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BoJ to the Fed: we are not interested in importing your bubbles

"One of the precious lessons we learned from the experience of policy operations during the bubble period is that monetary policy operations linked with control of the foreign exchange rate runs a risk of leading to erroneous policy decisions..."

— Bank of Japan, Sept. 21, 1999

Understanding the meaning and the benefits of unsterilized intervention has become de rigueur among popular financial journalists and commentators. Traders who did not know what money supply has to do with foreign exchange suddenly have become experts on the subject of unsterilized intervention, advancing its goodness for all the ills that affect Japan. And it is thus that the yen will fluctuate, from minute to minute, to the tune of the BoJ's pronouncements regarding unsterilized intervention.

What is unsterilized intervention? Simply stated, it is the purchase or sale by a central bank of foreign exchange (in Japan's case, mostly US dollars) for the express purpose of fixing a foreign exchange level, allowing the effect of these transactions to affect the nation's money supply. It is the way the gold standard system of old functioned. It was a time when central banks had no independent monetary policy; they merely reacted to the outflows and inflows of gold.

For example, when Japan purchases US dollars to keep the dollar from falling vis à vis the yen, it does so with newly created yen. These new yen deposits, which the sellers of dollars receive, swell bank reserves, and eventually money supply via the multiplier, in much the same way as yen would swell bank reserves when the BoJ buys any kind of asset, be it bonds, loans, or buildings. This is what is meant by a balance sheet expansion: The purchase of assets – any assets – by a central bank will affect money supply unless offset by a reverse operation, i.e., the sale of an asset.

When the BoJ routinely intervenes in the foreign exchange market, it will tend to offset some or all of the newly created yen deposits. This decision is totally independent of the foreign exchange transaction. In fact, the BoJ conducts monetary policy via setting interest rate levels, by way of providing a prearranged level of excess reserves to

the system. The higher the level of excess reserves, the more accommodative is monetary policy said to be. The present target level of excess reserves is approximately ¥1 trillion, a fairly substantial level, and one that indicates that the banking system is not willing to expand its own assets, either via loans or via the purchase of government bonds.

Should the BoJ believe that a higher level of excess reserves is warranted, it could do any number of things: Buy more JGBs, make more direct loans to banks and dealers, buy commercial paper, buy foreign exchange – always making sure not to offset the operation. It could thus be seen that unsterilized foreign exchange operations are just another way of expanding money supply via a more ample supply of excess reserves.

Now that we have demonstrated that unsterilized foreign exchange operations are no different than rinban (purchases of bonds) operations insofar as they tend to inflate the money supply (more on this later), it remains for us to explain 1) why traders, financial commentators, and Wall Street types have thrown their support behind unsterilized intervention, i.e., an expansion of Japan's money supply, 2) what the BoJ thinks about an expansion of the money supply, and 3) what the BoJ thinks about the likelihood that its own balance sheet expansion will lead to an expansion of

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

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the money supply. Finally, we will examine one other intervention option, one that perhaps is far more logical but that runs counter to the desires of the Fed and the ECB.

Those who advocate unsterilized intervention, including some Japanese officials, want Japan to inflate out of its stagnation. Broad money supply has been increasing at roughly 3.5% per annum. A faster pace, they claim, would speed up the recovery. This is a misguided idea: In the long run, money is neutral with respect to real economic activity. Even those who believe that there are short-term benefits to be had from a quick monetary injection, admit that the benefits can be obtained only if the central bank were able to conceal its inflationary printing operation, fooling most of the people into believing that there has been a genuine pick-up in real demand. Economists have called this subtle and revolting form of thievery "the gains of unanticipated inflation." The relative transparency with which most developed central banks conduct themselves, however, preclude this from happening, as economic agents begin to anticipate the effects of the reflation and, in the process, nullify its impact (most likely, they will tend to mark down the yen and raise prices, leaving real economic activity unchanged).

Does the BoJ countenance a faster expansion of money supply? Probably not. From the few statements made in this connection, we gather that the BoJ takes responsibility (though claims that it was not aware that a bubble had been created) for the asset inflation of the mid to late '80s, caused, as it happens, by trying to prevent the US dollar from collapsing. In effect, the unsterilized interventions of that period were one of the main factors that led to the greatest financial bubble of the post-war era. It is highly unlikely that the BoJ would want to take the same route to stimulate the economy. It would prefer, and it has so stated, to see deep structural reforms (including tax reform) and the slow disappearance of excess capacity that is plaguing industry (caused, of course, by the cheapness of credit).

Assume for the moment that the BoJ agreed to accelerate the growth of money supply. Can it accomplish this objective by merely expanding the monetary base (currency and commercial bank reserves)? Recent pronouncements from the governor of the Bank of Japan and from other members of the Board of the BoJ indicate that the BoJ believes that it is pushing on the proverbial string: Excess reserves are left idling at the BoJ. Commercial banks are not now willing to expand their own assets, preventing the multiple expansion of deposits. In monetary jargon, we are in a situation where base money continues to grow much faster than broad money supply (a situation, incidentally, that could reverse quickly should banks become more willing to make loans and/or to purchase government bonds) because of liquidity-induced leakages. No amount of base money expansion, says the majority of the BoJ Board, can induce banks to expand assets. And without them, money supply growth won't accelerate.

The extraordinary rise of the yen has been called a Japanese problem. Fed officials have said so, Treasury officials have said so, the Japanese have said so. This is not true. The recent strength of the yen is little more than the incipient weakness of the US dollar. Foreign exchange markets are merely reflecting relative patterns of money growth: US monetary conditions are extremely loose compared with Japan's. This can be measurably observed in their differential rates of money supply growth and intuited in their differential rates of demand for money: Not only is money supply in Japan growing slower than in the US but the demand for money/liquidity is far greater in Japan than in the US (witness the high level of excess reserves). A similar statement can be made regarding the euro: monetary conditions in Europe are far looser than in Japan. Ergo, the US dollar and the euro fall vis à vis the yen.

Foreign exchange markets don't lie. Though, admittedly, at times they reflect differential rates of growth, foreign exchange markets are often good barometers of monetary conditions. Given sharply contrasting economic conditions in the US and Japan, it is difficult to make a case for the yen on differential growth considerations, present or expected. The solution therefore lies, as we stated earlier, in monetary conditions. *The implication of this analysis is that the US and Europe must rein in their excessive money growth, not that Japan should inflate.* This can be accomplished by having the Fed and the ECB conduct unsterilized currency interventions by selling yen (borrowed via swaps with the BoJ) and sopping up dollars from circulation in Europe.

We conclude that the onus of unsterilized intervention is on the Federal Reserve Board and on the European Central Bank, not the Bank of Japan. Buying dollars and euros and selling yen will surely put an end to their inflation (provided, of course, they don't conduct offsetting operations) and to their ruinous export of inflation to the rest of the world. Until then, the dollar and the euro will continue to weaken.

Chart 1 - Japanese Yen



STOCK MARKETS**Bubbles and the external account***By Steve H. Hanke*

In "The Current Account Threatens Goldilocks and the Greenback" (FC&CC, November 30, 1998), I observed that the US current account was last in surplus in 1991 (\$4 billion), that it dramatically shifted into deficit in 1992 (\$51 billion), and that deficit had steadily grown more rapidly than nominal GDP since then. This left the US with a current account deficit of \$221 billion in 1998. And according to the IMF, projected deficits for 1999 and 2000 will be \$316 and \$325 billion, respectively. This simply means that domestic investment in the US exceeds domestic savings and that the US must import capital to finance its investment-savings deficiency. Or, to put it in other words, the current and capital accounts in the balance of payments must be equal and opposite in sign.

I also observed that the growing current account deficit and the US's ability to finance it with ease had allowed for above-trend growth in the US. In effect, the US has almost effortlessly been able to borrow both capital and capacity from the rest of the world. In consequence, the economy has boomed, equity prices have soared, the dollar has been strong, and inflation has been held in check. All this has been dubbed "The Goldilocks Economy." How long can it last? Only a fool would attempt to answer that question with precision. Indeed, in November of 1998, I made no attempt to predict when it would all end or whether it would end with a hard or a soft landing. I did conclude, however, that it would come to an end, and that the growing external imbalance would be Goldilocks' Achilles' heel.

There is, of course, nothing wrong with a current account deficit. Indeed, it can be viewed as a sign of strength, indicating that foreigners view the risk-reward relationship in the deficit country favorably. This has been the case in the US. Foreign funds have flowed into the US and have been rewarded with both capital gains in the stock market and (with the exception of the Japanese) an appreciating greenback. But can this happy set of events continue forever? In a word, no!

As foreigners continue to acquire more dollar-denominated assets in the US (claims on a country with a current account deficit), the foreigners will be exposed to more risks, both risks in the underlying assets they acquire and currency risks. Over time, then, foreigners will be comfortable financing the US current account deficit, only if the total returns they anticipate rise to offset the increased risks that they are taking. Since 1992, the financing of the current account has worked without a glitch. Foreigners have taken on more claims against the US, and they have done so with comfort, because they anticipated that equity prices would continue to rise and so would the value of the dollar. This, of course, is somewhat circular because injections of foreign funds into the stock market have pumped more air into Wall Street's speculative balloon

and also underpinned the greenback.

But at some point, asset prices and currency values in a country with a growing current account deficit must become vulnerable as they rise above their underlying fundamental values. In consequence, to lure foreigners to take on more claims against the deficit country, asset prices and/or the deficit country's currency must fall, so that foreigners can anticipate higher returns and justify the increasing risks they must take to finance an ever-larger current account deficit.

This brings us back to the US and the US stock market. Is the US stock market overvalued? And if so, is the overvaluation large? If the answer to these questions is "yes," then we could be close to the point where foreign investors will not continue to finance a growing US current account deficit, unless asset prices and/or the greenback fall from their current levels.

I use a bubble detector to determine whether US equities are overvalued and whether the overvaluation, if it exists, is large. Just what is the bubble detector all about? At the heart of the bubble detector is the ratio of wealth to income. This ratio indicates the length of time it takes for a constant flow of income to "purchase" a given stock of income-producing assets. As the ratio increases, more time is required to purchase a source of income, implying that assets are becoming more expensive relative to income. Values for the bubble detector are determined by dividing the wealth/income ratio for equities by the comparable ratio for bonds. The readings for the bubble detector increase when the wealth/income ratio for equities increases relative to the ratio for bonds. Equities are overvalued when it is more expensive to purchase \$1 worth of earnings from equities than to purchase \$1 worth of interest income from bonds. To put it in other words, equities are overvalued when it takes longer for a constant flow of income to purchase a stock of equities than bonds.

As a proxy for the wealth/income ratio for bonds, we use the reciprocal of the 10-year Treasury bill rate, or $1/\text{interest rate}$. Right now this component is $1/5.77$, or 0.1733 . If the interest rate decreases, this wealth/income ratio increases, and it takes more time for a constant flow of income to purchase a given stock of bonds, because bond prices have risen.

The proxy used for equities is the ratio of the S&P 500 Index to per capita personal income. If stock prices rise and income stays the same, the wealth/income ratio for equities increases, and it takes longer to purchase a given stock of equities. Right now this component is $1,277.36/\$27,428$, or 0.0466 .

If we divide the wealth/income proxy (a ratio) for equities by the wealth/income proxy (a ratio) for bonds, we obtain a bubble detector value. And if, over time, the number for the bubble detector increases, for example, it indicates that equi-

ties are becoming more expensive relative to bonds. That is to say, as value of the bubble detector increases, the length of time that it takes a constant flow of income to purchase stock of equities is growing relative to the length of time it takes a constant flow of income to purchase a stock of bonds.

The bubble detector's average value since 1980 has been 0.1430. Prior to the October 1987 crash, it peaked at 0.1864, and in May 1996 it shot up once again to 0.1850. Since then, the bubble detector has gone off the chart. It is currently 0.2687, or $(1,277.36/\$27,428)/(1/5.77)$. This is close to the bubble detector's all-time high, and indicates that the stock market is in a dangerous overvaluation phase. Indeed, the S&P index would have to fall by about 50% to push the bubble detector value down to its average level.

Do other, more conventional, measures signal such a large overvaluation and deviation from "normal" values? Professor Tim Congdon of Lombard Research has recently reviewed some of the most conventional measures, and his research confirms the signal received from the bubble detector (see Table 1).

The purveyors of Goldilocks would have us believe that all these measures of overvaluation are bunk. They argue that foreigners will continue to finance the US growing current account deficit, because the equity markets in the US are not overvalued and ever-larger capital gains are in the cards. As they see it, corporate earnings will continue to grow by double

digits (13% to 14% per year). If these represent real profits and not nominal numbers, they are absurd. With an annual nominal GDP growth of about 5%, double-digit real profit growth rates imply that (with compound interest) profits would eventually swallow almost the whole GDP. The Goldilocks crowd also argues that inflation is dead and that interest rates are bound to fall. This assertion is also absurd. Hourly compensation in the business sector has moved up from a 2% annual rate in the mid-1990s to 5% today. These data imply that unemployment is below its so-called "natural rate" at which pay settlements are stable. It also implies that more Fed tightening is in the pipeline. Absent corporate double-digit real earnings growth and falling interest rates, the Wall Street bubble will have to pop, validating all the overvaluation measures presented in Table 1.

When this unhappy day arrives, and it looks more imminent than it did in November 1998, Goldilocks will go into reverse. The US's external imbalance remains Goldilocks' Achilles' heel.

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Chart 2 – US\$ Finex Index

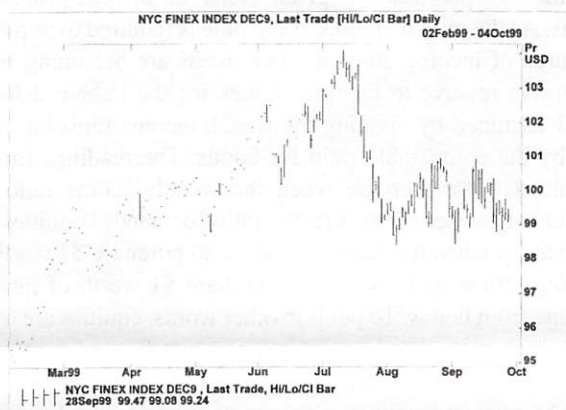


Chart 3 – S&P 500 Index

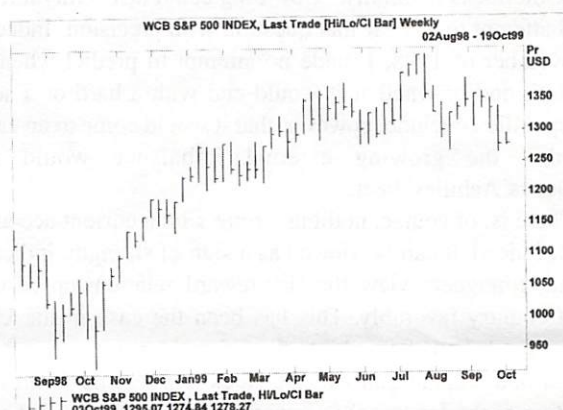


Table 1:
S&P 500 Reductions Required to Reach "Normal" Valuations

Valuation Measure	Price Reductions Required to Reach "Normal" Valuations
S&P 500 Price-Earnings Ratio	50%
S&P 500 Dividend Yield	60%
Yield Ratio (30-year Bond Yield/S&P 500 Dividend Yield)	50%
30-year Bond Yield/S&P 500 Earnings Yield	30%-35%
30-year Real Bond Yield/S&P 500 Earnings Yield	40%
Bubble Detector	50%

MONEY MISMANAGEMENT**Why central banks can't manage our money**

This article is reprinted from the Sept. 17 issue of the National Post. It is based on a speech delivered by Albert Friedberg in Toronto to the Ludwig von Mises Institute's conference on Austrian Economics and the Financial Markets.

Our fiat money system – the one currently in worldwide use – does not work. Although admittedly managed by sophisticated individuals called central bankers, fiat money – or managed money – has proven again and again to be an unmitigated disaster.

Here is a partial inventory of such disasters following World War II: the global inflation of the late 1960s and the entire decade of the '70s, caused by central bankers allowing money supply to grow at high double-digit rates, and the aftermath, the severe recessions – actually credit deflations – of 1974 and 1982. The 1986-87 stock market boom, caused by exceedingly easy money, and the aftermath – the crash of 1987. The ensuing mini-boom of 1988-89, courtesy of the Federal Reserve Board, and the tightening and inevitable bust of 1990-91 that gave the final coup de grâce to the US S&L industry and a goodly portion of the banking industry in Massachusetts and Texas. Of course, the cleaning crews called on US taxpayers, who shelled out hundreds of billions of dollars to help them clean up the mess.

We need not restrict ourselves to the US. Does anyone remember the UK inflationary episode of the mid-1970s and the destruction of its secondary banks? The runaway inflation in Latin America in the late '70s and early '80s as its central bankers struggled in vain to escape first, the clutches of a slowdown in the recycling of oil capital, and then the drying up of international liquidity, courtesy of the get-tough-on-inflation policy of then Fed chairman Paul Volcker? These bouts of hyperinflation destroyed Mexican and Argentinian banking systems, causing widespread failures and untold poverty. And what about the collapse of the Nordic banking system in the '80s, which cost 10% to 20% of GDP to “fix?” Or the disastrous Japanese Bubble of the mid-to-late '80s, courtesy of central bankers unaware – or so they admit today – that it was a bubble, followed by the most painful postwar asset and credit deflation anywhere, one that still mires them nine years later? In the meantime, Japanese taxpayers have been kindly asked to save the country by mortgaging the future of their children and grandchildren and, who knows, their great-grandchildren.

Need I mention Mexico 1995, Thailand, Korea,

Indonesia and Malaysia 1997-1998, and Russia 1998 – all the product of easy money, exported out of the US and Europe and underwritten by the imperatives of a fiat money system that not only creates too much money but also guarantees that fast and loose private lenders will not be allowed to fail? All in the name of avoiding systemic risk.

So there we are. Booms and busts, created by money and credit policies of well-meaning central bankers who have cost the civilized world literally trillions of 1999 dollars. No wonder these booms and busts come at repeated and short intervals, each time, it seems, amplified, more threatening, more terrifying.

Busts are not allowed to run their course, lest they bring down the entire economy. Calls for easy money, just for this once, become deafening. Central bankers, human beings that they are, restart the boom. Isn't that what happened in the US after the crash of 1987, the recession of 1990-1991, the Mexican tequila crisis, the Russian crisis? Isn't this about to happen in Japan? Indeed, haven't some of the world's most respected economists pounced on the Bank of Japan for not adopting quantitative targeting – that is, reflation? Does anyone really believe that Mr. Greenspan will allow credit deflation to bring down the largest US banks, investment banks, hedge funds?

But, why, you may ask, can't these intelligent government bureaucrats manage our money to lead us to Paradise without going through Hell? The great Austrian economist Ludwig von Mises, who so well exposed the pitfalls of socialism almost 70 years before the fall of the Berlin Wall, gave us the answer. Managing the quantity of money is no different than managing the quantity of shoes or shirts that a modern economy requires to satisfy its consumers.

Can a centralized economy provide the right amount of consumer goods? The socialist and Communist economies proved unable: Goods were either overproduced or underproduced. Millions of pairs of shoes were left in warehouses, tons of steel were abandoned while consumers queued for eggs, bread and cars. By the same token, our central bankers are unable to judge the right amount of money and credit required to satisfy the needs of a modern and sophisticated economy. At times they will overproduce, and at times underproduce. The first leads to booms – more correctly, credit inflations – the second to busts and credit deflations.

Central bankers appear to know what they are doing.

They debate endlessly, in private and in public, about the appropriate rate of interest to set. Can you think of a more idiotic exercise? It is like a gigantic marketing board in the US deciding on an appropriate price for bananas based on their knowledge of consumer tastes, population numbers, etc. How often do you think this marketing board would get the amounts right? You can be sure: never.

This is why most developed countries have abandoned their efforts to manage their agricultural sectors.

Thankfully, we no longer suffer from the wasteful grain surpluses of the '50s that enriched producers at taxpayers' expense. And yet we manage, quite comfortably, to feed a hungry world, year after year. The price set by the free market has been the best regulator of supply and demand. For some reason, however, when it comes to money, we abandon our senses and believe in the omniscience of a select group of bankers. A more appropriate monetary system exists, and it does away with central banking.

IT COULDN'T HAVE BEEN SAID BETTER

Perfect competition, zero profit

By Sunil H. Thakor

In his April 26 [1999] *Manager's Journal*, "Big Profits are in Store From the Online Revolution," David Alger argues that Internet retailers and service providers will revolutionize commerce, leading to enormous profits for participating companies. While it is true that the Internet is revolutionary, the real winners will be consumers, not investors.

The Internet is a realization of Adam Smith's ideal marketplace. Barriers to entry are low, market information is readily available to consumers, and product differentiation is all but impossible. All of this makes the Internet the most perfectly competitive environment that has ever existed. Any economist will be quick to point out that in the face of perfect competition, economic profit is driven to zero. To enter this marketplace is to forfeit all pricing power and become and price taker.

Many blue-chip companies achieve remarkable year over year earnings growth through their ability to raise prices in spite of fierce competition, thanks to their brand-name recognition and product differentiation. Online retailers are not afforded the

same luxury. Their appeal to the consumer is based on convenience and savings. Internet retailers and service providers can generate profits only through high volume and low margins. This sort of environment does not lend itself to excess profit potential. Mr. Alger argues that paying absurd multiples for the Internet darlings is somehow justified. I would argue that paying 500 times earnings for a company that provides a generic service (like Internet access) or sells the same product (like books) that countless other firms sell is foolish. How much money can possibly be made by selling books slightly above cost? To believe heavily in Internet retailers and the like is to ignore the fundamental economic principles that govern this new marketplace.

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