

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

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## What can a stock market bear (profitably) do?

By Albert D. Friedberg

You are one of those rare souls who refuses to join the Greater Fool game of chasing tech stocks. Interestingly, you appreciate the awesome power and versatility of the Net, and you may even be sold on the New Economy and its remarkable impact on productivity. You don't believe, however, that present stock prices bear any relation to future financial flows. Unlike many academics, you *know* that global stock markets are caught in a once-in-a-lifetime bubble. You are dying to sell short the Nasdaq index and/or a number of Nasdaq issues. But you realize that calling a top and selling into a blowoff is a deadly occupation. What do you do?

You keep your money in the bank. And you eat your heart out when your neighbor tells you that he just became a millionaire buying into the latest IPO. (No, he was not lucky enough to get shares in the initial offering – he bought them a few minutes later, after they had risen more than 300%.)

You search for clues to help you pinpoint the end of madness. You know that speculation here, everywhere, and always is caused by loose money and credit. Money that flows well in excess of the needs of commerce and the transactional and precautionary balances held by individuals. If and when these excessive flows disappear, speculation would come to an end. But what could cause just such a drying-up of money flows?

A strong revival of inflation, or, more correctly, a reacceleration of inflation. Having lost their old monetary anchors – be it gold or money supply – most central banks guide their policies by the pace of inflation. This is what is called in technical central bank jargon “inflation targeting” (the exception is the ECB, which purports to react to movements in broad money, but seems to tolerate overshoots if inflation is well behaved). Central banks would certainly tighten monetary policy should they be convinced that inflation was on the upswing.

Has inflation accelerated in recent months? Yes. A look at the US PPI and CPI (Charts 1 and 2) establishes beyond doubt that the mild disinflationary trend that prevailed during the '90s came to an end early this year. Years of disinflation, fear of collapsing

markets (if and when interest rates are finally hoisted), and a cognitive state that sees productivity and labor costs (still well-behaved for now) as the only determinants of inflation have conspired to help rationalize away the budding evidence.

Let us digress a moment. If US money growth was excessive since at least since 1995, why didn't inflation accelerate earlier? There are a number of good reasons. For one thing, inflation, *in the short run*, is inertial: If prices are rising at a moderate pace for some time, strong doses of money growth are required to ignite a change. Or, a powerful catalyst needs to appear on the scene – a war, a cartel-induced rise in price of a key commodity, etc. – to jolt inflationary expectations. Otherwise, velocity will diminish and absorb rising money balances without impacting inflation. *In the longer run*, velocity returns to its longer trend, and inflation begins to accelerate. (How long? It's hard to say, but it probably bears some relation to past history and the credibility built up by the monetary authorities.)

A second reason has to do with the deflationary effect of a negative trade and current account deficit. This balance of payments mechanism is of, course, far more complicated – foreign savings attracted by the boom conditions set off by loose money and credit in the first place, lower interest rates

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

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

below where they would have been absent these nonresident savings, raise the foreign exchange value of the dollar and fully fund the excess of consumption – but the effect is simple: The increased supply of goods and services obtained running an external deficit has held prices in check. This virtuous cycle has been aided by the rising value of the dollar, which cheapens the dollar-cost of imports. Over the past eight years, the US current account deficit has expanded from 0% to almost 4% of GDP. Studying capital flows in and out of the US, one can reasonably conclude that the booming stock market itself was one of the main, if not *the* main cause, of the rising dollar and the ease with which the US financed its almost grotesque current account deficit. In other words, Nasdaq and the tech stocks helped the US achieve a remarkably modest pace of inflation!

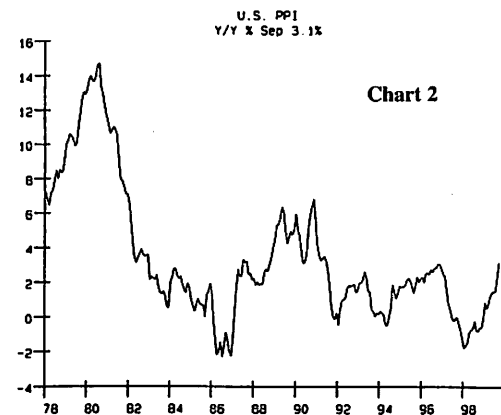
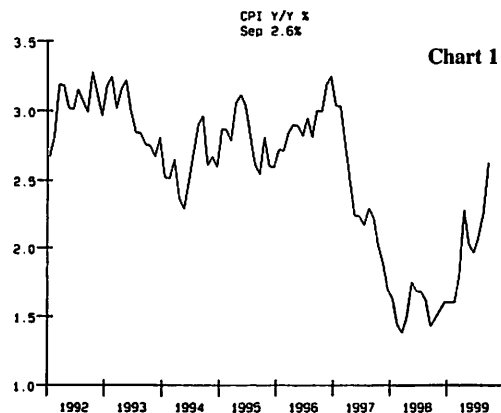
Finally, one might add that rising productivity has also had a favorable, short-term, impact on inflation via increasing the amount of goods and services and via its impact on lowering costs (though the initial impact was probably greater on corporate profits than on inflation). Since statisticians have been unable to capture these (intuitively) dramatic gains in productivity, we caution attributing to it more than a minor role in the moderate rate of inflation experienced during the '90s.

A detailed look at money growth should convince anyone that the US central bank has allowed money inflation to run rampant. If so, the recent acceleration of wholesale and consumer prices bodes ill and should not be lightly dismissed. Chart 3 depicts a remarkable downtrend in money growth from 1982 to early 1995. This explains rather well the corresponding downtrend of inflation. Since 1995, not coincidentally the year that ushered in the long string of emerging economies crises – first Mexico, then Southeast Asia, Russia, and finally Brazil – events that had a definitive and powerful hand in restraining the Federal Reserve from tightening, broad money growth has exploded. Also, transactional balances (M1) have shown positive year-over-year growth over the past two years despite the fact that the opportunity cost of holding non-interest-bearing balances has risen in line with rising short- and long-term interest rates and that technology has continued to facilitate the economizing of these balances. Finally, the growth in the adjusted monetary base, possibly the best measure of policy stance, has been in a persistent uptrend since early 1996, recording a 9% year-over-year rise this fall compared with an annualized sub-2% pace at its nadir in 1996.

Central banks, and in particular the US Federal Reserve, will have to be hit on the head with evidence of accelerating inflation before they take aggressive steps to rein in the growth of money. The factors outlined earlier are militating, and quite likely will continue to militate, against a forceful reaction. The Fed will fall behind the curve and only late in the game will it take appropriate measures (though it is possible that it will, at some point, relent and accept higher inflation numbers rather than risk economic collapse, as discussed in an earlier issue).

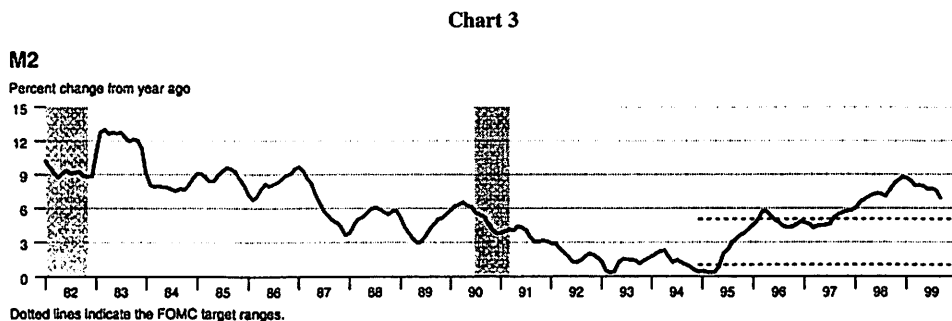
Financial markets, caught in a bubble and conditioned by years of a buying-the-dips mentality, will refuse to heed the signs for much longer than a bear would like. Commodity markets, on the other hand, will pay in timely fashion and in spades. The rise in the price of crude oil is not a sporadic event tied to special circumstances, as the media and the central banks would like to claim. Rather, it is the first manifestation of inflation on a global scale, to be followed by a number of other commodities. For those old enough to remember, the 1970s inflation did not begin with a simultaneous rise in the price of all commodities. Selectively at first, and pushed by favorable fundamentals, a few international commodities began to rise, later to be joined by a larger number, and finally by nearly all of them. This phenomenon is about to repeat itself.

We return to our frustrated stock market bear. Waiting for stock prices to fall need not be a frustrating experience. Since a bear market will not begin until the Fed becomes serious about inflation, and since the Fed will not become serious about inflation until inflation accelerates and becomes more widespread (for now, they have removed food, oil, tobacco, and used cars), one ought to consider commodity markets. In a sense, commodity markets will have to punish the Fed for misbehaving (and if they don't, then there will never be a bear market again!). We believe that oil prices will continue to surprise and go higher. We strongly believe that



metals will rise significantly, led by gold and platinum as our sister publication, *Focus on Futures*, details. Livestock prices are already in bull modes. Cocoa and coffee cannot be too far behind, nor can the grains lag for very long in view of tightening supplies. And so on.

Even stock market bears can earn a living.



## **EUROLAND**

### **Some Eurobasics**

*By Steve H. Hanke*

The euro was launched on January 1, 1999, with an impressive advertising campaign, the likes of which we had never seen before. Europride was off the charts. And why not? The euro was going to be a big, strong currency that would challenge the greenback for international supremacy, a silver bullet that would stop America's economic hegemony in its tracks.

During the past ten and a half months, the euro has not floated on a sea of tranquility, however. Instead, it has sunk to depths not imagined at launch time. Indeed, in January, talk of parity with the dollar was strictly verboten. That was then. Now we hear an ever-growing chorus of voices asserting that the euro is in trouble and that its plummeting value is a disaster for Europe.

The Europeans partly have only themselves to blame for this. Thanks to the euro's pre-launch propaganda, there is probably more mythology, confusion, and misplaced pride surrounding a new unit of account than at any other time in history.

The European elites argue that the countries belonging to the European Union (EU) constitute a larger economy than the United States and that EU exports to the rest of the world exceed US exports. Therefore, they assert that the euro will be a match for the mighty dollar because of the EU's huge economic size and international trade connections. But this is a non sequitur.

Even though Euroland represents an economic unit that can match the US, it does not follow that the euro will be able to challenge the dollar as an international money. At present, the dollar serves as an international unit of account and is a true international money. Because of its huge scale, the average cost of transacting in dollars is lower than transacting in other currencies. That limits the scope for another currency to serve as an international money and a vehicle currency.

To appreciate the dollar's dominant international role and why it will be so hard to dislodge, consider that the dollar enters one side of 90% of all interbank foreign exchange transactions in the world. This allows banks to cover both their forward exchange and option exposures efficiently, with great savings in transaction costs. The pattern for trade in primary commodities is much the same, with about 90% of these commodities being priced in dollars. And while not as strong as for commodities, the dollar's grip on the invoicing of manufactured goods and services is strong, very strong. Indeed, the dollar, not the yen, is

used to invoice almost 40% of all Japanese manufactured exports and about 70% of its imports.

Interbank foreign exchange markets, as well as commodity markets, are organized to use the dollar as the vehicle and invoice currency. So exchange market intervention by governments naturally follows the same pattern because intervention can be more conveniently handled by just using dollars. Not surprisingly, then, the dollar dominates as the intervention and reserve currency used by central banks. Apart from gold, the dollar accounts for 70% of all official reserves of central banks outside the EU. As long as there is reasonable confidence in US monetary policy, the dollar will remain king, the world's international currency. The euro will become queen, the world's most important regional currency. And the yen will remain an important national currency. The Big Three will, of course, float against one another.

In addition to missing the vehicle-currency arguments and the conclusion that the dollar will not be challenged as an international currency by the euro, the euroenthusiasts forgot that the euro was launched in the middle of a long-term dollar bull market. By studying a special report, "Long-Term Cycles In The Dollar's Value," written by Dr. Michael R. Rosenberg and issued by the Deutsche Bank on July 14, 1999, any euroenthusiasts should have been able to see that the dollar was little more than half way through one of its classic 10-year bull runs. That means that the euro will have to swim upstream for another three to four years. Not surprisingly, the eurocrats in Brussels failed to get the eurolaunch timing right. The amateurishness of the entire endeavor boggles the mind.

So much for the long-term trends that are driven by fundamentals. What about the current state of affairs with regard to the dollar-euro exchange rate? As Dr. Rosenberg, one of the premier currency analysts, carefully documents in his Deutsche Bank report, there are short- and medium-term fluctuations around the dollar's long-term exchange rate path, a path that rises and falls in regular 10-year cycles. And these fluctuations are driven by cyclical factors, such as relative GDP growth rates and interest rate differentials.

Since these two cyclical factors have begun to favor Europe slightly versus the US, Dr. Rosenberg concluded in his Deutsche

Bank *Foreign Exchange Weekly* of October 29, that the euro was due for a short-term, mid-course correction and strength versus the greenback. He also indicated that the technicals confirmed his mid-course correction call, because the euro had been trending up since its all-time lows of July (see Chart 4). Alas, shortly after Dr. Rosenberg's report was issued, the dollar-euro rate broke its technical support of about 1.05\$/euro. And it has remained below that level, even though the most recent German IFO business confidence survey has strengthened and the US trade deficit has widened sharply.

Short-term, it now appears that the euro will remain vulnerable, particularly since its technicals have broken down and the market is euro-overweight. The euro is poised to test its all-time lows. As for the long-term, the dollar's bull cycle remains intact, assuming that the US economy slows down and the current account deficit stops exploding (see my article "The Current Account Threatens Goldilocks and the Greenback," *FC&CC*, November 30, 1999). This is particularly the case versus the euro. Indeed, the following non-cyclical, long-term problems will continue to weigh on the EU economies and the beleaguered euro:

- Supply-side problems, very high marginal tax rates, and burdensome business and labor market regulations put huge tax and regulatory wedges in the EU's labor markets and severely limit the EU's growth potential. Indeed, the EU's Big Four, Germany, France, Italy, and Spain, which account for 85% of the EU's GDP, have labor markets that don't clear. That explains why headline unemployment is currently 10.5% in Germany, 11.2% in France, 11.8% in Italy, and 15.6% in Spain. This means that the European Central Bank (ECB) will be under constant pressure to stimulate the demand side of the European economies.

- The prospect for supply-side tax reforms does not look promising, either. Europe's pay-as-you-go pension systems are bankrupt, and with aging populations in Europe, demographics are working against a quick fix. Indeed, with ever fewer workers to support a ballooning retired population, there is pressure to increase, not cut, labor taxes.

- And the long-term funding problems associated with Europe's state pension systems aren't the end of Europe's fiscal nightmare. The prospect of early EU and NATO entry for the former communist countries in Europe is truly fiscally frightening. To get those countries up to EU and NATO standards, hundreds of billions of euros will be required. To put those fiscal burdens into perspective, we have to look no further than East Germany.

- By unifying the EU-11 currencies with the euro and opening Europe's capital markets, the Europeans have inadvertently given themselves another problem. If the Europeans do nothing, the capital markets will force them to adopt an Anglo-Saxon style of capitalism. I doubt that the European politicians will sit idly by and let this happen. Indeed, just last week Gerhard Schröder, the German chancellor, intervened in the \$123.6 billion takeover battle between Vodafone Air-Touch and Mannesmann, declaring that hostile bids would destroy "the culture" of the German target company. There will certainly be more of those interventions. As I see it, Europe will never clone Anglo-Saxon capitalism. Rather, the battle will be between German corporatism and French statism. This won't be good for the European economies or the euro.

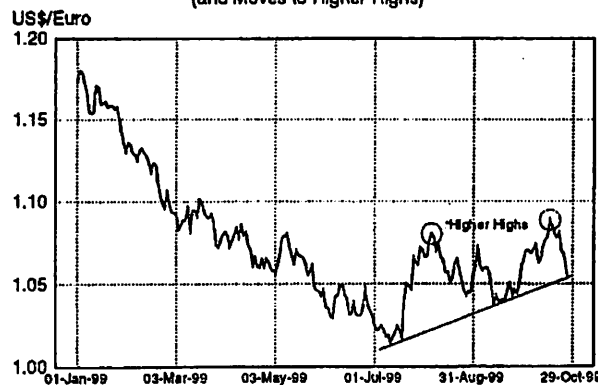
If all this weren't bad enough for the euro's long-term prospects, the ECB is having trouble getting its act together, adding to the euro's short-term problems. Indeed, ECB has become a Tower of Babel, with some officials literally spewing nonsense.

As I pointed out in "Bubbles and the External Account" (*FC&CC*, September 27, 1999), a euro mid-course correction versus the greenback will come. But, it will have to wait until Wall Street takes a hard hit.

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Chart 4

**The Euro Breaks Through Technical Resistance**  
(and Moves to Higher Highs)



## US BANKS

# Discovering leverage

So that you get a real-life flavor of the seriousness with which you ought to take this subject, we begin by quoting Citigroup's John Reed. These statements, which were made in the course of a risk-management conference sponsored by the Office of the Comptroller of the Currency, were carried by the *American Banker* but were brought to our attention by *Grant's Interest Rate Observer*.

Speaking about last year's near-blowout of Long-Term Capital Management, John Reed pointed out that the "models" failed to anticipate "second-order effects." Though Citigroup did not have direct exposure to LTCM, "we were over our heads with every one of the firms that did have direct exposure to Long-Term Capital," said Reed. "It would have reverberated through the system in about two nanoseconds."

None of these firms had the capital to sustain the losses.” (Our emphasis. Note: He is referring to some of America’s largest investment bankers.)

Six months ago, we penned a piece entitled “The explosion in leverage: a tentative, new proxy, and a very tentative forecast” (FC&CC, May 30,1999). In it we suggested that exploding financial leverage was responsible for the near-cataclysmic financial repercussions that accompanied Mexico’s 1995 default, the 1997 Asian crisis, and the 1998 Russian default. We demonstrated that increasingly, even minor financial events had the capability to destabilize developed markets, threatening to bring about a crash.

To support our thesis, we published a chart (now updated, Chart 5), a ratio of financial borrowings to broad money supply, that served as a proxy to show the almost exponential rise of leverage in recent years. The sense of it is to show how quickly, over time, one dollar of money supply turns over. (We should caution that the graph is more indicative of orders of magnitudes than of absolute levels.)

A recent IMF publication, the September issue of *International Capital Markets*, confirms our findings and provides a number of more direct and more exact measurements of leverage. It notes, dryly, that the “lack of comprehensive information about the degree and extent of leverage in the major financial systems, which could amplify and propagate shocks in these markets, complicates an assessment of the risks.” (Page 31.) The authors do not rule out that a 15% to 20% correction in the US stock market could cause a sharp slowdown in demand, and then repeat their earlier warning that “uncertainties about the extent of leverage in the global financial system complicate a broader assessment of the risks, however.” (Page 32.) This is another way of saying, in restrained and diplomatic language, that the IMF is growing extremely nervous about excessive leverage; first order effects, let alone second order effects, are becoming impossible to quantify.

In Appendix 1 entitled “Off Balance Sheet Leverage,” IMF staff describe the two ways of aggregating assets to arrive at an overall measure of leverage for a financial institution: the “gross leverage ratio” and the “net leverage ratio.” After discussing the strengths and weaknesses of each ratio (and the merits of a third measure, the value at risk of an entity’s portfolio relative to its equity, or the “risk coverage ratio”) the staff provides some numbers for gross off-balance-sheet leverage for the top 25 US banks, which in 1998 held approximately 99% of the total notional amount of derivatives in the domestic banking system and 38% of derivatives outstanding worldwide.

The figures are instructive: In the aftermath of the 1996 bond market turbulence and the associated de-leveraging, leverage among the top 25 banks increased gradually from 70 in 1996 until the second quarter of 1998 (see Chart 6). It surged by 18% to 91 in the third quarter of 1998. (The authors note that one globally active bank reached a ratio as high as 579!

Could that have been Mr. Reed’s institution?). So that we are able to judge whether these ratios are high, the IMF researchers comment that “in contrast, traditional balance sheet leverage ranged between 6 and 7 during the same period.” In other words, off-balance-sheet leverage during this period dwarfed on-balance-sheet leverage by no less than 14 times. Are the Basel Agreement bureaucrats looking in the wrong place?

What are we to make of this? Financial crises will continue to occur. Because of explosive leverage, one of those mishaps, inevitably, will be so severe that it will rock the boat. Central banks will attempt a rescue. If they succeed, they will ratchet leverage ratios to new heights (thanks to “moral hazard”), bringing ever closer the day on which a breakdown will occur. If they don’t make it on time, first and second order effects will, almost certainly, sink the world’s largest financial institutions. Stock markets and economies will implode, and perhaps paper money will lose some of its attractions. Gold, anyone?

Chart 5

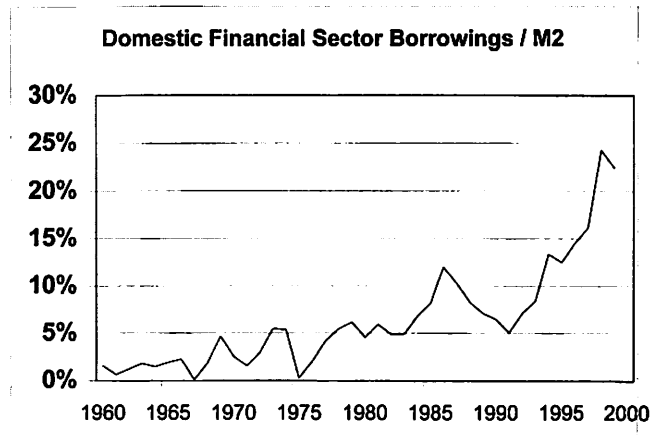
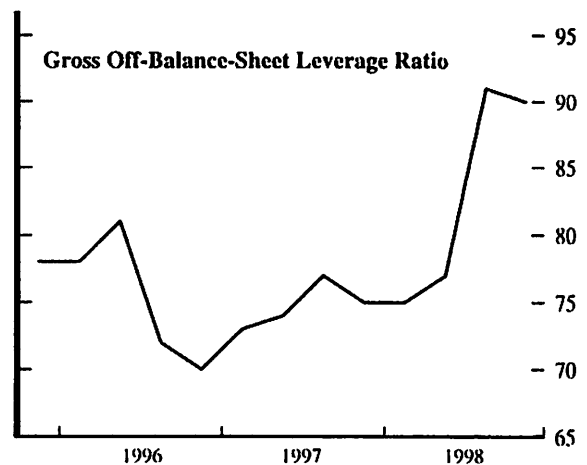


Chart 6



Source: Office of the Comptroller of the Currency.

**TURKEY****A Turkish delight?***By Steve H. Hanke***The backdrop**

Almost a year before the Mexican peso collapsed in December 1994, the Turkish lira bit the dust. Turkey, like Mexico, was the victim of a pegged exchange rate system that invited contradictory exchange rate and monetary policies.

Since the lira's maxi devaluation, Turkey has been operating in an economic twilight zone, one characterized by a very high average annual inflation rate, about 80%, and a high average annual rate of real growth, about 5%. Turkey's high inflation rate is, of course, the result of rapid money growth. And Turkey's solid economic growth rate reflects roughly a 2% annual population growth and a 3% underlying rate of growth in productivity. That productivity figure is relatively high and owes much to Turkey's entrepreneurial culture and dynamic private sector, one that doesn't toil under high marginal tax rates and potentially burdensome regulations. How can that be? In Turkey, it is easy.

Tax loopholes, corruption, and tax amnesties allow the formal economy to lighten its effective tax and regulatory burdens. But that is not the end of the story. At 50% of GDP, Turkey has proportionately the largest informal economy in the world, beating out both Russia and Columbia, where the informal sectors account for about 30% of GDP. All this, coupled with relatively small social safety net burdens and low union representation, means that the real economy is very flexible.

Consequently, the labor market clears, with workers, on average, being fully employed. And thanks to the underleveraged nature of the private sector, the economy is famously resilient to the financial crises that have hit Turkey at roughly three-year intervals. In a nutshell, the Turkish economy is flexible, tough, and highly productive. In addition, its products are highly competitive on international markets, with exports as a portion of GDP rising from 8% in 1990 to 16% today.

**The current state of economic affairs**

So much for the backdrop. What is the current state of Turkey's economic affairs? Turkey is in a severe recession. Indeed, real GNP will decline by almost 2.5% this year, and successive earthquakes, including the one I witnessed on November 12, have dimmed the prospects for a powerful rebound. The slump was brought about, in large part, by the Russian ruble crisis in August 1998.

Turkey's export demand from Russia and the CIS countries, which accounts for 30% of Turkey's exports, collapsed. And about \$6 billion of hot money took flight in the fall of 1998, sending real interest rates to 50%. This deadly cocktail plunged Turkey into a recession. It also put enormous pressure on the fiscal system. Although Turkey's domestic debt is below 25% of GNP, it is short-term, with an average maturity of nine months. Consequently, the high real interest rates sparked a fiscal crisis, with the fiscal deficit moving from 7% of GNP in

1998 to about 12% this year, and interest payments on the government's debt moving from 17.7% of GNP in 1998 to a whopping 21.7% in 1999.

Unlike 1994, the lira's crawling peg has continued to steadily crawl downward, without suffering from a maxi devaluation. This has been due to the central bank's clever management of the crawling peg and domestic monetary policy. As the foreign component of the monetary base collapsed in 1998, the central bank partially offset the foreign outflows with injections of domestic liquidity (see Chart 7). Consequently, the monetary base growth slowed modestly and the crawl stayed on course. This contrasts sharply with what happened in 1994, when the central bank more than offset the loss in foreign reserves by making huge injections of domestic liquidity. That dramatically increased the rate of growth in base money and created a contradiction between its exchange rate and monetary policies (see Chart 7). Something had to give, and it was the lira.

Thanks to the central bank's skill in managing the dangerous crawling peg in 1998 and 1999, confidence in the exchange rate system and the lira have been maintained, and the overall balance of payments is healthy. Indeed, even though the current account for 1999 will be negative, that deficit will be more than offset, primarily by large long-term capital inflows – \$5.5 billion in 1999 versus \$4.0 billion in 1998 – and portfolio investments – \$1.5 billion in 1999 versus a negative \$6.4 billion in 1998. Incidentally, that huge positive swing of almost \$8.0 billion in portfolio flows goes a long way toward explaining why Istanbul's stock exchange is up almost 100% in dollar terms this year, making it the world's hottest exchange. Foreign exchange reserves also remain at comfortable levels, increasing modestly during the year to \$23.8 billion. And crucially, residents continue to hold a stable ratio of lira to foreign currency deposits in local banks.

As I pointed out in "Emerging Markets, Slim Pickings" (*FC&CC*, August 2, 1999), Turkish T-bills have been, and remain, attractive. Accordingly, we have been aggressive buyers. That is to say, we have been short-term bulls. Will we become long-term bulls? That will depend on whether Turkey can implement the radical economic reforms being talked up in Ankara. If the Turks can pull off their reform agenda, Turkey will become what Chile, New Zealand, and Argentina were when they implemented radical economic reforms. For investors, that will be a Turkish delight.

**The Turkish-delight scenario**

Turkey cannot continue to operate in an economic twilight zone. Consequently, the Turks have decided to go for much lower inflation, more stability, and higher economic growth. And the new coalition government of Bulent Ecevit hasn't wasted valuable time in its attempt to pull Turkey back from the twilight zone. Indeed, during its first 50 days in office, it passed

46 bills. These included important pieces of an economic reform program designed to deliver a Turkish delight.

A constitutional amendment that allows for international arbitration of contracts has been approved. This will remove a bottleneck in Turkey's ambitious privatization program and stimulate larger foreign direct investment (FDI) inflows, which, at \$500 million per year, are pitifully low. Indeed, with the new arbitration law in place, annual FDI of \$2 billion should be easily achievable and sustainable.

Following the August 17 earthquake, the government's popularity took a hit as a result of the public's displeasure with the government's slow earthquake relief efforts. That didn't deter the government's reform efforts, however. Shortly after the earthquake, the government passed a tough social security reform package. By dramatically increasing the minimum retirement age for new entrants and increasing the minimum contribution period for new entrants, among other changes, the system has been given a new lease on life. Consequently, over the next 10 years, instead of increasing by 2.5% of GNP, the system's deficit will fall by 1% of GNP.

These Herculean efforts have made it all but certain that Turkey will be made a candidate for the European Union accession process at the Helsinki summit next month. The implications of that for a convergence play are literally mind-boggling. And if that were not enough, Turkey's first steps on the road to reform have positioned it to have an IMF three-year stand-by agreement approved in Washington, DC on December 20. That agreement will put plenty of teeth in Turkey's reforms. And while the IMF is ready to offer a \$4 billion package, the Turks, after the November 12 earthquake, are pushing for \$6 billion, and they just might pull it off.

### Just what will the IMF package entail?

- The IMF's standard medicine, an austere budget for 2000, will be mandated, with a primary surplus of 4% of GNP. And while this IMF medicine has often been wrongly prescribed for example in Asia, it is just what the doctor ordered in Turkey. Indeed, fiscal discipline has never been a hallmark of Turkish policy and is a necessary condition to pull Turkey out of the twilight zone.

- The passage of a new banking law, establishing an independent regulatory and supervisory agency to raise standards to international levels has already been passed. In addition, however, Turkey will have to limit banks' open foreign exchange positions from the current 30% level to 20%.

- Agricultural subsidies will be dramatically reduced, and the system will move away from direct government purchases toward a more transparent system of direct cash payments. This will not only have a favorable fiscal impact, but also it will affect many people. For example, six million people (about 10% of the population) are involved directly or indirectly in the hazelnut industry alone, mostly around the harvesting period.

- An ambitious, but achievable, privatization program will be mandated.

- The government wants to bring down WPI and CPI inflation to 20% and 25%, respectively, by the end of next year.

Although inflation might temporarily increase in the very near term, because of increase in indirect taxes (VAT and petrol taxes), a tighter fiscal stance and strong nominal price anchors could put the inflation targets in the sights of the Turks.

For the inflation targets to be met, however, next year's public sector wage and farm price-increases will have to be capped at around 25%. This, of course, will result in reductions of real incomes in sectors of the population that can potentially become vocal critics of the disinflation program.

In addition, and perhaps more importantly, the rate of devaluation of the lira will have to be slowed in 2000 to about 30% to 35% against the basket of currencies that the central bank pegs the lira to. That would anchor the price of tradeables directly and the price of nontradable goods indirectly via imported inputs. This, of course, implies that the lira's real exchange rate will appreciate. That, no doubt, will bring howls of protest from Turkey's exporters who are a strong lobby in Turkey.

Although these tough nominal price anchors will result in a dramatic reduction in Turkey's inflation, the Turks' targets for 2000 are overly optimistic. Indeed, they probably won't be achieved until the end of 2001.

If Turkey stays the course with its reform program, inflation will decline dramatically. Consequently, asset prices (for both debt and equity) will soar. And a credit upgrade, or two, will add frosting to the debt cake by narrowing Turkish spreads. The Istanbul equity market, which is dominated by banks that hold over 50% of their assets in government debt, will continue to make new highs in 2000. In addition to domestic banks, Turkish retailers will outperform Turkish exporters.

Under this Turkish-delight scenario, the central bank, burdened with a pegged exchange rate system, will be challenged. A surge in foreign capital inflows will be a sure thing. To control the growth in Turkey's monetary base, the central bank will have to offset these foreign inflows by sterilization operations that push the domestic component of the monetary base into serious negative territory (see Chart 7). The rub here is that the central bank has a limited range of instruments to sterilize foreign inflows. Ironically, therefore, massive foreign inflows could turn out to be one of the major challenges to the reform program and the attainment of Turkey's inflation targets.

### Some words of caution

What could derail the delivery of the Turkish delight? The jaded Istanbul bankers, who are still taking a "wait and see" attitude, respond with two words: "Many things."

- Since 1961, Turkey has signed onto 16 IMF programs, and it has a perfect record of failure. Not one program has been completed. Why will the 17th program be different? With entry into the European Union hanging in the balance, I believe Turkey will have to bite the bullet and tough out the IMF program.

- Exporters, civil servants, and farmers are powerful lobbies that will be squeezed during disinflation. Although they could derail the reform train, I believe the government will be forced to play hardball. However, the coming arm-wrestling between the government and the lobbies bears careful watching.

- The banks also represent a powerful lobby in Turkey.

With such a load of government debt on their balance sheets, they will benefit from disinflation in the short run. However, longer-term they could pose problems, because banks will be forced to transform themselves from speculative trading houses and facilitators of the government's fiscal operations into real banks that evaluate credit risks and extend credit to the private sector. I believe that the odds favor the bankers' enjoying their short-term gains and soaring share prices. The bankers will defer worrying about the prospect of becoming real bankers.

- The lira's pegged system might not provide an adequate nominal price anchor, resulting in a very drawn-out disinflation process. If this becomes apparent, I believe that Turkey will bite the bullet and install a currency board, something the IMF has already suggested. Incidentally, that suggestion was rejected by the Turks because the currency board was deemed to be too tough a system. However, if the lira's peg doesn't deliver a sharp fall in inflation, the Turks will embrace a currency board.

- Since 1988, Turkey has endured a fiscal crisis every three years, resulting in a deficit monetarization and maxi devaluation. And since the 1994 devaluation, the private sector's foreign debt has more than doubled to 25% of GDP. If there was a devaluation, this could push a lot of private firms to the wall and push the economy into a serious slump. Also, as a result of endemic very high inflation, the economy has become extensively dollarized and the lira monetary base has fallen below 10% of GDP. Accordingly, the shrinking tax base for an "inflation tax" raises the risk that a fiscal crisis could lead to hyperinflation as Turks abandon the lira at any price. While all this is true, it leads me to the conclusion that Turkey has no choice but to bite the bullet and push the reform program forward at all cost.

- Turkey's byzantine politics have always doomed past reform efforts. Two factors favor a long-lived, stable coalition government this time around, however. The coalition's majority is large, and the opposition is in disarray. That said, there remain potential transparent political trouble spots that could shake the coalition.

The major one revolves around the Kurdish terrorist Ojalan. The government gained a great deal of popular support when Ojalan was captured. However, P.M. Eçevit and his party, the DSP, oppose carrying out the death penalty passed on Ojalan by the Turkish courts, while the DSP's coalition partners, the MHP, favors an execution. Also, on some contentious religious issues, the coalition partners differ, with the DSP being strong secular-

ists and the MHP nationalists being much softer on Islamic issues, like women wearing headscarfs in public buildings.

The major threat to political stability and reform will come if there is foot-dragging and/or the disinflation process becomes drawn out. I remain unsure about the strength of the coalition in that case.

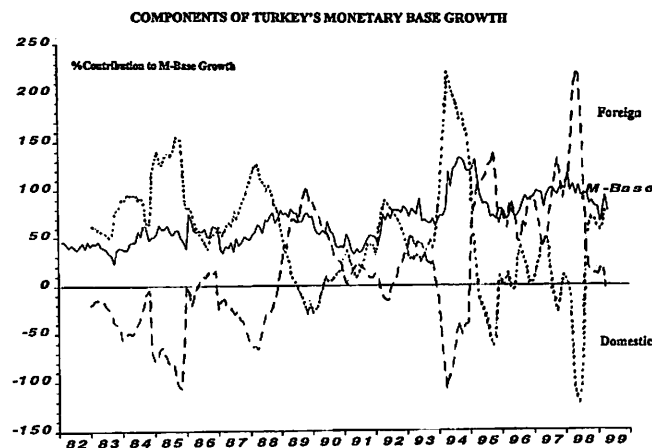
- The Turks don't have a General Pinochet, a Sir Roger Douglas, or a Carlos Menem leading the charge and deflecting the arrows. Consequently, I refrain from putting Turkey into the same league as I once put Chile, New Zealand, and Argentina, when they ramped up their reform programs.

## The bottom line

Where does all this leave me? I remain a raging short-term bull and a cautious long-term bull. Although the odds favor Turkey's becoming the next century's first mega-convergence/mega-reform play, the odds will have to improve a bit more before I would commit serious long-term funds to Turkey. Maximize your short-term exposure to Turkey and start building your long-term commitments.

**NOTE:** After this article had gone to press, Turkey surprised the markets by imposing a 4% to 19% withholding tax on existing T-bills and T-bonds as part of a one-time "quake tax". No wonder the bankers in Istanbul are jaded! If you are going to swim in Turkish waters, beware of sharks.

Chart 7



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