

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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## Bear markets, everywhere

Look at Chart 1. Bear markets everywhere. They have not only sprung up suddenly, but they have done so rather stealthily. Before you knew it, markets were already down as much as 40%.

Investors, as someone has wisely commented, are like frogs. Turn up the water temperature in the boiling pot – if ever so gradually – and they will forget to jump. Until, of course, it is too late. The Fed, too, has been turning up the heat, but investors have accepted it with complacency. They hope that the Central Bank knows what it is doing and that the bitter medicine will not be administered for too long. The sad truth is that the Fed has misread the implications of its own actions and has no idea how long the current tightening will have to last. (For a semi-technical elaboration of these points, please refer to the accompanying article “Greenspan has already lost the inflation fight”). We shall promptly return with a view of our own. But first, we ought to say a thing or two about bear markets.

Bear markets are easier to identify than their closest kin, bull market corrections, because unlike them, they are born and raised in a climate of continued optimism. How many remember the dark and ominous days of the late summers of 1997 and 1998, when it seemed that civilization as we had come to know it was coming to an end (and we stoked the fires of that fear!)?

The background guaranteed, at least in retrospect, that the corrections were going to be severe but brief. Paradoxically, the bad news prompted a quick official response, and soon enough, the markets were off to the races again. It's when markets see further and more clearly than officialdom that corrections turn into prolonged declines. Not seeing fear or panic, officialdom does not react.

The market, however, sees the onset of stagflation, brought about by a new cycle of stop-and-go monetary policy. The decline will continue until bad economic news hits the headlines. Then, provided the Fed and the Treasury have room to maneuver – that is, if inflation is not out of control – an attempt will be made to reverse the situation. But we are clearly getting ourselves ahead of the game. For now, suffice it to say that the continuing “correction” meets the criteria of a bear market – not because of the extent of the decline – but because it proceeds in a climate of hope and optimism that things will soon improve.

There is one more thing. Old fashioned bear markets, as

John Dorfman has so felicitously put it, don't stab you with a sword, as the mini-crashes of 1961, 1980, 1989, 1997, 1998, or even the spectacular crash of 1987 did. Rather, they nick you with a thousand cuts. And perhaps this follows from what we explained earlier. Crashes and mini-crashes are accompanied by ugly and fear-inducing news; bear markets, on the other hand, are early expressions of uneasiness, palpitations of a very distant and amorphous crisis. (A post-mortem: Having foreseen in good time the Southeast Asian and the Russian crises, we overstayed our welcome, not taking into account the salvational arsenal and determination of the Treasury, the Fed, and the multinational lending agencies. The trick will be to assess the degree of freedom at their disposal at the next critical juncture.)

We are in a global bear market. While the crisis has as yet not become evident to the majority of investors, smart money has begun to sense the danger from afar. The danger is rapidly accelerating inflation with its corrosive effect on profits and purchasing power. The longer it is allowed to stay on, the more difficult it will be to eradicate it, the more drastic will be the central banks' reaction, and the deeper will be the next recession.

Commodity prices are continuing to rise. The Commodity

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Contributions by Albert D. Friedberg, Dr. Mark Mullins, and Prof. Edmund Phelps.

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Research Bureau Index has risen 20.3% year on year, the most in over 12 years. Producer prices have been restrained by the powerful US dollar surge. The same cannot be said about services and housing price components – these are clearly exploding. Consumer price inflation is on its way to 3.5%-4% before year-end. The Fed will need to throttle back much more aggressively. By one measure, it will need to raise the Fed Funds rate to the 8.25%-8.5% range just to match nominal GDP growth. By our measure, it will need to press until the monetary base slows to a crawl for at least six months (it has recently logged a totally unacceptable 7.3% year-on-year growth).

Will a deep market swoon itself be the trigger for some fiscal and monetary easing? Maybe. Or maybe not if the Fed is more convinced now (after being severely criticized for the Mexico and LTCM bailouts) that it urgently needs to lower moral hazard. Besides, the Fed has repeatedly denied that it is targeting stock prices. While it is still difficult to assess the degree of pain that sharply lower stock prices will have on consumers and business,

we need to be a bit more flexible than on past occasions. If it is as bad as we imagine it to be, it is highly improbable that some sort of official intervention will not be attempted.

To summarize: Before the global bear markets come to an end, the following will need to happen: terrible economic news. The following is *likely* to happen: Stock prices will drop until mutual fund withdrawals will become serious business. Some (most? all?) mutual fund will suspend redemptions for lack of cash, as bids on countless stocks will disappear. Some banks, investment banks, and brokers will go to the wall thanks to the devastating impact of falling asset prices on excessive leverage. Inflation will accelerate long after the onset of a recession. The mighty US dollar will fall. The only imponderables will be timing the abortion of the Fed's tightening operation and the Treasury's reversal of fiscal impulses. Their degree of freedom to act, to which we alluded earlier, will be delimited by inflation, the weakness of the US dollar, and the level of long-term interest rates.

Chart 1 – Performance of Selected Stock Markets

PERFORMANCE OF SELECTED STOCK MARKETS		52-week high	May 26/00	
		( in USD)	(in USD)	
Dow Jones Industrial Average	14/01/00	11,750.2800	10,299.2400	-12.35%
S&P 500 Index	24/03/00	1,552.8700	1,378.0200	-11.26%
NASDAQ Composite Index	10/03/00	5,132.5200	3,205.1100	-37.55%
NASDAQ 100 stock Index	24/03/00	4,816.3500	3,101.4400	-35.61%
Wilshire 5000 Equity Index	24/03/00	14,991.6800	12,617.0400	-15.84%
Russell 2000 Index	10/03/00	614.1600	457.3700	-25.53%
Canada - TSE 300 Index	24/03/00	6,947.3000	6,003.0000	-13.59%
England - FTSE 100 Index	04/01/00	11,357.2100	9,227.7400	-18.75%
FTSE techMark 100 Index	10/03/00	9,073.0000	4,465.3900	-50.78%
France - CAC 40 Index	09/02/00	6,347.0000	5,704.0900	-10.13%
Germany - DAX Index	09/03/00	7,820.0000	6,461.3200	-17.37%
Europe - EASDAQ index	13/03/00	2,491.0000	1,260.1500	-49.41%
Japan - Nikkei 225 Index	31/03/00	200.2100	148.7500	-25.70%
JASDAQ Stock Index	01/03/00	1.1994	0.7576	-36.83%
HongKong - Hang Seng Stock Index	28/03/00	2,363.2500	1,761.0900	-25.48%
Korea - Korea Composite Index	04/01/00	0.9500	0.5812	-38.83%
Indonesia - Jakarta Composite Index	22/06/99	0.1068	0.0566	-47.04%
Mexico - Mexico Bolsa Index	09/03/00	905.1200	592.9800	-34.49%
Brazil - Bovespa Stock Index	27/03/00	10,965.1700	7,901.2500	-27.94%
Argentina - Merval Index	06/03/00	648.6700	457.9906	-29.40%

Chart 2 – Commodity Research Bureau Index

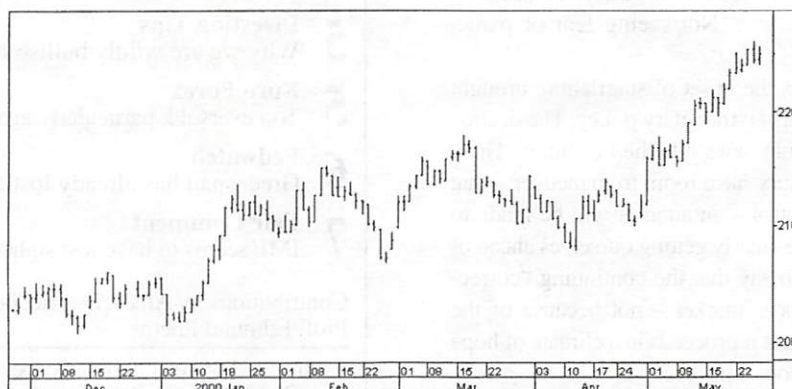
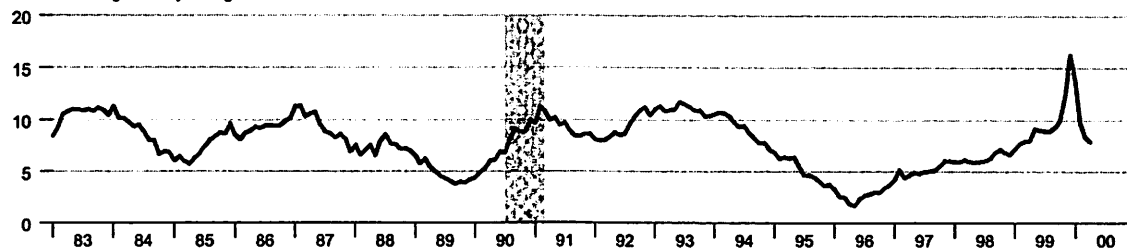


Chart 3 – Adjusted Monetary Base

**Adjusted Monetary Base**

Percent change from year ago



Federal Reserve Bank of St. Louis

**NOTABLE & QUOTABLE****On manias and panics**

The following quotation was sent to us by a keen market observer and a very dear friend of ours, the late Jack Rosenbloom, whose untimely death we still mourn.

“Much has been written about panics and manias, much more than with the most outstretched intellect we are able to follow or conceive; but one thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money. At intervals, from causes which are

not to the present purpose, the money of these people – the blind capital, as we call it, of the country – is particularly large and craving; it seeks for someone to devour it, and there is a ‘plethora’; it finds someone, and there is ‘speculation’; it is devoured, and there is ‘panic’.”

–Walter Bagehot (1826-1877)

“*Essay on Edward Gibbon*”

The more things change, the more they stay the same.

**FEDWATCH****Mr. Greenspan and the markets**

By Mark Mullins

Message to Alan Greenspan: Do not target the stock market. This plea comes from academic researchers (about this, more later) and from politicians mindful of the soothing balm provided to their constituents by rising equity prices. It comes from market participants and even from the quiet corner of the Fed chairman’s mind that almost always leans in the direction of market forces. And do you know what? All of these petitions are of little use, because the Fed already (and always has) supported stock prices.

This conclusion may strike some as odd, because the Fed makes a fetish of keeping its hands off the equity market. It does not buy equities for its own account. It almost never changes the interest rate that prices credit for those buying stocks on margin. It rarely comments formally on market valuation (with the odd “irrational exuberance” statement usually shrugged off by investors after a day or two of collective navel-gazing). It does not accumulate

holdings of equities, domestic or foreign, as part of its balance sheet asset holdings.

Nevertheless, the Fed targets the stock market indirectly. And it does this in three ways.

First, it controls the levers of money creation that provide liquidity to the market and credit to a growing economy. As long as reserve growth and the Fed balance sheet are growing at a rapid clip, you can count on the stock market moving ahead with the confidence that investor demand will be forthcoming and corporate profits will be growing.

Second, the Fed intervenes frequently in the shortest-duration money market, where it essentially sets call-money interest rates. This rate setting spreads up the yield curve and across maturities, from 1-day to 30-year paper, and has a direct impact on the discount rate for the stock market. When rates are low and/or falling, stocks benefit

by being able to value corporate cash flows further into the future.

Third, the Fed ignores rapid upside movements in the stock market but always eases policy when stocks crash. It does this because financial institutions rely on confidence and collateral for their lending activities – a crash hampers both of these and thus can lead to real economic effects. This asymmetry creates what economists call “moral hazard” – because the Fed essentially underwrites the risk of a crash, investors will logically take on more risk themselves and thus drive stocks above their fundamental values.

So, the Fed targets the stock market in an indirect fashion. A rising market reflects well on the Fed, because it indicates that the economy is growing, that interest rates are not onerous, and that the financial system is stable. By contrast, significant downside in equities points to recession risk and potential for a systemic shock to the financial sector. And this reflects poorly on a Fed that has a mandate to create economic conditions conducive to a growing standard of living for Americans. The Fed, therefore, also has a vested interest in a rising stock market, contrary to many who argue that it would be satisfied with sagging equity prices.

Many academics challenge the view that the Fed sets monetary policy according to the whims of stock market volatility. For example, a recent paper by Ben Bernanke and Mark Gertler (“Monetary Policy and Asset Price Volatility,” *NBER*, February 2000) says that the Fed “has neither actively sought to stabilize stock prices nor reacted to [non-economic] information in stock returns.” The authors make their case by using a small macroeconomic simulation of Fed policy – an attempt to mimic the Fed’s ad hoc and opportunistic approach to setting interest rates with a quantitative model. They find that there is no statistical support for a stock market effect on monetary policy, after controlling for the impacts of expected inflation, deviations from economic potential, and the natural inertia in money market interest rates.

However, this entirely misses the point concerning current Fed operating policy. The Open Market Committee makes its rate decision on a monthly basis, taking into account all available information, especially new economic data and financial market pricing changes. How else can it change its opinions but with new information?

When stocks are down, Fed statements typically reflect caution regarding policy, and the market knows this: Witness the way that Fed Funds futures price the ups and downs of stock market fluctuations. In effect, the stock market is a conduit for a market message to the Fed. Parts of the financial markets (Fed Funds futures, bonds, currencies, and commodities) respond in turn by pricing their expectations of how the Fed will respond.

The system iterates over and over, in a dance between market pricing and central bank expectations. It is no wonder that a statistical model using monthly data over 18 years is unable to pick up this effect. And, in any case, it is clear from historical examples (the Crash of 1987 and the Long Term Credit debacle of 1998) that the Fed responds directly and forcefully to stock market distress.

Generally, the “hands-off-but-supportive” stance to the stock market comes into peril only when it conflicts with the mandate of the Fed to keep inflation under control or when stocks collapse. There was no conflict between inflation and stock pricing through the 1990s until last year. From 1990 to 1998, inflation rates declined with boring regularity, until we reached the point in October 1998 when many economists actually feared a bout of deflation.

However, those watching the rapid growth of money supply begun in 1995 and the favorable oil price shock in 1998 would have concluded that renewed inflation and economic growth were the likelier outcomes. And so it has turned out that inflation is now running close to 4%, and the economy is bursting at the seams. In response, the Fed has tightened monetary conditions, with short-term interest rates rising 250 basis points since October 1998’s 3.5% low.

The market response has been unremarkable, because it is quite typical. Real short-term interest rates are up 170 basis points and real long rates have risen 40. A real monetary conditions index, including the impact of rates and the US dollar, is up 120 basis points. A real financial conditions index, including the above plus the equity market, is up only 90 basis points.

What to make of all these numbers? First, the Fed has tightened policy more than inflation has risen, showing its keen concern over inflation. Second, bond markets have suffered less than money markets, suggesting that the market foresees the Fed succeeding at its inflation control policy. Finally, equities have suffered least, putting paid to the idea that the Fed is trying to work the market lower.

The real question for the future, though, is the course of inflation and the impact of stock market fluctuations on the Fed. The Fed appears to be firm in its resolve to deal with the inflationary pickup, hence arguing for higher rates. However, the stock market is notably under pressure from the rate increases already in the bag. Higher rates risk a more severe equity downdraft. And on past form, as argued above, the Fed will err towards easier monetary policy with weaker equity prices. What will it be, Mr. Greenspan: Wholehearted inflation control or support for the retirement dreams of millions of Americans?

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**INVESTING TIPS****Why we are wildly bullish on TIPS**

Stagflation is the answer. Our scenario calls for a dramatic worsening of the real growth/inflation mix. Even if nominal GDP continues to gallop ahead at an 8% growth, inflation will begin absorbing an ever-larger share of the nominal income.

The continuing implosion of asset prices will have a significant wealth effect, which in turn will cause private savings to rise. It should be noted that private net savings, at negative 4% of GDP (and certainly higher since last fall), have not been negative in 40 years. The collapse in net private savings is also reflected in the eye-popping deficit on current account. By definition, the external deficit is equal to the sum of private and government net savings. In effect, the government's budget surplus has barely dented the fall in private savings.

Economists at Phillips and Drew estimated, late last year, that a reversion of the savings rate to its historic average (1% of GDP on the old series, from negative 4%-5% now) causes the economy to stagnate for five years, with average annual growth of 0.4%. A hard landing is produced if savings overshoot, as they did in the recession of 1973-75, and rise to 4% of GDP by 2004: GDP falls by an average of 0.3% a year over the next 5 years (and the unemployment rate rises to 11%!).

Stagnation, and all the more so stagflation, is bearish for real interest rates (careful, nominal rates may rise if only to compensate holders for higher rates of inflation). As an

example, Japan's real rates currently hover around 2.5% (nominal yields of 1.7% and an annual deflation of .8%) compared with TIPS in the area of 4%. During the last great stagflation, the decade of the '70s, real rates in the US fell to negative values. Real interest falls of this magnitude yield substantial capital gains and are thus extremely bullish for Treasury Inflation-Protected Securities (TIPS).

There's more. We believe that real rates have already fallen but that for a number of reasons, the market is mistakenly undervaluing TIPS. The main reason for this undervaluation is that nominal bonds still act as benchmarks for interest rate levels. In effect, the bond investor does not consciously price real interest rates and expected inflation rates separately, as he should. As a result, real rates are a residual rather than a driver of the equation. The proverbial story of the tail wagging the dog.

Our proof is that the breakeven (the difference between nominal yield and real yield bonds of equal maturity) at 2.3% is too low relative to recent year-on-year consumer price inflation (3%) and relative to the most recent survey on inflation expectations conducted by the University of Michigan (3.6%, or perhaps a bit less, if we deal with long-term expectations). To our way of seeing things, nominal-yield bonds are a sale and real-yield bonds are a buy.

Mortgage your house, and buy long-term Treasury inflation-indexed securities.

**EURO FOREX****Too oversold, particularly against the yen and sterling**

The euro's two main problems, rigid labor markets and a lack of political cohesion, are not only not new, but they have been extremely well advertised. Less noted is the fact that the European Central Bank's monetary policy is, unlike its US, UK, and Japanese counterparts, anchored to something (admittedly, loose monetary targets), business is booming, stocks represent a much smaller percentage of European wealth than in the US or the UK, and the current

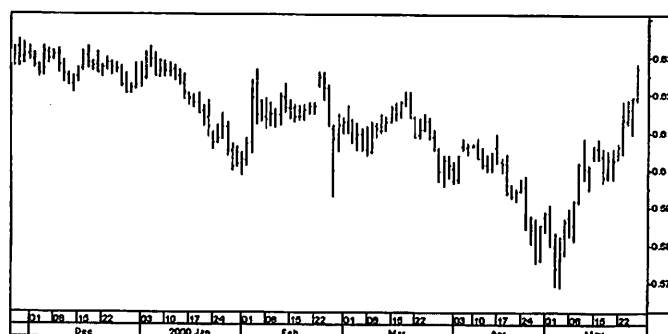
account is positive. Granted that foreign exchange rates are indeterminate over a fairly wide range, but there is little justification for the euro to have fallen by upwards of 30%. More likely, a typical bandwagon effect has been in operation, with selling begetting more selling by technically-oriented accounts.

At the very least, expect a sizeable bear market correction. Buy euro/yen and euro/sterling.

Chart 4 – Euroyen



Chart 5 – Europound



**FEDWATCH**

**Greenspan has already lost the inflation fight**

*Albert D. Friedberg*

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It is not, as many believe, that the Fed has been too timid in fighting inflation. It is far worse than that: Alan Greenspan's Fed has been blissfully misguided.

Central bankers in the United States, and for that matter the rest of the world, have lost their true North. Aside from reiterating their strong commitment to fighting inflation, these central bankers lack the will and the proper understanding to conduct such a policy.

Start with basics. Inflation is and always was a monetary phenomenon. Creating money in excess of the desire to hold money causes prices to rise. Very few serious economists doubt this simple assertion. Yet, central bankers insist on discussing everything but money when they explain policy: They speak about productivity, pools of labour, unemployment, real growth and so on, without once addressing the issue of the supply and demand for money (not to be confused with loan demand).

Technology has made remarkable progress in allowing consumers and corporations to reduce the need for money. Witness, for example, the huge rise in the use of credit cards and ATMs, which eliminate the need to carry around bulging rolls of cash. What purpose would be served, in such a cash-efficient society, to allow cash balances or other transaction balances to grow year after year? Why has the central bank shoved money into an economy that clearly was not demanding it? The answer is that the Federal Reserve does not take into account the growth of monetary aggregates when it conducts its monetary policy. Instead of determining the quantity of money, it merely sets the price of money through interest rates, and in a highly discretionary manner at that.

If the Fed merely regulated the quantity of money – a policy called monetarism – the free interplay of market forces would set interest rates. Focusing on supplying the right quantity of money, while still a highly imprecise exercise, would have given the Fed an anchor, albeit an imprecise one, on which to base policy. It would have had to justify the excessive growth (or the growth altogether) of transactional money, instead of expounding on the “right” level of interest rates.

Fussing over the right level of interest rates is part of a socialist mind-set. Does anyone truly believe he can know the right level of prices for wheat, shoes, media spots or any other product in a free market economy? Why do central bankers think they know the right level of interest rates? Why do they praise free markets in everything but money? Setting interest rates affects the demand for money, which in turn, via interest rate intervention, affects the supply of money. An upside down world.

True, monetarism was discarded in the late 1970s and early 1980s because of the difficulties of defining money. Nevertheless, the extraordinary progress in the fight against inflation was achieved, not coincidentally, by a very steady fall in the growth of money supply. From annual growth rates of 12% in 1983, growth in the broad M2 money supply fell to almost 0% by early 1995. The massive monetary shock administered in the early 1980s by Paul Volcker, then chairman of the Federal Reserve Bank, halted rising inflationary expectations almost in their tracks. As the demand for money grew and interest rates threatened to fall below the Fed's funds target rate, the Fed absorbed funds and the supply of money slowed to a crawl. Unintentionally, the Fed was fol-

lowing a monetarist prescription. Predictably, price inflation fell continuously over the 12-year span, to less than 2% from almost 15%. The upshot was that prices and inflation behaved as if monetarism were still in place.

By the middle of the decade, the Fed's concern with inflation became mere lip service. The excellent behaviour of prices, reinforced by cyclical and secular productivity improvements, allowed the Fed great freedom. With the first global financial crisis, the Mexican Tequila affair, Fed policy changed, from an inflation focus to a crisis management one. Henceforth, Fed policy would be conducted with an eye toward averting systemic failures. The South Asian crisis, the Russian crisis, and the Long Term Capital Management crisis saw the Fed at its paternalistic best. It set interest rates solely to help stave off a presumed financial collapse; its policies had lost any focus on creating supply of and demand for money that would yield a reasonable, let alone a zero, inflation rate in the medium term. In the meantime, asset inflation began to erode whatever goodwill the anti-inflation campaign had gained. Interest rates were set at levels that produced an excess supply of money; no longer could the Fed rely on the rising demand for money balances.

The stage was set for a significant rise in inflation. Note, however, that consumer prices took some time to reflect this latent inflation. For one thing, commodity prices had taken a drubbing in 1997 and 1998, as a result of the Southeast Asian crisis. For another, the trade-weighted US dollar, buoyed by large portfolio flows generated by a very strong stock market, rose by almost 20% in real terms since 1995, putting a pow-

erful lid on import prices. The accompanying and growing trade deficit also did its part to help maintain reasonably steady prices. The lag fooled the Fed and most of the financial community into thinking, as late as the beginning of this year, that inflation was still under control. In fact, inflation has been out of control since at least the mid-1990s. It is just that consumer prices were being repressed by the temporary weakness of commodity prices and the rise in the US dollar.

Except for the still strong US dollar, the corset is off consumer prices. Core consumer price inflation (even excluding tobacco) has risen sharply, as measured by either the personal consumption deflator (almost 3% year-over-year) or the core CPI (a shade above 2%). Note that consumer prices, unadjusted by the rise in food, energy and tobacco, have risen 3.7% year over year, the highest rate in a decade. Because money growth has been excessive for at least six years, we estimate that inflation rates are set to rise considerably before the Fed lands us into a recession, in a belated attempt to regain control. Unfortunately, our troubles will not end there. A recession will almost certainly weaken the US dollar, removing in its wake the last corset.

As consumer prices begin to gallop, financial markets will wilt, writhe and then implode. Glitzy theories about productivity miracles, Internet price-chopping and lack of pricing power will again be recognized as new versions of the cost-push theory of inflation. Money will once again take centre stage. And, as we never tire of saying, it will painfully be realized that money is too important to be entrusted to central bankers.

## **FAIR COMMENT**

# **IMF seems to have lost sight of rationale for capitalism**

*Prof. Edmund Phelps*

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### **From Letters to the Editor of *Financial Times***

Sir, Your wrap-up on the recent IMF/World Bank resolutions ("Spring meetings fail to burst into blossom," April 19) conveys a dearth of progress. What went unremarked was the radical ramping up of the agencies' stated mission.

Signs of the International Monetary Fund's enlarged ambition appeared two years ago, amid the financial crises. The agency said then that international financial flows ought to be "stable," and if they were not, they ought to be "stabilised" to the extent feasible. Most economists must have

supposed that the IMF was expressing badly its more modest desire for global standards of financial transparency and codes of national policy conduct – two avenues being pursued now. One would not have thought that the IMF envisaged a global financial utopia in which it would second-guess the bets made by informed international lenders and seek to modify the flows accordingly.

The IMF speaks grandly of "crisis prevention." True, the operational content of this objective is not much more than the greater transparency and the policy conduct that all agree will improve investment allocations and help investors not to

be taken to the cleaners.

However, when Stanley Fischer, the IMF's acting managing director, clarifies that he is "under no illusion that there will never be a financial crisis again," he evidently means: not for want of trying. A general policy of crisis prevention is a worrying notion. What will the IMF do the first time transparency plus good policy codes prove not enough?

This zero tolerance for financial crisis suggests that the IMF has lost sight of the rationale for capitalism. Western nations, or a good many of them, adopt it not so much because Stalin's Gosplan could not get the relative prices of nuts and bolts right, but because its pluralism of entrepreneurs and investors, all with differentiated insights and experience, is an inspired way to manage the uncertainties that creating new futures entails.

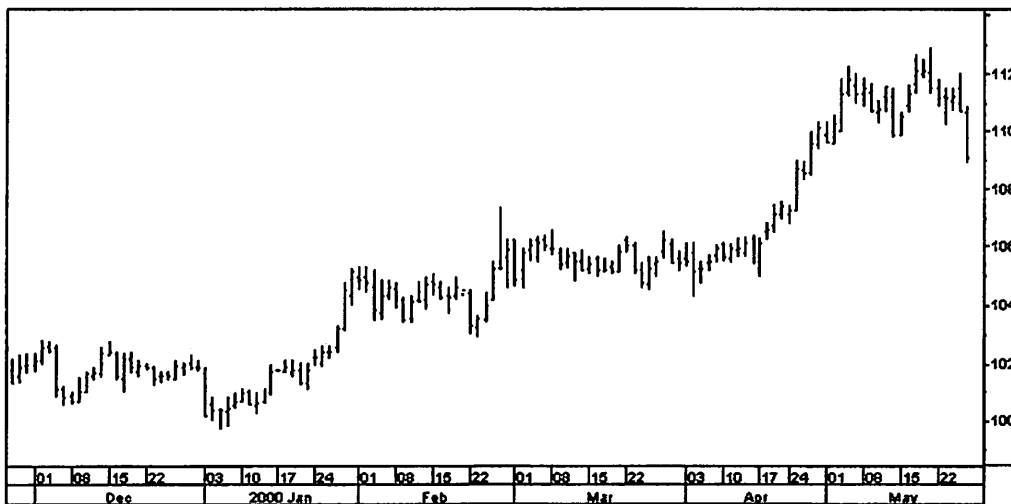
In this process, a series of even minor pieces of information may at times precipitate a massive reappraisal of company shares. And such market crashes are not always dysfunc-

tional, because they may serve to wipe out some of the weaker entrepreneurs and the dumber ideas. Thus, seemingly pathological crashes and the crises that may ensue are an inherent part of the market economy's creative – and destructive – processes. Like forest fires and nervous breakdowns, they have their function. Yes, the poor are casualties of a crisis. But they are also great beneficiaries of capitalism's productivity and dynamism.

In demonising imbalances and crises, both inherent in capitalist economies, the International Monetary Fund seems to share the populist under-appreciation of capitalism shown by the protesters. In so doing it may help create the outcome that is the wish of many of the protesters: the eventual shut-down of the capitalist system.

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Chart 6 – US Dollar Index



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