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Why is gold leading the charge against the dollar?

We closed the lead article of our March 24 issue with the words, "Gold and TIPS are looking better all the time." A perfunctory look at the accompanying charts prove the, shall we say, omniscience of the call.

The dynamics behind this gold call were spelled out in detail in our Oct. 1, 2001, issue. Below, we present an excerpt of that argument and then add a new and confirming piece of information that has come to light in recent weeks.

After describing the extraordinary magnitude of the global monetary stimulus, we turned to its implications and the possibility of capitalizing on the "inevitable" conclusions. Here, in part, is what we wrote:

> Neither foreign currencies nor industrial commodities are likely to be the early winners…the early winner in our view will be gold.
>
> The special circumstances that brought it so low are disappearing. For one thing, the bulk of demonetization has occurred; henceforth, official supplies are predictable and digestible. For another, forward selling has telescoped future mine supplies, but accelerated supply totals have remained fairly steady. If anything, mines are likely to lift hedges going forward, to take advantage of paper "profits" and repair weak balance sheets.
>
> Goldfields reported that mines added to demand by lifting hedges on 41 tonnes during this year's first half. Moreover, it is quite possible that all the gold that could profitably be locked at forward prices was already sold. Further hedging would necessitate much higher prices. But much higher prices are also likely to cause a rush of short-covering, particularly for those mines that need to raise external funds and thus need friendly investors (hedged companies are no fun).
>
> This spells, potentially, a gigantic short squeeze as short positions are equal to one-year mine supplies. Favorable price action should also awaken investor interest: Last year's disinvestment and source of supply would turn into this year's demand. The sudden change in the gold equation has the potential of causing a veritable price explosion.

Well, Goldfields' figures for the full year 2001 are in, and the early trend is confirmed: The global producer hedgebook dropped by a not immaterial 147 tonnes. A net reduction in outstanding positions, naturally, implies that gold is being withdrawn from the market. In other words, it should correctly be viewed as an increase in demand. What is significant is that this is the first full-year reduction in many years (there was an minor reduction in 2000 of just 15 tonnes), and it points to an acceleration of the trend – 41 tonnes in the first half of 2001, 106 tonnes in the second half. Clearly, hedging is out.

If our assumption that hedging is no longer fashionable or profitable or both (mostly because of bullish prospects for the metal) is valid, which we think it is, the implications are

In this issue

3 **Gold**
Intellectualizing the gold move

5 **US Dollar**
The US dollar has rolled over

6 **Forex**
Where to hide from the falling dollar

8 **Latin America**
The curious case of Ecuador

8 **Geopolitics**
Analytics of the India-Pakistan Conflict

11 **Argentina**
The calm before the storm

Contributions by Albert D. Friedberg, Steve H. Hanke, Vincent de Caën, Jeremy Fand, and STRATFOR.

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extremely bullish. Here's why. The world supply and demand for gold is finely balanced, with total supply (including official sales of over 500 tonnes per year) at 3,868 tonnes, and total demand (including bar hoarding, but no allowance for investment demand) at 3,722 tonnes. Hedge lifting makes up the difference (last year, as we said, 147 tonnes). The hedgebook totals 3,067 tonnes. A slight acceleration in the pace of hedge lifting, say a 10% reduction of the book, would, ex ante, overwhelm supplies by 150 tonnes (that is, over and above last year's 150 tonnes reduction). This would be accommodated by rising prices, which admittedly would decrease fabrication demand but which would increase, by presumably a far greater factor, investment demand.

One hundred fifty tonnes represents the equivalent of 45,000 Comex contracts. To assess the market impact of this buying, one needs to compare the 45,000 contracts with some measure of market liquidity. Because volume includes heavy day-trading activity on the part of "locals" and substantial spread trading, both of which have little or no net price impact, we discard average daily volume. Instead, we submit that the more significant figure is the average daily change in the open commitment over some recent period. Changes in the open commitment reflect genuine "ownership" changes. In fact, ownership trends tend to parallel price movements (whether new buying or short-covering) and can thus be thought of as price-making transactions.

Since Dec. 1, prices have advanced $48/ounce on an open interest increase of approximately 90,000 contracts. The absolute average of daily changes of open interest works out to 2,374 contracts. Hence, the 45,000 contracts of potential short-covering represents nothing less than 19 days of trading, a mighty prop to prices indeed!

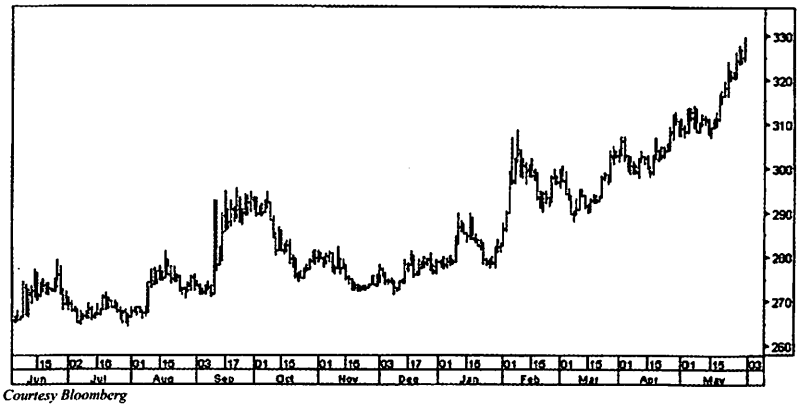
Consider, however, a more catastrophic scenario (*à la* Ashanti, September 1999): Gold producers are forced out of their hedges by their bankers because cash flows are mismatched, i.e., marked-to-market losses are immediate, and revenues are years away. In such a case, hedge lifting can easily represent multiples of 45,000 contracts. For example, a 50% reduction (1,500 tonnes) in the hedgebook represents the staggering sum of 450,000 Comex contracts, or 190 days of trading, probably enough to drive up prices by hundreds of dollars if executed in some rush.

Not only could a Middle East and/or Indo-Pakistani conflict trigger such a catastrophic scenario but, we suggest, so could the simple continuation of the present advance moving through, for example, the 1997 (a year of record hedge selling) highs of $368/ounce.

Watching the tape, we have taken note of the recent "tightness" of daily ranges, bounded by substantial buying on all dips coupled with careful bidding on upticks, a clear attempt not to frighten sellers. This "controlled" action is typical of hedgers and commercials (who may be trying to wiggle out of short positions), not of speculators. In fact, our sense tells us that this market is being driven by hedge lifting, with speculators (futures traders, Japanese savers) playing a much more reduced role.

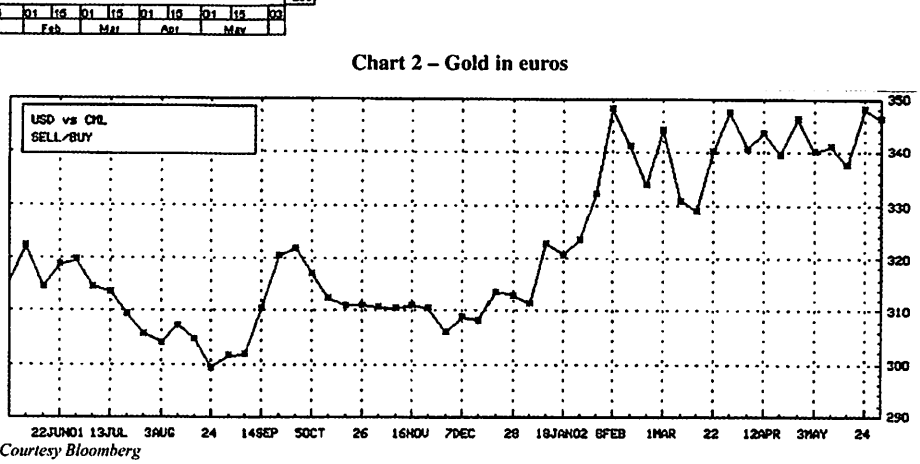
If our intuition and our math are correct, gold prices are poised to explode on the upside.

Chart 1 – Gold 06/03/01 - 05/31/02



Courtesy Bloomberg

Chart 2 – Gold in euros



Courtesy Bloomberg

GOLD

Intellecualizing the gold move

By Vincent DeCaën

In this article we examine the determinant(s) of the price of gold in a somewhat roundabout manner. We begin with an important, much-cited paper by Barsky and Summers, "Gibson's Paradox and the Gold Standard" (1988). In this paper Barsky and Summers, building on the work of Robert Barro, claim that the paradox is simply a function of a gold standard: With the imposition of a gold standard, gold has both a monetary and a non-monetary use, and the two uses have two different demand functions. En route we will encounter the genius of Keynes and Knut Wicksell as they wrestle with the paradox. Finally, the behavior of gold prices since the early 1970s and the end of the gold standard is reconsidered in this light.

1. Gibson's Paradox

Orthodox monetary theory posits an inverse relation between the money supply and the interest rate: a simple supply-and-demand function. Furthermore, an expanding money supply is positively related to prices (inflation). This is the heart of neo-orthodox monetarism. Thus, interest rates and prices are supposed to move in *opposite* directions.

However, in his seminal articles in the *Bankers' Magazine* (1923, 1926; cf. Peake 1928), Gibson observed that in fact, the interest rate, as measured by the British consol, moved closely with the wholesale price index (1820-1926), apparently undermining classical economics. Interest rates and prices were observed to move in the same direction. But monetarists insist that prices move with, in fact are moved by, the growth of the money supply.

Keynes (1930), observing further that this comovement was confirmed for two entire centuries (1730-1930), dubbed this decidedly unexpected behavior "Gibson's Paradox." This paradox, "one of the most completely established empirical facts in the whole field of quantitative economics" (Keynes 1930: 198), has been the thorn in the side of orthodox macroeconomics to the present day.

2. Wicksell and Keynes: changing demand schedules for loans

Both Wicksell (1935, 1936) and Keynes (1930), in an unorthodox fashion, thought that the paradox might have something to do with the shifting *profitability of capital*. They both thought that movements of interest rates and prices were the common result of independent changes in *demands for loans*: A rising profitability of capital encourages investors to seek ever more capital to invest. An increasing demand for loans obviously bumps up interest rates *directly*. Furthermore, because the banks are proverbially slow to react to the new environment (Keynesian "stickiness"), the money supply is furtively expanding. According to theory, an expanding money supply fuels inflation. And so we also see that the demand for loans increases prices *indirectly*. A declining demand for loans, contrariwise, pushes both interest rates and prices downwards.

Whereas Wicksell simply required variations in the reserve ratios of the banks; Keynes zeroed in on the contracting *ratio of gold reserves* vs. monetary liabilities. But as Cagan (1965) emphasizes in his magisterial study of economic variables, neither proposal is empirically supported. "Neither changes in banks' reserve ratios nor in the ratio of the domestic gold stock to high-powered money account for any sizable part of the long-run movements in the U.S. money stock before 1914." (Cagan 1965: 254 [sic].)

Cagan's study, incidentally, also tested Irving Fisher's idea of lagging inflationary expectations (Fisher 1930) as an explanation (Cagan 1965: Appendix B, pp. 305-309). The important conclusion is that the lag is "so long [decades in fact] as to seem implausible" (p. 257).

Strike three.

3. Excursus: Wicksell's rate gap

We must note in passing the crucial insight that is buried in Wicksell's discussions: the problematic *gap* between what he calls the "natural real rate of interest" and the nominal rate. If the going rate were to sink below this "natural" rate, for example, investors have every incentive to borrow to take advantage of the difference. The resulting expansion of the money supply, according to theory, triggers inflation.

Conversely, nominal rates, if pushed above this natural rate, would sap demand for loans, thereby contracting the money supply and so putting downward pressure on prices. "The primary cause of price fluctuations in both cases is the same, namely the difference arising no matter how, between the normal [read "natural"] and actual money or loan rates." (Wicksell 1936: 208.)

The implications for central bank policy are clear, but we digress.

4. Barsky and Summers: monetary vs. non-monetary gold

Barsky and Summers (1988), following the lead of Robert Barro, build on the observation that Gibson's paradox is *temporally correlated with the period of the gold standard (primarily* 1821-1913) and that this paradoxical behavior of interest rates, money supply, and prices vanishes by the 1970s with the collapse of the fixed-rate regime and the gold standard. They suggest, then – not unreasonably – that it must in fact be in the very essence of gold itself (or *mutatis mutandis* any precious metal employed as standard) that we will find the resolution of the paradox.

Crucially, with the imposition of a gold standard, gold is *both* money *and* precious commodity. Its monetary use has one demand function, while its non-monetary use has a different demand function. It is the *combination* of these two uses and these two demand functions that pushes prices and interest rates in the *same* direction – so they conclude.

With the end of the gold standard, however, gold retains only its non-monetary use and function; therefore, the dynamic created by its monetary use, and the shifting back and forth of the gold stock between the two uses, vanishes. The price of gold once again behaves like that of a durable store of value – no longer subject to price-fixing by the central authorities. And the relation between interest rates, money supply, and general prices then conforms to orthodox monetary theory.

The foundation of their reasoning is the relation between the *real* price of gold and general prices under a gold standard. After all, the central authorities fix the *nominal* price of gold. And yet, the *real* price of gold fluctuates. If general prices are rising and the *nominal* price of gold is fixed, then the *real* price of gold must be falling. Conversely, if general price levels are falling, then the *real* price of gold must be rising.

Other elements of the model include the following:

1. There is assumed to be a *fixed* stock of gold ($\bar{G}$), shifting back and forth between monetary and non-monetary uses. This is a zero-sum game.

2. The *non-monetary* use of gold (G_n) is inversely related to the real gold price (P_{gold}) by supply and demand.

3. Finally, demand for the *monetary* use of gold (G_m) moves in tandem with the changing money supply (M). A contracting money supply, for example, means a falling demand for gold in its monetary use.

We can summarize this model as follows, using arrows to indicate comovement and reading left-to-right as the chain reaction. (Notice the crucial equilibriating mechanism that operates after a lag.)

$$\begin{array}{lllll} \uparrow i_{real} & \Rightarrow & \downarrow P_{gold} \Rightarrow & \uparrow G_n & \\ & & \Downarrow & \Downarrow & \\ & & \uparrow P & \downarrow G_m \Rightarrow & \downarrow M \quad \textbf{...lag...} \quad \downarrow P \end{array}$$

Let us read off this model:

First, assume an exogenous shock to the return on capital, and so a rising real interest rate (i_{real}). How does the real price of gold react? Remember, gold as a durable and precious commodity is an asset in competition with a whole array of assets – stocks, bonds, etc. If the profitability of capital is rising, investors are shifting out of gold and into other assets; therefore, the real price of gold is inversely related to the real interest rate, as diagrammed.

If the real price of gold is falling, then general prices are rising (inflation). This is the iron law of the gold standard. Recall that the authorities fix the nominal price of gold. Price changes must move in the opposite direction to the real price of gold.

If the real price of gold is falling, then the demand for gold in its non-monetary uses is rising. This follows from the theory of supply and demand.

If the demand for non-monetary gold stocks is rising, then the demand for monetary gold stocks must be falling. Remember that the existing stock of gold is assumed to be fixed.

If the demand for monetary gold stocks is falling, then the money supply must be contracting. We need not go into the behavior of the central banks in buying and selling to establish this connection.

We have just derived the behavior of economic variables identified as Gibson's paradox: Interest rates and prices move in the same direction, not in opposite directions as expected. Notice, crucially, that real long-period interest rates are *inversely* related to the real price of gold, regardless.

Of course, according to orthodox theory, after some unspecified time lag, prices must eventually respond to the contraction of the money supply. This feedback loop sends the system into its opposite mode. The system under a gold standard is thus self-equilibrating.

5. Conclusion: the determinant of the price of gold today

With the collapse of Bretton Woods and the end of the gold standard, the distinction between monetary and non-monetary uses of gold vanishes, as Barsky and Summers emphasize. But what then happens to the price of gold? What can we establish about gold prices today?

We still find the striking correlation between real long-term interest rates and year-over-year gold prices. What, after all, determines the desirability of gold as an asset versus the whole array of other assets? As explained, if the productivity of capital (and so real long-term interest rates) is rising, for example, the investor shuns gold as an investment. Conversely, if the outlook sours and real long-term rates are falling, gold as a store of real value becomes desirable. Gold as a durable asset is *necessarily* sensitive to real interest rates.

In the current environment, we note that the real interest rates are falling. We conclude that the price of gold will follow falling returns and index-linked securities. Onwards and upwards.

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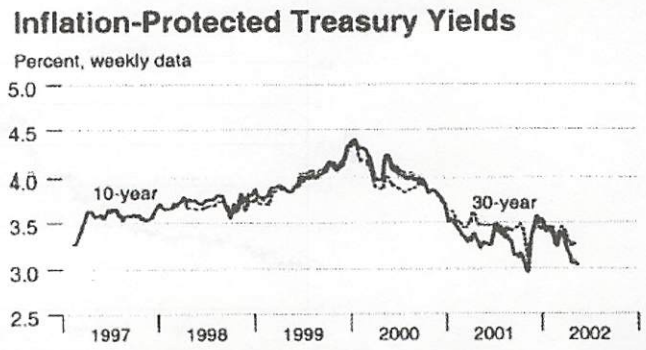
Chart 3 – Inflation-Protected Treasury Yields



Reprinted from Monetary Trends, *courtesy The Federal Reserve Bank of St. Louis*

US DOLLAR

The US dollar has rolled over

Note: This article was e-mailed to clients on April 22 as a special Focus on Futures feature. We are still of the same mind, but we recommend substituting the Mexican peso and the Brazilian real with the euro.

You would not know it by watching the euro and the yen. Or even the Swiss franc and the British pound. That is because, unlike previous bouts of US dollar weakness, the present weakness is not attributable to the desirability of the major foreign currencies, but to the inherent weakness of the greenback. And the weakness is showing up in the high-yielding "peripheral" currencies.

Let us explain. We have all known for some time that the surge of the dollar that commenced in 1995 was not sustainable. The US was running a serious and widening current account deficit, equal now to perhaps 5% of GDP. This deficit was the natural counterpart of a declining household savings rate, in turn caused, if not aggravated, by a persistent cheap-money policy.

The early effects were beneficial for the dollar: Cheap money sparked an extraordinary and absolutely unprecedented securities boom that attracted huge portfolio flows from abroad. For a long time, these capital flows overwhelmed the balance of payments account, more than offsetting the current account deficit, and pressured the US dollar upwards.

Quite understandably, the onset of the bear market in stocks should have spelled the end of the dollar reign. It was not to be. As Wall Street sneezed, foreign stock markets caught a cold. Differentially, the US was still the world's preferred haven. Fifteen months into the collapse of Nasdaq, the dollar was still rising. But then came the straw that broke the camel's back.

Cheap money gave way to super-cheap money as the Fed panicked in reaction to 9/11 and the brutal fall in corporate profits. Easy money also brought economic relief the world over. As global economic activity recovered, excess dollar balances began to find an expanding list of attractive havens: South Korea, Thailand, Singapore, China, Hong Kong, Mexico, Brazil, Central Europe, Australia, New Zealand, and yes, even Canada. As water overflows a cup, so the dollar began to overflow its main receptacle. The dollar measured against a simplistic index of the world's most tradable currencies, equally weighted (see Chart 4, current levels indicated), paused around the end of the first quarter of 2001 and most recently rolled over to break its year long consolidation. More importantly, it managed to break an uptrend that reached back all the way to 1995.

Productivity considerations argue against an inordinately large fall. After all, the US still enjoys the world's freest (large) economy, unparalleled property rights and unparalleled entrepreneurial talent, a stable taxation environment, and a relatively modest government sector. In real terms, the dollar is unlikely to be overvalued by much more than 10%. The main source of weakness, in our opinion, is monetary.

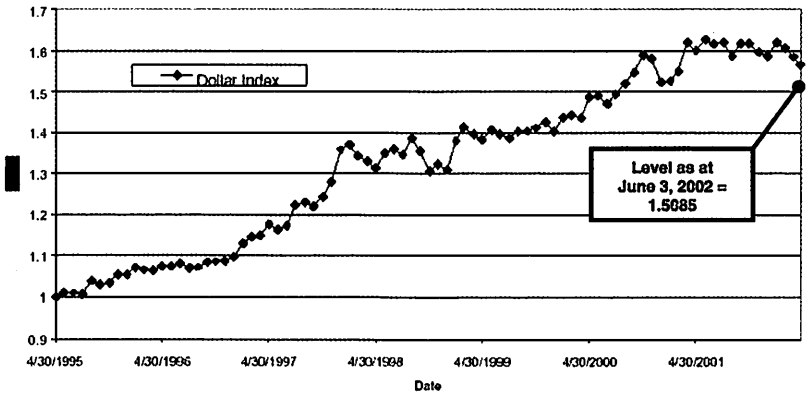
Not only is US monetary policy at this time too loose, but prospects for a significant change are difficult to imagine under the stewardship of Alan Greenspan. In his latest policy remarks, he indicated a strong wish to be very patient in moving away from an accommodative stance. In fact, he saw fragilities in business and financial conditions and few fears about an acceleration of inflationary pressures.

Our scenario, already outlined in previous issues, is that the Fed will be hard put to return to a Fed Funds rate of 4.25% prevailing at the height of the Russian/LTCM crisis, let alone the 6.5% prevailing at the peak of the boom. And yet, with nominal GDP running at 5% per annum (on the low side), Fed Funds would need to trade above 5% just to stay neutral.

Until such time as US monetary policy regains equilibrium, the dollar is likely to remain under pressure. Should the Fed procrastinate beyond a reasonable time-frame, the dollar may overshoot on the downside: A 10% expected decline could well turn into something more serious.

We recommend exposure to a basket of currencies that could well include the Canadian, Australian, and New Zealand dollars, the Central European currencies, the South Korean won, Thai baht, Brazilian real, Mexican peso, and the Scandinavian duo. The yield pick-up is exceptionally attractive and provides an added measure of risk protection. ***– A.D.F.***

Chart 4 – Dollar index - 17 currencies



FOREX

Where to hide from the falling dollar

By Jeremy Fand

The foreign exchange markets have become more interesting recently as the US dollar continues its slide. The concerns over the strength of the US recovery, weakness of the US stock market, the sustainability of the US to attract capital, and continued threats of terrorism are weighing heavily on the greenback. The longer-term threat to the US dollar is that this toxic mix of concerns may lead to a current-account sustainability problem for the US.

With the US requiring significant investment from abroad to finance its current account deficit, and with evidence mounting that capital is not finding its way to US shores at the same rate that it had been, the US dollar may indeed fall further.

The US stock market is critical here. If stocks continue to retreat on concerns about persistent relative overvaluations, corporate earnings, accounting concerns in the wake of Enron, and soft capital spending, the ability of the US to continue luring that capital will deteriorate. Add to that the relatively low rates of interest paid on US fixed-income securities, and the flows could continue significantly away from the US.

Another critical dimension to the US dollar's fortunes is the persistence of the terrorist threat and the politics of the strong dollar. What the foreign exchange markets have learned in the wake of 9/11 is that the US is vulnerable to terrorism. This has clearly eroded the safe-haven status of the US dollar. A growing chorus of complaint from US manufacturers that the strength of the US dollar is making exports increasingly uncompetitive is also dragging the buck down.

Assuming that the dollar has passed its peak, the big foreign exchange question becomes one of finding a worthy alternative to the US dollar and to US investing generally. The rise of the dollar over the past few years is largely the result of the potent mix of significant US economic and investment outperformance. In simple terms, the US was the best place to invest. If the US is no longer assumed to be the best place to invest, do the yen or the euro offer a worthy alternative?

Japan is in vogue

The growing confidence in the recovery of the Japanese economy is having a strong positive effect on Japanese assets. Not only is the yen strengthening despite official protests and intervention but markets are also starting to price a global reflation based on a long-awaited Japanese economic recovery.

Hopes for a Japanese recovery have revived on improving economic data (especially gross domestic product for the first quarter) and on increasingly positive government assessments of the economy. But Japan is by no means out of intensive care – the banking sector is still a wreck, and numerous industries are on governmental life support. At the end of May, credit rating agency Moody's Investors Service downgraded Japan's credit rating two more notches (to Aa3) – a clear message that Japan still has some significant concerns going forward.

Those who are measuring global reflation also need to take note that key measures of inflation in Japan are still falling (and have been for 31 months in a row). Indeed, it is a stretch to describe Japan's turnaround as anything other than an export-led recovery. This fact has put pressure on the government to step in an attempt to slow the rise in the yen for fear of cutting off the main engine of recovery.

Is a strong yen a problem?

Bank of Japan intervention to weaken the yen is interesting, because it has the potential to disrupt the positive flow of confidence that has put Japan back into vogue. While worry about a strong yen cutting into exports seems to be driving the current round of BOJ intervention, the trend strength of the yen may not be a bad thing, because it is a sign of growing confidence in Japan as an alternative to the US for investment.

There is no question that the best stimulus for Japanese growth remains US demand. A strong US economy is the economic lifeline most often mentioned by Japanese government officials. Second to that the Japanese need to resort to confidence building, because most other economic policies have failed.

So far this year, the Japanese have pushed harder on fiscal and monetary policy tools, despite their lack of success in the past. The increase in the BOJ's rinban (outright bond purchases) was heralded as a solution, but the evidence is that monetary policy is ineffective. A weak yen policy was also embraced as a way of further stimulating growth, but outside of the export effect, it is a weak policy tool. The government even went as far as artificially supporting the stock market to help spark the recovery.

The foreign exchange market was betting that the BOJ printing of yen combined with a weak yen policy was the solution for Japan's economy. Hence, the yen fell to ¥135 vs. the dollar only a few months ago. Printing yen, however, may be putting the cart before the horse. A weak yen may actually kill the horse. With rising unemployment and a double- or even triple-dip recession, one cannot blame the Japanese for stuffing their mattresses full of yen. This high savings rate is a good proxy for the lack of confidence. Yet it is the confidence issue that needs attention, because it is the secret weapon.

Correlation of confidence assets

If Japan were to experience a return of real confidence, all the liquidity might start flowing out. The Japanese authorities are starting to understand this, but have not yet been able to motivate it. They recently tried to support the stock market to boost confidence but made the mistake of trying a weak yen policy at the same time.

In coming months the Japanese should begin to realize that all Japanese assets need to rise. Rising and correlated asset prices will ensure that confidence too is rising, and the recovery can truly get under way (with the help of a strong US economy.) If the stock market, interest rates, the yen, and economic data can all start rising, the Japanese can start to declare victory.

At the moment, however, the authorities are standing in the way of further yen strength. And another critical confidence asset – Prime Minister Koizumi's popularity – is falling. His popularity has dropped below 40% from levels in excess of 80% last year, and could potentially be a drag on confidence.

Authorities are waking up

The Ministry of Finance has asked the Bank of Japan to intervene in the forex markets to sell yen and buy dollars. While this action indicates that the Japanese are concerned with the strength of the yen, the intervention is likely only to slow the rising yen, not to stop it. Indeed, the verbal intervention that accompanied this action seems to indicate a concern with the speed of the rise of the yen, not the level or the direction.

BOJ Governor Hayami added another reason – concern about the falling dollar and the impact that it might have on the US economy. This is a true reflection of the Japanese need to see continued strong US demand (and a relatively strong dollar) to support the Japanese economy.

Finance Minister Kuroda made it clear that the yen and confidence are indeed linked. He said that "the first task is to regain people's confidence in (Japan's) economy." He went on to say that the yen's reputation had been hurt by 10 years of slow growth. With Japan's growing focus on confidence, the yen should continue to show relative strength.

Every dog has his day

The euro too has displayed some uncharacteristic strength versus the US dollar in recent months. While most of this can be attributed to the weak dollar side of the story, it is worth asking if the euro provides the alternative to global investors.

The case for the euro is a tough one to make, because the currency has not performed well since its launch, and Europe continues to lag the US economically. Even with concerns about the US growth, most forecasts for European growth are half that of the US. With growth running low, EU member states have been having trouble with their deficit/GDP ratios fitting into the pre-set limits.

Structural reform is still in its infancy in Europe, while the US productivity figures show how mature the US has gotten on reform. Indeed, productivity differentials have been a very good guide to understanding the weakness of the euro relative to the US – and that differential is unlikely to narrow much in coming months. Higher interest rates in Europe relative to those in the US have been a draw for investing in Europe. The fall in the US stock market has also caused some small changes in capital flows that have benefited the euro.

Europe doesn't want a strong euro either

Like the Japanese, European finance ministers are starting to complain openly about the recent strength of the euro. They are particularly concerned that a strong euro and a weak US economy (as a result of a current account crisis-induced flight of capital) might hamper the feeble European recovery. Indeed, Europe has become addicted to the strength of the dollar, because it has benefited greatly from the euro's competitiveness. Indeed, formal discussions between European finance ministers on the concern of euro strength will take place this month. While intervention isn't in the cards at this point, the complaints are being heard.

US authorities must also be nervous. Given the frequency of press reports on the dollar's demise, the US Administration and the Fed must be getting a bit worried. The dollar boom cycle of strong US growth, surging productivity, strong asset market performance, capital inflows, strong dollar is beginning to unwind, and the potential reversal of that cycle would clearly not be welcomed.

While Federal Reserve Board Chairman Alan Greenspan continues to be proud of the productivity boom, and the Administration can be happy that growth is still strong, they must be concerned that a decline in the dollar could cause a current account crisis and a subsequent massive outflow of capital. The White House (normally quiet on the dollar) has issued a couple of reminders that the strong dollar policy is unchanged – a sign that they are indeed watching.

Preference for yen over euro

The dollar is under pressure, and will continue to be very volatile. That uncertainty and the question of finding a worthy alternative to dollar investments forces the examination of the euro/yen cross rate.

With Europe still struggling with structural reform and still lagging the US economy, it is hard to make a case for the euro. European dependence on the weakness of the euro prob-

ably will prevent any further surge in confidence in the euro.

While the Japanese are actively trying to stem the dollar's fall against the yen, it appears to be a smoothing operation. The Japanese need a strong yen as part of a confidence boost. The yen should find more strength in the months than the euro – forcing a decline in the euro/yen cross exchange rate.

While the dollar might continue to fall or find itself rescued by a stronger US economic outlook, it's becoming increasingly evident that the path of euro/yen cross is down.

Jeremy Fand is a Forex strategist with the Friedberg Global Macro-Hedge Funds. Formerly Global Head of FX Strategy at UBS Warburg, he and his team were ranked second in the FX Strategy category of Euromoney's *May 2002 foreign exchange poll.*

LATIN AMERICA

The curious case of Ecuador

By Steve H. Hanke

Little more than two years ago, Ecuador was an economic basket case. Today – thanks to its switch from the sinking sucre to the US dollar – Ecuador's economy is back from the dead. Last year, Ecuador was the fastest-growing economy in Latin America, and this year real GDP growth will be a respectable 4%. Annual inflation has come down to 13% from almost 100% and will reach single digits by the end of the year. The unemployment rate is 8.7%, down from over 13% in 2000. Bank deposits have increased by 50% since 2000. The fiscal accounts are in surplus: 0.9% and 1.5% of GDP in 2001 and 2002, respectively. And the ratio of public debt to GDP has been falling rapidly, from about 130% in 1999 to 70% today.

Last month the Minister of Economy and Finance, Carlos Julio Emanuel, was roughed up in Washington by the IMF. Yes, I am an advisor to Minister Emanuel, but even he stated in a Reuters interview that he had made little progress in his negotiations with the IMF. Why the stonewalling? According to Emanuel, it is because the IMF doesn't like dollarization. I am not so sure.

A May 2002 report issued by the US State Department, "Patterns of Global Terrorism," concluded that Ecuador "neither improved control over its porous borders nor cracked down on illegal emigration/immigration. Quito's weak financial controls and widespread document fraud remained issues of concern, as did Ecuador's reputation as a strategic corridor for arms, ammunition, and explosives destined for Columbian terrorist groups."

I think the State Department report is the smoking gun. The war on terrorism is the only game in town. It takes precedence over all others in Washington. This not only explains Ecuador's problems with the IMF but also why the US economic policy ship is adrift. Never mind. What to do about Ecuador?

Even under the worst-case scenario of no IMF agreement and credits, Ecuador will avoid default. After all, it has just established an oil stabilization fund for buying back debt. Seventy percent of the new oil revenues in Ecuador will be earmarked for that purpose.

Ecuador's travails with the IMF are being priced into the bond market. That's why Ecuadorian bonds were one of the worst performers in the world in May, giving up almost 15%. With a spread of about 1,250 basis points, Ecuador's bonds are starting to look interesting. With that kind of carry and a sound funding set-up in place, aggressive investors should start building a position. And they should buy aggressively if it looks like Ecuador can sort out its issues with Washington concerning its efforts to fight terrorism, because that will unlock the IMF funds in short order.

Steve H. Hanke is a Professor of Applied Economics at the Johns Hopkins University, a regular columnist for Forbes *magazine, and Chairman of Friedberg Mercantile Group, Inc. a US affiliate.*

GEOPOLITICS

Triangle of tension: India, Pakistan and the United States

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Summary

Historical distrust and tensions between India and Pakistan have reached practically unsustainable levels. New Delhi cannot tolerate paramilitary attacks such as the one against its parliament in December, but the regime of Pakistani President Pervez Musharraf simply may not be able to rein in the militants. Any concession on Islamabad's part could set off a destabilizing political backlash, but this reality also moves the countries closer to a war footing. The United States, meanwhile, has willingly used the threat of war to pressure Islamabad for cooperation in its battle against al Qaeda. Washington realizes that actual war between India and

Pakistan would harm its own interests, but for New Delhi there has never been a better time to act.

Analysis

Tension between India and Pakistan has been a feature of the international system since Britain withdrew from the subcontinent and its imperium was partitioned between predominantly Muslim Pakistan and predominantly Hindu India. The rhetoric has concerned Kashmir, but the reality is that each nation deeply distrusts the intentions of the other. As with other conflicts, the litanies of injustice on both sides are real but ultimately irrelevant. India and Pakistan are two nations that regard the very existence of the other as a threat to their fundamental interests.

From India's viewpoint, Pakistan represents the only serious national security challenge. However bad Sino-Indian relations might become, China's ability to sustain an invasion deep into India, with a supply line running over the Himalayas, is negligible. To the east, India is buffered by deep jungles and weak nations. To the south lies the Indian Ocean, which is militarily dominated by the United States, a country whose interests frequently have diverged from India's but which never has threatened India's existence. In other words, India is effectively an island except on its western frontier. There lies Pakistan: insecure, fragmented and therefore unpredictable.

If Pakistan were to cease to exist, India's strategic situation would shift to invulnerability on land, thus opening up strategic opportunities at sea.

On a deeper level, the Pakistani-Indian frontier represents the borderland between the Islamic and Hindu worlds. Whatever the current condition of India, the broad historical threat is that the Islamic world one day might unite. In that case, the manageable threat posed by Pakistan would become a potentially unmanageable situation, in which the weight of re-emergent Islamic power would thrust up against an India that might not be able to resist. These are hypothetical fears, far in the future, but they are not trivial.

Islamabad is acutely aware of India's hopes and fears. Given India's enormously greater size and military potential, logic would dictate that it would be in Pakistan's strategic interest to reach a stable accommodation with its neighbor, but two problems prevent this.

First, Islamabad perceives – not irrationally – that India's ultimate goal is the dismemberment of Pakistan. Rather than stabilizing the situation, any concession to India would simply increase the disadvantage at which Pakistan is already operating.

Second, Pakistan as a nation is fragile. It is divided by ethnic group as well as by worldviews. The essentially secular Pakistan of the founders and their heirs collides with the profoundly religious Pakistan that has re-emerged. It would be difficult, if not impossible, for a Pakistani government to make substantial concessions to India. Any concession – in Kashmir, for example – would come at the expense of an ethnic group and a religious perspective that has the potential to destabilize the entire regime if displeased, thereby increasing the danger to national survival.

Under these conditions, it has been Pakistan's historical imperative to avoid engaging India in any negotiations that might lead to a comprehensive settlement. This is because of both reasonable fears of India's long-term intentions and even more reasonable fears of the domestic response to any concession. For instance, if Pakistan were to accept the current Line of Control in Kashmir, the consequences would be destabilizing.

Pakistan has therefore adopted a three-part strategy that is essentially military in nature.

First, it has created a military force designed to impose heavy costs on any Indian offensive. While this has strained Pakistan's economy in comparison with India's, the country has had, as force multipliers, the advantages both of terrain and of being on the defensive.

Second, it has developed nuclear weapons – not only to counter India's nuclear force but also to deter India from threatening its existence. In the central region of the front, where terrain is less defensible, Islamabad is aware that India potentially could launch an attack that would split the country in half. Pakistan's nuclear force, like that of Israel, is designed to prevent conventional defeat by making the risk of success too high for its foe.

Third and most risky, Islamabad has adopted a strategy of permitting paramilitary operations by various groups against Indian installations, such as that against its parliament in December. It might be overstating it to say this is part of a strategy. Rather, these well may be groups whose operations the government can't control or, alternatively, whose operations it chooses not to control for domestic reasons. Clamping down on these groups might pose political challenges at home.

The paradox is that the domestic benefits of permitting these operations inevitably increase the risk of Indian military action. It has been Pakistan's strategy to present a substantial defense along the frontier while using the nuclear threat as the final deterrent. If India were to penetrate the frontier to any depth, it is not clear whether Pakistani forces would fall back, regroup and allow guerrillas to operate to the rear of the Indian forces or whether they would rapidly grow nuclear. This is precisely the indeterminacy Islamabad wants to create.

The situation was fairly stable, if noisy, until the United States entered the picture after Sept. 11. For Washington, the essential strategic problem in the region has been Pakistan, not Afghanistan. After the defeat of the Taliban regime, al Qaeda redeployed into Pakistan, joining forces that were already there. In the same way that Islamabad found it less risky to permit paramilitary operations against India than to prevent them, it found it less risky to permit al Qaeda forces sanctuary than to close them down – not to mention permitting US forces to take on al Qaeda in Pakistani territory.

Following the attack on India's Parliament, New Delhi created the first post-Sept. 11 crisis. The United States used that crisis to back the government of Pakistani President Pervez Musharraf into a corner: While publicly seeking to defuse the crisis, Washington used the Indian threat to change the equation for Pakistan. Officials made it clear that, in fact, permitting al Qaeda to operate in Pakistan is a greater threat to regime survival than permitting US forces to operate against al Qaeda. If India attacked Pakistan and the United States remained neutral or actively participated, the consequences for Pakistan would be catastrophic.

Musharraf publicly conceded, and US forces entered Pakistan. Obviously, with India and the United States involved, Musharraf had to re-evaluate the value of his nuclear capability. The United States clearly had the ability to destroy Pakistan's nuclear facilities more effectively than India might. When Washington announced a shift in its nuclear policy to permit first strikes, Pakistan was the unmentioned audience. Musharraf clearly heard and understood. Unconfirmed rumors have persisted in the region for several months that Pakistan's nuclear arsenals already are in US hands or that US observers are at least positioned at various facilities. *The Times of India* recently published an article to this effect, without providing evidence.

Musharraf, however, has limited control, whatever his desires might be. Operations against al Qaeda in Pakistan clearly have been less than successful because of limits on Pakistani cooperation. Musharraf's ability to control anti-Indian groups is similarly limited. Thus, the recent attack on an Indian facility by Pakistan-based paramilitaries has reignited the crisis with India – at the same time that the United States is revisiting the issue of Pakistan's support for US operations against al Qaeda.

Washington has been moving steadily closer to India, particularly in the area of military cooperation. This is partly out of recognition that the two countries have similar interests in combating Islamic groups in Pakistan. It also is because the United States wants to replicate its maneuvers of earlier this year, using India as the lever to compel cooperation from Pakistan.

Washington expects it can manage the India-Pakistan confrontation effectively, but there are two reasons this might not be the case this time. First, Musharraf simply may have reached the limits of his power. He just may not be able to provide the United States and India with the degree of control over Islamic factions that they seek.

Indeed, Musharraf has known his limits all along and has been playing for time, hoping the crisis can be defused. The Islamic groups do not want to see the crisis defused, since their goal is to create a cauldron that draws in US forces on the ground, sucking them into a war of attrition that will, in the long run, enhance their own position. Since Musharraf cannot deliver what is demanded, he is being forced to consider alternative solutions to the crisis. The solution is to increase the fearsomeness of his military – in short, brush aside US threats and brandish Pakistan's nuclear capability.

The second problem is India. New Delhi understands that there will never be a better time to deal with Pakistan. Paramilitary attacks are genuinely intolerable to India. They also provide an excuse for war to which the United States cannot ultimately object, given its views on al Qaeda and its support for Israel. Washington is neither politically nor militarily in a position to block New Delhi. Therefore, if India ever intends to deal with Pakistan, now is the time to act.

There are two problems with action. First, from the Indian standpoint, the Pakistani nuclear threat must be treated as real and likely to be used in the event of war. This leaves New Delhi with two options. One is a non-regime threatening strategy of special operations against Islamic groups in Pakistan, but this would not solve the core problem. The second option is a broader attack into Pakistan, designed to shatter the country. That attack could be carried out only with a pre-emptive strike against Pakistani nuclear facilities. The issue is the degree of confidence India has in its own surgical nuclear capabilities – or the United States' willingness to take out Pakistani weapons in order to prevent nuclear escalation.

This brings us to the second problem. The dismemberment of Pakistan would compound rather than solve the United States' problem. The chaos that would follow would create precisely the conditions al Qaeda needs for its own security. Entire areas of the country, in the least hospitable terrain, would become more secure for al Qaeda than before. Therefore, from the US standpoint, using the threat of an Indian attack is ideal; a successful Indian attack would be harmful.

India's calculus is not the same, however. If it is accepted that Pakistan represents a permanent strategic threat to India, the question of war is not whether but when. Given the current political situation and correlation of forces, if this isn't the perfect time, what is?

If war is inevitable, it is difficult to see how India can act without taking out Pakistan's nuclear capability. It is unclear how India could take those out without nuclear weapons, or without US precision-guided munitions, Special Operations, and other covert forces. But at the end of the day, the United States does not want Pakistan in chaos, it does not want an Indian nuclear strike, and it certainly doesn't want Pakistan – facing a use-it-or-lose-it scenario – to launch its own nuclear strike.

The United States probably could paralyze Pakistan's nuclear force. That, however, would open the door to Indian attack, since the United States could not prevent paramilitary operations and cannot permit India to achieve its historical goal – at least not until al Qaeda has been dealt with. On the other hand, India cannot afford to miss this historic opportunity.

We are therefore in an extraordinarily difficult crisis. The three players each have strategic interests that simply don't mesh. If Washington convinces New Delhi to wait, it will have to convince Islamabad to stay in India's crosshairs and India to put up with intolerable attacks. If India proceeds, it essentially would save al Qaeda by shattering Pakistan. In the event of complete mismanagement, a nuclear exchange costing millions of lives is a genuine possibility.

India has given Pakistan a small window of opportunity to solve the problem it cannot solve. It gives the United States a period of time to defuse a situation that, in STRATFOR's view, could suddenly and catastrophically get out of hand.

STRATFOR: 700 Lavaca, Suite 405 Austin, TX 7870. Phone: 202-204-2580. Internet: http://www.stratfor.com. Email: info@stratfor.com.

ARGENTINA

The calm before the storm

By Steve H. Hanke

Many eminent economists – Olivier Blanchard, Michael Bordo, Sebastian Edwards, Martin Feldstein, Ricardo Hausmann, Paul Krugman, Allan Meltzer, Michael Mussa, Joseph Stiglitz, Thomas Willett, and John Williamson – told us that dumping convertibility would work wonders in Argentina. Indeed, they trotted out every half-truth or non-truth under the sun to bolster their claims that the source of Argentina's problems was convertibility and that a floating peso and pesofication of contracts and financial liabilities and assets were just what the doctor ordered.

Under the Convertibility Law, the peso and US dollar legally circulated at a one-to-one exchange rate. The owner of a peso had a property right to a dollar and could freely exercise that right by converting pesos into dollars. That redemption pledge was credible because the central bank was required to hold foreign reserves to cover fully its peso liabilities. It doesn't take a rocket scientist to conclude that the floating peso and pesofication have put the patient in death's grip. What went wrong?

It turns out that the medicine they prescribed required contracts to be broken and property rights to be destroyed. The resulting chaos should serve as a grim testimonial to all those, including the International Monetary Fund, that advocated a floating peso and pesofication.

If Argentina hopes to reemerge from its current chaos, its fiscal regime must be fully subordinated to its monetary regime. The only way to do this is to dismantle the central bank, liquidate the peso, completely dollarize the economy and prohibit the issuance of quasi-monies, the bonds provincial governments issue to finance their budget deficits. Dollarization would not only ensure fiscal subordination and solve Argentina's currency problem once and for all – would also give Argentina a much-needed confidence shock and reverse the dramatic decline in the government's tax revenues. This medicine would work in Argentina. After all, it delivered a positive confidence shock to Ecuador, a country that was in the grips of economic chaos before it dollarized in 2000. Now Ecuador's economic growth tops the charts in Latin America and its non-oil tax revenues are growing at over 40% per year.

It is important to stress, however, that dollarization is a necessary, but not sufficient condition that must be satisfied before Argentina can turn things around. More broadly, the rule of law must be respected. No country can prosper if it fails to recognize the sanctity of contracts, which are the foundation of all private morality and the indispensable condition of every sane social order. This point about the rule of law cannot be stressed enough. The Duhalde government has focused its efforts – much as the Bolsheviks did in Russia – on abrogating private contracts. For example, it has done away with the Convertibility Law, embraced the corralito, and pesofied the economy, to name but a few gross infractions of contract law.

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Before stability can be restored, Argentina will probably face a bout of very high inflation, however. At present, 67 billion in peso bank deposits are trapped by the corralito. Argentines want the corralito lifted so that they can get their hands on their deposits. They desperately want to take the money and run.

To lift the corralito, which is both a political imperative for the Duhalde government and a condition for the release of any IMF credits, the government is contemplating a so-called Bonex II Plan. Under that, new US dollar-denominated 10-year bonds would be issued by the government in exchange for reprogrammed deposits. The problem with the Bonex II Plan, in all its forms, is that it will leave a monetary overhang in the banking system. This overhang will be the difference between the amount of the deposits that will be swapped for new bonds and the total deposits of the banking system. Given the current state of affairs in Argentina, the depositors will probably attempt to withdraw a large portion, if not virtually all, of those residual deposits. And given the state of the banks and the illiquid assets on their balance sheets, the central bank will have to open the discount window so that banks can rediscount illiquid assets to cover withdrawal demands. Hence, the phrase "monetary overhang."

The arithmetic of the monetary overhang is simple. Let's say the overhang is 15 billion pesos, not an unreasonable number. Accordingly, the monetary base would increase by 15 billion pesos if all the residual deposits were withdrawn. On February 4, 2002, the base was 15.5 billion pesos, and now it's 21.2 billion. If anything approaching 15 billion pesos is added to base money, the floating peso will sink and inflation will be off to the races.

How will we know if this likely scenario is going to be played out? Watch for the resignation of my old friend Mario Blejer, the president of the central bank. To avoid having his reputation as an economist tarnished any further than it already has been, I conjecture that Blejer will jump ship if he anticipates that the central bank is going to be forced to open the discount window very wide. As bad as things are at present, they represent the calm before the storm.

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After the storm, dollarization would, by definition, solve Argentina's currency problem. But what about banking? Given Argentina's history, the banking problem will be a tougher nut to crack. A bifurcated banking system coupled with dollarization might just do the trick.

Banks that are unquestionably solvent should be allowed to issue their own notes (paper money), denominated in dollars. In the current context, the only banks likely to qualify would be foreign banks whose head offices promised to support them in full. People holding these bank-issued dollar notes could demand payment in notes issued by the US Federal Reserve or in an electronic form acceptable to note holders, such as Fed funds. Bank-issued notes would be much like bank-issued traveler's checks. People would accept the notes if they had confidence in the issuer and reject them if they lacked confidence.

They would always have the option of continuing to use dollar notes issued by the US Federal Reserve.

Allowing banks to issue dollar-denominated notes and repealing the central bank's power to issue pesos would have a powerful effect in making monetary policy "looser," by reducing interest rates. Monetary policy is much "looser" in the United States, Panama, and Ecuador than in Argentina because the perceived risk of devaluation is absent.

Allowing banks to issue dollar-denominated notes would help them increase their supply of reserves on hand by "capturing" some of the Federal Reserve notes now held by Argentines and replacing them with bank-issued notes. Allowing banks to issue dollar-denominated notes would reduce banks' demand for reserves by reducing their need for Federal Reserve notes as vault cash. The boost to confidence that would result from eliminating the peso could lead depositors to bring back the deposits that have flowed out of Argentina's banking system in recent months. A similar thing happened in Ecuador after it dollarized in 2000.

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Allowing banks to issue their own notes might seem farfetched or at least novel, but it is neither. Many financial firms already issue paper travelers' checks, which resemble currency although they cannot pass from hand to hand without being endorsed. Before the 20th century, commercial banks issued their own notes in most financially advanced countries of the time, nearly 60 countries in all. Multiple brands of notes need not confuse people any more than multiple brands of traveler's checks now do. Governments took over note issuance from commercial banks not because the private sector was doing a bad job, but because governments wanted the profits for themselves. The record of private issuance of notes was generally good. In some countries bank failures caused losses to note holders, but the losses were small compared with the losses inflicted by the central banks that later took over note issuance.

Argentina was one of the countries that had note issuance by commercial banks in the 1880s. Argentina had a rather unhappy experience because it made a number of mistakes. One was that rather than being redeemable in gold, bank notes were redeemable in government-issued pesos, a depreciated fiat currency, rather than in an international unit such as gold or the pound sterling. Another mistake was that as a condition for issuing notes, banks were required to hold specified Argentine government bonds.

Argentina's default on its foreign debt in 1890 triggered a currency and banking crisis. It was not the banks, but the government that created the crisis. Even so, the government responded by ending note issuance by banks and establishing the Caja de Conversión in 1891. In 1902 the Caja began to operate as a currency board, and continued to do so, providing Argentina with one of its few periods of monetary stability, until the First World War broke out in 1914.

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Nothing in Argentina's constitution stipulates that it must have a central bank or a nationally issued currency. In fact, because the constitution has roots in the 19th century, when note issue by multiple banks was widespread around the world, the constitution contemplates the possibility of multiple issuers. Article 75, paragraph 6 of the constitution gives the Argentine Congress the right to "Establish and regulate both a federal bank with the ability to issue money, and other national [that is, federally chartered] banks." However, the constitution explicitly contemplates the possibility of multiple note issuers in article 126, which states that "Provinces may not coin money or establish note-issuing banks without the authorization of the federal Congress." By implication, the federal government may itself authorize banks to issue notes, or it may authorize the provinces to charter private or government-owned banks that issue notes.

Argentina's Law on Financial Institutions does not mention note issuance as a permitted power of commercial banks or other financial institutions. The Organic Law of the Central Bank gives the central bank power to issue notes but does not state that the power is a monopoly. It may be possible to give commercial banks the freedom to issue notes through administrative decisions, without changing any existing laws. But it would be desirable to eliminate any role for the central bank as an issuer of currency, which would require amending the Organic Law of the Central Bank.

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Allowing banks to issue notes would broaden the reach of solvent banks into an area currently monopolized by the government. Another reform would be to convert the immediately salvageable part of banks of doubtful solvency into so-called narrow banks to preserve a role for them in the payments system. Narrow banks would be deposit-taking banks that operated as money-market mutual fund banks (a modified form of 100% reserve banking). Depositors in these banks would no longer have to live in fear of being unable to withdraw their deposits because banks would have the liquid reserves to cover the withdrawals.

Another important advantage of money-market mutual fund banking is the fact that these banks would need very little equity capital to cover the small risks associated with the matching of their assets and deposits. Finally, to make both the note-issuing and money-market mutual fund banks (private pension funds, too) safe from the grabbing hands of the authorities, they should be free to operate offshore.

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Subscription Enquiries for
Friedberg's Commodity & Currency Comments
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

Managed Accounts
All enquiries concerning managed accounts should be directed to:
In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 364-2700

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1910
New York, N.Y. 10005
(212) 943-5300