and sell more assets; they need to rebuild their tattered and illiquid balance sheets, not to be forced to lend

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

more money, as the Japanese authorities demand. The more modest monetarists, those at the helm of the Bank of Japan, are less wrong than their Western counterparts.

We now consider the fiscal problem. In an attempt to revive their moribund economy, the Japanese government has legislated fiscal deficits of gargantuan proportions (10%-13% of GDP) for as far as the eye can see. By the year 2003, Moody's estimates that Japan's gross debt will equal 140% of GDP, a level "far in excess of anything ever seen in an industrialized country," according to Moody's managing director.

This is of course a bit of an exaggeration: Net debt will not come to even half of this amount. Italy and Belgium, with far less stable governments, have lived and prospered with debt burdens that closely approximate this level. The estimates are highly sensitive to projected growth rates (and they are mostly pessimistic), and so on.

We want to make it clear that we are not advocates of fiscal reflation, and surely not on the scale and on the manner adopted (lots of pork barrel and senseless expenditures). Yet it should be noted that *half or slightly more than half* of the contemplated ¥120 trillion increase in the debt to the year 2003 is constituted by the socialization of the bank loan losses, i.e., the recapitalization of the banks and deposit insurance. The value of bad loans at Japanese banks for which the government would likely have to take responsibility could total as much as 20% of GDP, compared with the almost insignificant 2% cost borne by the US government during the S&L crisis in the early '90s.

This exchange of government debt for doubtful claims on banks produces two benefits: It cleans up the clogged up arteries of the dying banking system, improving the eventual resumption of its credit intermediation activities; and it increases public confidence. This is clearly positive. Another substantial portion of the increase in the public debt goes to finance tax cuts on income. This, too, is positive.

The critics of fiscal reflation have argued that fiscal reflation without monetary accommodation is ineffective primarily because fiscal deficits of such large magnitudes are confidence-sapping, because ultimately they must be repaid via increased taxes. This forces consumers to save (the Ricardian equivalence theorem), which in turn negates the fiscal stimulus.

The monetary accommodation of fiscal deficits implies below-market interest rates and a fresh impetus to credit expansion, a path rejected by the Bank of Japan, as we have seen. What is more, such a manipulation of interest rates, and the concomitant concealment of the true costs of the banking bailout and deficit spending in general, should be inimical to any free-marketeer, much less to our illustrious monetarists.

Fortunately, and surprisingly, the Bank of Japan has acquiesced in the dramatic rise of interest rates that followed its partial withdrawal from the government market. The independent central bank and its courageous governor have begun to flex their muscle, opting for transparency and realism.

What about the argument that consumers, frightened by future taxes (to pay off the larger public debt), will retrench and thus offset the stimulatory impact of the deficit? This is a powerful argument, all else being equal. But not all else is equal, as we have seen. To the extent that new government debt takes the place of claims on banks of doubtful value, it restores rather than saps consumer confidence. If so, this fiscal reflation, undertaken as much for practical reasons as for its Keynesian promise, stands a fair chance of providing meaningful support to the economy, while it painfully sheds the legacy of the last boom.

In conclusion, the Bank of Japan, traumatized by the credit and asset bubble of the '80s, has resisted the temptation to monetize, and for good reason. (For much the same reason, historians like to attribute the Bundesbank's penchant for hard money to the trauma caused by the hyperinflation of the '20s.) The modest pace of monetary expansion will assure that Japan does not "spiral into a deflationary vortex," as the monetarists like to dramatize.

The substantial bank safety net will restore consumer confidence over time and, as importantly, will encourage the new and tougher regulators to close and liquidate insolvent institutions without the fear of setting off a bank run. This we already saw with the nationalization of Nippon Credit Bank, an event that sounded the death knell of the old and pernicious convoy system that protected bankrupt banks.

More is on the way before the fiscal year is out. Interest rates will be allowed to find their own, *higher* level. It is eminently reasonable to expect 10-year government debt to trade down to yield between 3% and 4%. As interest rates differentials narrow vis à vis the euro area and the US, and as monetary expansion remains relatively subdued vis à vis its trading partners, the yen will rise. A freer government bond market (we note that even Financing Bills will no longer be sold directly to the Bank of Japan; instead they will be sold to the market, encouraging an active secondary market) will help internationalize the yen – just when the euro and the US dollar, each for its own reasons, enter a depreciating cycle. This, too, will help the yen.

In short, steady as she goes combined with a good dosage of realism and patience will restore the patient's health. Kudos to the brave, new Bank of Japan.

Chart 1

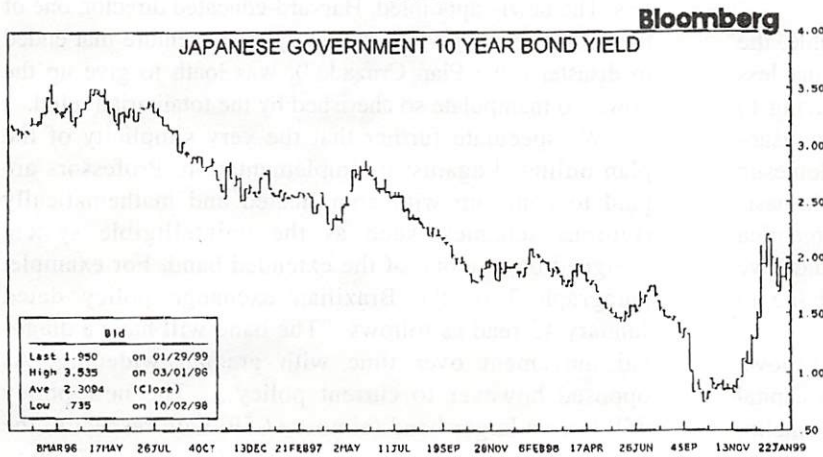


Chart 2 - \$/Yen



BRAZIL

The wages of sin and folly

Brazil finally succumbed to the onslaught of market forces, as predicted here less than eight weeks ago.

This is a tale of two tragedies. The first was that Brazil did not heed the early warning sounded at the height of the Asian crisis, over 15 months ago. There was still enough time to have taken dramatic fiscal measures, mostly, as we pointed out in our last issue, on the spending side. Instead, Brazil relied on monetary policy, hoisting rates to unsustainable levels – in the context of its bloated domestic debt. The fabulously successful Telebras privatization temporarily covered up the less-than-credible monetary defense. But not for long. Holes in the fiscal dike were uncovered with every passing day, Minas Gerais' moratorium being merely the apparent cause of a fated outcome.

The second tragedy has to do with the central bank's refusal to adopt a currency board. As we demonstrated in our last issue, Brazil's net international reserves were more than sufficient to "cover" its monetary base, the prerequisite for a

solid currency board arrangement and, in fact, one that compared rather favorably – given its amplexity – with the ones operating in Bulgaria, Estonia, and even Argentina. Instead, the Bank opted first for a wider band and later for a dirty float.

Before it had a chance to catch its own breath, the *real* had collapsed more than 40%. Putting up a brave face, the Bank explained that a free float was going to allow interest rates to fall, which after all was the main problem. This was not to be. Overnight interest rates, guided by the central bank, have risen to 35.5% from 29% before the devaluation. Futures markets indicate that rates will rise to 51% by March. Ironically, these interest rates evidence strong expectations of further devaluation.

To appreciate this grand folly, one need see only that the market had been expecting a devaluation IN the order of only 20%-25%, a magnitude that can be approximated by comparing interest rates on government debt denominated in local currency with interest rates on its external dollar debts

(so as to eliminate the country-risk component).

Since currency boards are *financially* impregnable, the central bank had an opportunity to devalue somewhat less than the market's expectation, say 20%, without having to worry about a second attack on its currency. With the disappearance of expectations of a further devaluation, domestic interest rates would have fallen to within perhaps 200 basis points of those prevailing on dollar debt (using the Argentina example), or to +/-17%. This fall in interest rates would have represented an enormous benefit to the Treasury, solving all by itself the problem of the fiscal deficit.

One could speculate further on the virtue of such a move, postulating the return of foreign funds to Brazilian capital markets, the favorable impact on confidence, and the amelioration of the recession. Finally, one could have expected a further tightening of sovereign risk, causing interest rates to fall to the 8%-11% level.

Why did the Bank reject a currency board? While we may never know for sure, we suspect that there were two factors at work: a) the IMF's disdain for currency boards, in itself a mystery, and b) the pride of the Bank's staff, refusing to relinquish control – and sovereignty – over monetary mat-

ters. The newly appointed, Harvard-educated director, one of the authors of a previous monetary misadventure that ended in disaster ("the Plan Cruzado"), was loath to give up the power to manipulate so cherished by the totalitarian mind.

We speculate further that the very simplicity of the plan militated against its implementation: Professors are paid to come up with complicated and mathematically rigorous schemes, such as the unintelligible system designed on day one of the extended band. For example, paragraph 3 of the Brazilian exchange policy dated January 13 read as follows: "The band will have a diagonal movement over time with gradual widening. As opposed however to current policy.... The new policy will have a larger band (almost +/-5% with respect to the center) with less diagonal movement (around 2.7% annual rate on the ceiling). This means that the interest rate needed to defend the band can be, *ceteris paribus*, substantially reduced." (We can only hope that the message was clearer in the Portuguese language.)

Having been dealt a devaluation twice as large as expected, we gladly accept profits. As for Brazil, however, we doubt that its troubles are over.

CURRENCY CRISIS

Reflections on the world's currency geography and dollarization

By Steve H. Hanke

The dramatic events in Asia, Russia, and Brazil during the past year have generated a torrent of commentary about exchange rates, hot money, exchange controls, and dollarization. Unfortunately, most of the commentary has been either half-baked or dead wrong.

The wags in Washington misdiagnosed the patients and prescribed the wrong medicine in Asia, Russia, and Brazil. But that hasn't stopped the Doctors of Rotational Medicine from spinning a different story, one that is contradicted by the facts. Just last week, US Deputy Treasury Secretary Lawrence Summers said that "the financial turmoil that has affected Asia, Russia, and Brazil in the past year would have been worse without the IMF."

The world's changing currency landscape

To put my reflections into perspective, it is instructive to consider recent changes in the world's currency landscape. Its morphology has been in a state of flux during the decade of the 1990s. Volatile hot money flows have battered pegged exchange rate regimes, causing volcanic eruptions in the European Exchange Rate Mechanism (1992 and

1993), the Turkish lira (1994), the Mexican peso (1994-95), the Thai baht and the other Asian currencies (1997-98), the Russian ruble (1998), and the Brazilian *real* (1999).

Balkanization has also been a prominent force in the 1990s. With the collapse of the Soviet Union, a large unified currency area was dismembered. In consequence, 15 national currencies officially circulate where the ruble once ruled the roost. Much of the same occurred after Yugoslavia broke apart. Now five currencies circulate as legal tender in a region where one currency used to do the job.

The last time currency balkanization occurred on such a grand scale in Europe was during the monetary chaos that followed World War I. In 1914, Europe had 10 currencies, all with fixed gold parities and fixed exchange rates. By 1920, Europe had 27 paper currencies, none with a gold parity or a fixed exchange rate.

Even more dramatic than the trend toward balkanization has been that of unification. Argentina, Estonia, Lithuania, Bulgaria, and Bosnia have unified their domestic currencies with stronger anchor currencies by establishing currency board systems (CBSs). And in 1998, Indonesia and Russia

flirted with CBS proposals. These two CBS episodes merit special attention for the light they shed on the international politics of currency reform and the Machiavellian role played by the US Department of the Treasury and the IMF.

The Clinton administration was determined to mortally wound or topple President Suharto, and it was betting on monetary chaos to do the job. When President Suharto embraced the CBS idea in February 1998, the US Treasury and its stalking horse, the IMF, panicked because they thought the CBS would stabilize the rupiah and elevate Suharto to the status of a Javanese god. This explains why the US Treasury and the IMF used their friends in the press to mount a swift and massive counterattack.

The Russian story was quite different, however. In August 1998, the Clinton administration was desperately trying to prop up the ruble and President Yeltsin. That's why a CBS for Russia was viewed in a favorable light by the US Treasury and the IMF. They knew that a CBS had provided a quick and sustainable fix for the hyperinflating Bulgarian lev in July 1997.

On January 1, 1999, 11 European countries embarked on the greatest monetary experiment of the century. That's when they unified their national currencies and replaced them with a new currency, the euro. This currency unification was accomplished by establishing a monetary union. The European Monetary Union has been followed by calls to establish other monetary unions, most notably in the Mercosur and Asian regions.

If all these changes in the world's currency landscape weren't dramatic enough, Russia and Belarus are negotiating a deal in which the Belarus "hare" would be replaced by the Russian ruble. And now Argentina is studying the possibility of pushing its currency unification with the United States to the limit by officially replacing the peso with the US dollar. Argentina's move has motivated monetary unification discussions in Central and Eastern Europe. Indeed, these countries are beginning to debate "dollarization" or the replacement of their national currencies with the euro.

Currency unification via CBSs and dollarization

As we enter the 21st century, globalization (the liberalization of financial and trade flows) is threatened. Volatile hot money flows are identified as the problem and exchange controls the remedy. This prescription, which is based on a wrongheaded diagnosis, will lead to monetary nationalism and the type of chaos the world encountered after World War I. The only way to avoid such a disaster is for developing countries to unify their currencies with stronger ones. This can be accomplished by either establishing a CBS or by replacing a national currency with a strong foreign cur-

rency (official dollarization).

An orthodox CBS is a monetary institution that issues notes and coins. These notes and coins are backed with a minimum of 100% (up to a maximum of 110%) of foreign reserve currency, and they are fully convertible into the reserve currency at a fixed exchange rate on demand. In addition, an orthodox CBS cannot act as a lender of last resort, does not regulate reserve requirements for commercial banks, earns seignorage only from interest on reserves, and does not engage in forward-exchange transactions.

Hong Kong's CBS, as well as those established in the 1990s, all deviate in important respects from orthodoxy. While these CBSs have performed well, something even the skeptics have admitted, they are not trouble-free. For example, even though Argentina weathered the storms of 1995, the spread between interest rates on Argentine 30-day loans in pesos and dollars has varied between 0.5 percentage points and 4.4 percentage points during the past year. If the peso-dollar fixed exchange rate was perfectly credible, these spreads should have been close to zero.

The peso-dollar interest rate spreads are not zero, because the Argentine CBS deviates from orthodoxy. It engages in lender-of-last-resort activities, it regulates reserve requirements for commercial banks, and up to one third of the dollar denominated reserves it holds to back its monetary liabilities can be held in the form of bonds issued by the government of Argentina.

To make Argentina's currency unification with the dollar perfect, President Carlos Menem has suggested that Argentina replace the peso with the dollar. This official dollarization would close the peso-dollar interest rate spreads. In addition, peso notes would no longer circulate and Argentina would no longer earn seignorage from its CBS. Argentina could easily implement official dollarization by exchanging its dollar reserves for outstanding peso notes and coins and by declaring that all peso assets and liabilities in Argentina be denominated in dollars.

The major benefit of dollarization would be reduced interest rates in Argentina. With no peso-dollar exchange rate, currency risk would be eliminated and the spread in interest rates between pesos and dollars for loans within Argentina would be closed. In consequence, Argentina's trend rate of growth would be higher with dollarization than with its currency board-like system. Indeed, a government memorandum estimates that lower interest rates resulting from dollarization would add two percentage points to Argentina's annual growth rate. Under dollarization, Argentina would literally become an investor's paradise.

At least 120 countries have officially used the currency of another country at some time. Today, the best-known country that is dollarized is Panama, which has

operated under that monetary set up since 1904. However, there are 27 other countries and dependent territories that currently don't have a national currency and use a foreign one instead. Even though facts unambiguously support official dollarization as a superior monetary regime, the Prince of Spin, Lawrence Summers, doesn't like the idea. Indeed, last week Treasury Secretary Robert Rubin's Deputy pulled one of his old Indonesian tricks out of the hat and confidently asserted that monetary unification via dollarization would not provide a "quick fix" for monetary crises.

Concluding observations

Until recently, most economists have refused to consider CBSs or dollarization. Many have just declared that fixed rates are inappropriate or claimed that the facts are erroneous. There's nothing new here. Indeed, Michael Polanyi

concluded in his 1958 book, *Personal Knowledge*, that it is "the normal practice of scientists to ignore evidence that appears incompatible with the accepted system of scientific knowledge." With the failure of pegged and floating rates in Asia, Russia, and Brazil, the tide has begun to shift. This shift is welcome and has left me feeling a bit like Winston Churchill on his return from the Boer War, when he remarked that "nothing in life is so exhilarating as to be shot at without success."

Note: For a technical treatment of dollarization for Argentina, see Steve H. Hanke and Kurt Schuler, "A Dollarization Blueprint for Argentina," *Friedberg's Commodity & Currency Comments Experts Report*, February 1, 1999.

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CHINA

Will China devalue?

By Steve H. Hanke

Over the past few months, economic growth in China has decelerated, unwanted inventories of manufactured goods have piled up, export growth has ground to a halt, and finance companies have gone bust. These events have given rise to rumors that China will devalue its currency. For now, these fears are unwarranted. Indeed, even though China will not meet its 1999 target for growth of 9%, it will not seriously consider devaluation, unless the Japanese yen's value vis à vis the dollar plummets to 160-170.

In an otherwise dismal world, the following six reasons justify such an optimistic conclusion:

1. Defended by exchange controls, China's currency will not have to endure a frontal attack by speculators.

2. China's war chest of foreign reserves is \$145 billion, \$5 billion higher than a year ago.

3. China's trade and current accounts remain positive. Consequently, the external balance poses no threat to the currency.

4. China wants to project, both internally and internationally, an image of stability. After all, stability equals power.

5. Beijing does not wish to disrupt Hong Kong, something a devaluation on the mainland would do. Indeed, just the rumors of a devaluation have caused Hong Kong dollar forward spreads to widen, as the speculators have positioned themselves.

6. A devaluation would cut China's geopolitical wings in the Asian region, leaving the advantage to Japan.

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