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A Sustainable Bull Market?: Better to Carry an Umbrella

By Scott B. MacDonald

Since March 2003 the U.S. stock market has enjoyed a remarkable run despite continuing volatility. There is a lot of talk that we are at the beginning of a new bull market. The argument is simple – the federal government is pumping in a massive amount of money to stimulate the U.S. economy in the second half of 2003. Responmding to incentives totaling $210 billion over 16 months, tech sales are starting to show signs of life, housing starts are strong, inventories are falling, and temporary employment numbers are up -- despite high unemployment of 6.4% for June. There is even the beginning of a new round of M&A in the tech and banking sectors. The bottom line is many investors and fund managers are starting to believe we have hit the turning point and that this will sustain corporate profits, revive capital spending and relieve the tiring consumer. At a recent private investor conference there was even talk of real GDP growth of 3-4% for 2004.

In the U.S. corporate bond market this positive tone is playing out in a more active new issue pipeline and generally tightening spreads. Investment grade issuance has climbed over $250 billion. Although it seems that spreads are tight -- and compared to 2002 they are -- on a historic basis spreads are still wide. There is room for tightening – if conditions merit it.

All of this positive sentiment is balanced by lingering problems – overcapacity in sectors including autos, airlines and pulp & paper; geo-political risks such as terrorism, new problems in the Middle East, North Korea, etc.; higher pension costs; litigation costs involving asbestos and tobacco claims; and weak growth. In some sectors, debt reduction remains a slow and painful process, with little to show for corporate belt-tightening. Although the case can be made for a stronger economic recovery in the months ahead -- we see real GDP at 2.4% in 2003 and 2.7% in 2004 -- the actual pick up in growth in a sustainable and dynamic fashion is not here – yet. We still have Q2 corporate earnings season to get through and in some sectors, such as pulp & paper, autos, airlines and chemicals, there could be ongoing pain related to higher energy costs, overcapacity, and a lack of pricing power. Although we do not see the U.S. economy falling into a deflationary spiral, deflationary pressures are likely to remain.

Part of the deflationary pressure comes from Asia. China is a major producer of low-cost goods in a vast array of sectors exported around the world and Japan, the world's second largest economy, struggles to pull out of its deflationary mode. In addition, the world's third largest economy, Germany, is increasingly being hit by deflationary pressures, which may push it toward another recession. The rest of Europe is not doing terribly well either. All of this puts more pressure on the United States to buy European and Asian goods – which contributes to a widening current account balance of payments deficit – something that is not sustainable in the long-term.

We would love to believe that a bull market in equities is here to stay and that the corporate bond market will easily sail on toward much tighter spreads -- but we are not entirely convinced. We expect that the second half of 2003 will be defined by a balance between a moderate strengthening in real GDP growth and ongoing doubts over whether the growth is sustainable. This in turn could have a negative impact –in the form of a correction – in the stock market. Consequently, the sun is out, but we still see dark clouds on the horizon and remain happier carrying an umbrella at the party.

Site-By-Site !

Global and Domestic Investment Information

Europe's Economic Troubles

By Scott B. MacDonald

There is a whiff of tear gas in the air in Europe this summer. Vocal and sometimes violent opposition against economic reform is giving Europe a troubled image. Indeed, the Eurozone economy is struggling to stay on the positive side of the growth picture, especially as Germany, the major locomotive, is expected to slip back into recession this year. Most recent economic forecasts for the German economy call for a decline of 0.1%, which would be the first annual contraction since 1993.

The outlook for economic growth in the Euro area is expected to be an anemic 1%. At the same time, unemployment is rising. In Germany it is shooting toward 11%, while Belgium has the distinction of having the highest unemployment rate among Eurozone countries at 11.6%. The average across the Eurozone is close to 9%. At the same time, much of the Eurozone's labor unions are in a militant mood about their rights, with demands ranging from shorter workweeks to pension benefits.

What is the problem with Europe? The Eurozone economy (excluding the UK and Ireland) is in the process of some very painful changes. The old system of state-dominated economies, protected labor markets, and generous and extensive social nets paid by high taxes is clearly in trouble. In a sense, many of the European economies, like France and Germany, wanted to enjoy the benefits of market forces such as stronger economic growth, while managing the risk through less social upheaval and lower unemployment. The recent roots of this system of managed risk economics came at the end of World War II and were implemented to help stop any drift toward Communism as well as to pull badly damaged economies out of dire straits. Consequently, inflexible laws concerning the firing of workers, unemployment compensation and retirement benefits, became engrained in the system. Over time they have become entitlements – something that many Europeans have come to expect.

That was then. This is now. Globalization and technology have put the old system under acute pressure. Economies that are more open to risk taking, such as the UK, Ireland and Netherlands, were rewarded by the new world that opened up in the 1990s. They have proven more flexible in adapting to change and the more managed risk-adverse economies have had to move at a slower pace. At the same time, demographics indicate an aging European population. This raises the delicate question of how to pay for generous benefits and early retirement, let alone the question of how to sustain businesses by working fewer hours. Add to this mix, a lack of domestic demand throughout much of the Eurozone and a weakening in export performance due to the rise in the value of the Euro.

Another factor facing the Euzozone economies is that the corporate sector is in the process of deleveraging and restructuring. This means short-term pain, but probably long-term gains. Generally speaking, most companies are cutting capital spending and payroll and pricing power is declining. Consequently, 2003 is not going to be a year of economic recovery for many corporations in terms of profitability. It is also indicates that Corporate Europe is responding more aggressively to the globalization of world markets.

Although we have our concerns about the Eurozone economy and there are clearly deflationary pressures at work, we think the slump will bottom out during the second half of 2003 and as the U.S. economy regains momentum, the seeds for a moderately stronger 2004 will be sown. Despite labor unrest in France, Germany and other countries, economic reforms are gradually making headway. Tax cuts should pass in

Germany and some form of compromise will be negotiated over pension plans in France -- though not enough to make the problem go away. Moreover, the European Central Bank has finally indicated that inflation is no longer the main concern, but deflation and therefore they are in an interest rate cutting mode. All the same, angst is in the air in Europe over the state of the economy and there will be ongoing worries that European governments have opted for reform too late to deal with deflation. Europe is in for a long hot summer.

Asian Business Watch

Japan Views You Can Use

Asia-Pacific– Japan – Feeling a Little Better?

By Scott B. MacDonald

After months of bad feelings over the economy, it looks as though things are improving – to a point. The Bank of Japan's most recent quarterly Tankan report showed that business sentiment has almost made it to positive territory. On the day of the announcement, the Nikkei 225 stock index rose 2.2% to 9,278, a nine month high and things have continued to improve, with it now approaching 10,000. The improvement in business sentiment comes as disruptions from SARS and the war in Iraq fade, while oil prices are gradually falling and stock prices have enjoyed a two-month rally. The U.S. economy is also gradually getting better, which helps the outlook for exporters such as Toyota, Honda Motor, and Matsushita Electric. Reflecting the Tankan, a number of manufacturers have raised their pre-tax profit forecasts for the fiscal year that began in April.

Part of Corporate Japan's cautiously improving sentiment comes from the fact that companies have been active cutting costs. Yet, there are also indications that sales will be up in the second half of the year, part of which will come from overseas. This, in turn, is helping to push an increase in capital spending.

Although the Japanese economy is showing a stronger staying power than earlier thought, the "recovery" is far from dynamic and the banking sector remains a concern. Exports remain the hope of achieving 1% GDP growth for the year, especially as domestic sales remain sluggish. The job market is hardly reassuring, with unemployment hovering above 5%. The Japanese consumer also faces falling incomes hurt by ongoing deflationary pressures and higher taxes. On top of this government finances are in bad shape – the fiscal deficit will easily top 7% of GDP this year and public sector debt to GDP is the highest among G-7 economies. Yet, the situation is perhaps not as dire as initially thought. Revised figures for GDP in Q1 2003 show that it grew at an annual rate of 0.6%, rather than stagnating. And Japan still maintains a massive current account surplus. It actually widened by 2% in April, to $111.7 billion, equal to 2% of GDP. This compares favorably to the U.S. which is expected to run a 5% deficit.

One consequence of the uptick in business sentiment is the recent decline in the Japanese Government Bond (JGB). With hopes of a better economy and less deflation, many Japanese investors have opted to put their funds into equity markets, fueling an upward swing in the Nikkei. The recent volatility in JGBs has also helped make U.S. and European bonds more attractive. The top four Japanese life insurance companies increased their holdings of foreign bonds by more than Y2 trillion to Y10 trillion at the end of March over the same period a year earlier. Does all of this portend a major crisis for JGBs? Although it is easy to point to the Nikkei and say that good times are here – considerable deflationary pressures remain that will drive investors back to JGBs. Moreover, 95% of the $4.7 trillion in JGBs are held by Japanese investors – many of who will maintain a position, unlike more fickle foreign investors.

All of this has important political consequences for Prime Minister Koizumi. He has an upcoming LDP party leadership convention in September, in which his more conservative rivals will seek to either displace him – which is not likely -- or to cut into his influence by attacking Economy Minister/chief financial regulator Heizo Takenaka, whose tough decisions on Resona Bank angered party conservatives. With the recent

Tankan report and indications that industrial production and exports grew over the last two months, Koizumi goes to the LDP convention in September with a much stronger hand than he has had in months. This gives us hope about reform. If nothing else, it helps Koizumi keep Takenaka in the driver's seat on the economy and bank reform.

Thaksin's Wars

The Thai Prime Minister's battles against drugs, crime and beyond

By Jonathan Hopfner

Whatever accusations have been laid upon Thai Prime Minister Thaksin Shinawatra by his detractors – that he has dictatorial leanings, that he is prone to nationalistic rhetoric, that he continues to pander to his own business interests – even his staunchest critics are forced to admit he is a man of results. Under his tenure the Thai economy grew over 5 percent last year, by far its best performance since the 1997 economic crisis, and despite the damage wrought to the crucial tourism industry by Severe Acute Respiratory Syndrome (SARS) and renewed terrorism fears, it is poised to exceed 6 percent growth in 2003.

More importantly, in the eyes of a jaded electorate, he has fulfilled the main pledges he made in the run up to his election in 2001: a 30 baht (US$0.70) per hospital visit medical scheme, a 1 million baht (US$23,000) fund for each of the country's villages and a moratorium on farmers' loan repayments have all been instituted during his time in office. The government is now in the midst of an effort to supply low-cost computers to a wide segment of the population and also has plans to build state-subsidized housing for Bangkok's low-income earners.

All carefully orchestrated PR moves, say the Prime Minister's critics. But for a man said to be almost morbidly concerned with his image, Thaksin has proved surprisingly willing to court controversy in other areas; most notably when it comes to human rights issues. His "war on drugs," a February to April crackdown designed to purge the country of "yaba" (methamphetamine) users, resulted in 2,200 deaths. While the government insists most of these deaths resulted from frightened drug dealers turning on each other, human rights monitors insist the police were responsible for the vast majority of the killings. The Bangkok-based Asian Forum for Human Rights and Development said the muted atmosphere surrounding the fatalities showed the government was "bypassing human rights and the rule of law."

Thaksin and leading members of his Thai Rak Thai party have insisted tough measures were needed to deal with what was becoming an epidemic. One in 17 Thais over 15 is addicted to methamphetamine, according to some estimates, and the United Nations ranks Thailand as the largest consumer of the drug in the world. In the eyes of the government, the ends of the drug war – nearly 20,000 dealers arrested, 280,000 addicts in custody or rehabilitation programs, and a tripling in the street price of yaba, according to the country's Narcotics Control Board – more than justify the means.

It would seem the public agrees. Recent polls show support for Thaksin and the ruling party at 54 percent, far higher than the 14 percent registered by the country's opposition, the Democrats. Most political analysts now see the current government not only completing its four-year term in office – which would make it the first of any government in Thailand to do so – but winning another term when general elections are held in two years' time.

Thaksin himself is obviously confident enough to set the stage for a showdown with another, and far more insidious, problem than drugs: corruption. The government is in the final stages of compiling a list of over 2,700 criminal figures, army and police officers, contractors and opinion leaders who will be targeted in the government's forthcoming "war on dark influence". Thaksin claims this will strike at the very heart of the nepotism and shady business dealings that have plagued Thailand for so long. While the aim is to give the figures on the list a chance to rehabilitate, rather than to detain or eliminate them, the Prime Minister is once again promising results as concrete as those that emerged from the battle against drugs.

Yet this time around, even the dynamic Thaksin may have overstepped his bounds. Government spokesman Sita Divari told reporters on July 1 that provincial governors and police officers responsible for compiling the list had not proven fully cooperative. This is unsurprising as few are inclined to implicate their own friends or associates. The criteria used in drawing up the list has also been called into question. It has yet to be fully disclosed and inside sources claim it includes no one within the current government, and the head of the campaign, General Chavalit Yongchaiyudh, has himself been implicated in a number of scandals.

While foreign investors and firms operating in Thailand would no doubt welcome any efforts to stamp out corruption in the country, the vast majority of their most common complaints – bureaucratic inefficiency, ambiguous legislation and a lack of coordination among government departments dealing with large-scale business ventures – have less to do with underground crime lords than the realm of officialdom itself. As Thaksin's current war looks set to leave the mechanisms of government unscathed, it is unlikely to make Thailand a significantly more attractive place to do business.

Indeed, while he has little trouble gaining the approval of his own people, Thaksin has proven far less adept at winning international hearts and minds. His decision to turn down a visit by the United Nations High Commissioner for Human Rights at the height of the drug campaign and a current dispute with the United Nations High Commissioner for Refugees – Thaksin claims the agency has violated Thailand's sovereignty by granting refugee status to Burmese exiles in Thailand without consulting the Thai government – have once again put his apparent lack of concern for human rights issues in the spotlight.

Few would deny that the Prime Minister's first duty is to his people. But he would do well to remember that much of Thailand's prosperity in recent years has been a direct result of the country's status as one of Asia's most stable democracies and a haven of political and economic freedom in a troubled region. In pitting his government against multilateral agencies such as the UN, Thaksin may find himself mired in the first war he cannot win.

Indonesia – The Long March Back to Investment Grade?

By Scott B. MacDonald

Before the 1997-98 Asian financial crisis Indonesia was rated Baa3/BBB. It was regarded as a stable investment grade credit, based on the country's relative political stability, strong export base, and competent fiscal management. The Asian financial crisis, however, left Indonesia in a state of shock. Political stability was shown to be fleeting as the longstanding Suharto regime fell and successor governments wrestled with new democratic procedures and institutions. Political Islam rediscovered its voice. Long dormant regional loyalties resurfaced to challenge Jakarta's central power. And, the economy took a sharp downward plunge that has taken several years to recover. Indonesia's sovereign ratings reflected this descent, falling to B3/CCC+. Although tough challenges remain, Indonesia is turning the corner and the long climb back to investment grade has begun. On May 21, Standard & Poor's recognized this and upgraded Indonesia to B-, with a stable outlook. In June, Moody's put Indonesia's B3 ratings on review for an upgrade.

How has Indonesia's progress been marked? Consider the following:

- Inflation was down to 9% in 2002. Since year-end 2003, it has fallen further to 7.54% in April. If the government maintains a tight monetary policy, inflation could fall below 9% in 2003.

- The budget deficit has been reduced from 6% of GDP in 1998 to 1.8% in 2003 and less than 1% is projected for 2004.

- The burden of Indonesia's public debt (which is half domestic and half foreign) as a percentage of GDP will fall below 70% of GDP by year-end 2003.

Despite ongoing political and social unrest on a number of fronts, the democratic experiment continues. Since the fall of Suharto in 1997, the country has seen three different civilian leaders, all assuming office by constitutional means and supported by the public.

As a result of these improving prospects Indonesia's ability to return to the international bond market for financing have improved. Indeed, Indonesia's finance ministry at the end of April announced it may issue international bonds next year for the first time since the 1997-98 Asian crisis as part of an effort to end its reliance on the International Monetary Fund. "We are studying possibilities to issue international bonds," Finance Minister Boediono was quoted as saying by Dow Jones Newswire. The country wants to end its IMF program at the end of this year. Without an IMF economic reform program in place, the country's international creditors are unlikely to agree to further debt restructuring.

Indonesia will need to refinance about US$3 billion in debt coming due next year through a combination of international and local bonds if it ends the IMF program.

Yet, Indonesia faces a number of challenges, which have the potential to slow ratings upgrades. These include:

- The tourist sector is still in difficulty. Islamic radicalism and terrorism as well as SARS, is putting a dent into tourism. In 2002, tourism earned the country $4.3 billion from 5.03 million tourists, 20% down from 2001. Bali is still suffering from the bombing.

- Oil prices vulnerability: as long as oil prices do not drop significantly the financing gap is manageable.

- Institutional weakness: The process of democratization is hardly over and the country's political institutions remain weak. Corruption remains a problem. The central government's authority is being challenged by new regional governments, which have recently been given greater autonomy as part of the decentralization process. As S&P noted: "Indonesia's institutional weaknesses can often hinder policy coordination and could undermine a timely response to political and external shocks."

- Related to the weakness of central authority is the ongoing problem of separatist movements in Aceh and Irian Jaya. In 2003, negotiations between the local independence movement, the GAM, and the government broke down. Clearly Acehese aspirations for an independent country carved out of northern Sumatra have little appeal in Jakarta, which has already felt the loss of East Timor and is threatened by separatist groups in Irian Jaya. Although the war is popular in Indonesia and is helping Megawati in opinion polls, the conflict does have a cost – both on the fiscal side and in terms of Indonesia's image as a place to invest.

- 2004 is a pivotal year – elections and debt coming due.

- Maintaining positive relations with the IMF and other donors. There is growing political pressure on the government to end the IMF program by year-end 2003. President Megawati would stand a greater chance of reelection if she can demonstrate that her administration has made progress on the economic front and regained independence vis-à-vis outside influences.

Indonesia has some tough challenges ahead. Moving back to an investment grade rating will be a multi-year process, with ongoing concerns over policy slippage, terrorist threats and potentially volatile international market conditions. In the short-term, the focus on the war in Aceh could obscure ongoing efforts to reform the economy – even past August 2003 when parliament ends and electoral politics come into play. Along these lines, it is encouraging that the government went ahead in June 2003 with the privatization of PT Bank Mandiri, which was heavily oversubscribed. Following that success, the Indonesian Bank Restructuring Agency (IBRA) signaled that it was moving ahead with the sale of about 20 percent of PT Bank Danamon and PT Bank Niaga. Indonesia remains a pivotal country on many fronts. Sustained economic reform and growth could be a major positive for its large population as well as the rest of Asia. Reflecting this, the long path back to investment grade will be closely watched by investors.

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Russia Eyes World's Energy Markets

By Sergei Blagov

The Russian government has moved to adopt a strategy through 2020 to "position itself" as a leader in the world's energy markets. Yet with a looming flood of Iraqi oil this strategy may soon undergo a re-think.

In May, the Russian government approved the country's energy strategy. According to the draft, by 2020 Russia is to pump 450-520 million tons of crude oil and 700 billion cubic meters of gas per year. With domestic demand stable, the bulk of the surplus is destined for exports. In 2002, Russia pumped 379 million tons of crude, 9 percent up compared to 2001.

However, the energy strategy draft, which has been debated for the more than a year, now seems to be set for a major re-write. Until late last year, Russian energy strategy aimed at taking over from Saudi Arabia as the main oil provider to the US. At their May 24, 2002 summit in Moscow, United States President George W. Bush and Russian President Vladimir Putin signed a joint declaration on energy cooperation.

At the "energy summit" between in Houston in October 2002, Russian and American officials signaled readiness to boost Russian oil supplies to the US. Russian executives told the Houston summit that Russia could export as much as one million barrels a day to the US within five years.

Notably, in October 2002 Russia's state-owned Rosneft oil company and the US firm Marathon Oil Corporation announced a decision to participate jointly in Urals North American Marketing (UNAM), a project to supply oil from the Urals region in Russia to North America. Actual supply under this project was due to begin in the third quarter of 2003, but now it's far from certain whether this plan may materialize.

In the wake of the war on Iraq, which Russia had strongly opposed, plans of Russian oil supplies to the US look increasingly unrealistic. Moreover, in the wake of Iraq war a potential conflict between Russian and US oil firms is brewing. US officials have warned that Russian companies had little hope of fulfilling contracts to develop Iraq's oil reserves because of Russia's opposition to the US-led war.

LUKoil has threatened to seek a court injunction from an international tribunal in Geneva to block any attempts to develop the field and to seize all Iraqi crude if the country's postwar administration allows West Qurna development. LUKoil signed a contract in 1997 to develop the oilfield and pledged to invest some four billion dollars by 2020. Now LUKoil insists it still owns the right to develop the oilfield.

Meanwhile, the consolidation of the Russian oil industry is widely seen as a sign of the country's growing competitiveness in the global economy. YUKOS-Sibneft's $15-billion merger, that created the world's fourth-largest private hydrocarbons producer with a market capitalization of $35 billion, gave Russia a strategic player in the global oil industry which will give its businesses greater clout worldwide.

On the other hand, the Russian oil sector needs stable and predictable crude prices. Moscow is wary that with a possible flood of Iraqi oil, Russian Urals crude could become less competitive and much cheaper.

After meeting OPEC president Adbullah al-Attiyah's in Moscow last May, Russian Energy Minister Igor Yusufov said that Russia was prepared to join other oil-producing nations in cutting back exports if prices dropped too low. He did not name that low price level, saying only that Russia favors a range of $20 to $25 per barrel. In the past, Russia has twice promised to cut its exports to help OPEC support oil prices, but rarely sticks with its pledges.

Al-Attiyah, also Qatar's oil minister, said OPEC wants Russia to be a full member of OPEC. Yusufov said: "Russia's accession to the OPEC is a matter for negotiations," indicating that Russia would remain a non-OPEC producer. However, Russia accepted OPEC's invitation to attend its meeting June 11 in Qatar as an observer.

Founded in 1960 in Baghdad, Iraq, OPEC aims at coordinating and unifying petroleum policies among member countries, in order to secure stable prices for petroleum producers. OPEC's 11 members collectively supply 40 percent of the world's oil output, and posses more than three-quarters of the global proven crude reserves.

OPEC's members are Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates and Venezuela. Since the end of the US-led war in Iraq, there has been speculation that the country would leave OPEC. Subsequent oversupply and a sharp drop in oil prices would be detrimental to the Russian economy as the state budget was heavily funded by revenue from the commodity.

A sustained period of high oil prices provided the cash: the government's budget went into surplus in March 2000 -- and has stayed there -- while oil companies' investment capital quickly trickled down to the rest of the economy, throwing fuel on the consumer-spending fire.

Hence, 2003 may become Russia's fifth consecutive year of growth, fourth of budget surpluses and third of early debt payments to international creditors. The economy remains in the midst of a bull run.

However, in his address to the nation earlier this year, President Vladimir Putin acknowledged that most of Russia's good fortune over the last five years has been "due to external circumstances." He also says that the "pace of reform is too slow," and challenged the government to find ways to double the size of the economy by 2010, which would require average annual growth of about 8 percent.

It is understood that if crude oil prices permanently fall to $10; the global economy quickly recovers and interest rates rise again; and the euro plunges against the dollar, Russia's high inflation rate and strong ruble may become economic problems. In this scenario where all these things happened at once, Russia may face serious problems, although they are unlikely to be as bad as in 1998. With a backdrop of the economy's strong performance over the last five years, the consensus is that the Russian economy is relatively safe, at least for a few years.

Bulgaria - Riding the Wave

By Scott B. MacDonald

Bulgaria has recently been hot on the credit ratings front. At the beginning of 2003, the Balkan country was rated B1/BB. In the late 1990s, Bulgaria struggled and came close to defaulting on its external debt. After several years of structural reform and sacrifice by the Bulgarian population as well as the looming probability of EU membership, Bulgaria is now heading toward an investment grade rating. This was underscored in late May and early June, when Moody's upgraded the Balkan country from B1 to Ba2, a two-notch increase, and Standard & Poor's raised it from BB to BB+. The key reasons for the upgrades are as follows:

- Continued reduction in Bulgaria's general government debt burden from 80% of

GDP in 2000 to around 60% in 2002, with further projections of falling debt. Along with this the government is benefiting from improved liquidity.

- The government has greater credibility for its fiscal policy, reducing the fiscal deficit to a little under 2% in 2002, though it is expected there will be moderate increases through 2005.

- Marked increases in productivity and competitiveness have added export increases.

- The government is making progress, albeit slower than initially expected, in initiating structural reforms. These reforms entail such things as accelerating the implementation of the National Revenue Agency (NRA), broadening the coverage of the large taxpayer office, improving arrears collection, and changing the labor code to promote flexible forms of employment and reduce hiring and dismissal costs.

While Bulgaria has made considerable progress since the late 1990s, tough challenges remain, which could constrain the movement to investment grade. Key areas that need improvement are privatization, corporate governance, an inefficient energy sector, and deficiencies in property law and contract enforcement. In addition, the long process of economic reform has been painful and popular discontent has been growing. As an IMF report earlier in the year noted: "…the increased political pressure stemming from still-low standards of living and the declining popularity of the government have exacerbated demands for higher public spending and slowed the momentum on reforms."

A critical upcoming test for the government will be the sale of the MobilTel, the country's wireless operator. It was acquired 15 months ago by an Austrian consortium for Euro 850 million. It is expected the valuation will be around Euro 1.5 billion. The Austrian consortium brought in a management team from Vodafone, Libertel, Teleglobe and Ameritech and have made it a stronger company. MobilTel's main selling point is that Bulgaria is still a growth market in terms of wireless penetration. It is around 28%, compared to 83% in the Czech Republic and 68% in Hungary. While this is not an issue of privatization of a public holding, the sale of a majority share to other major telecom companies represents whether Bulgaria has the ability to keep attracting foreign direct investment.

Bulgaria's move toward an investment grade rating is ultimately anchored in how the government is to weave a much closer linkage with the West. In this, Bulgaria has had a solid track record. It has been invited to join NATO and the European Union has endorsed the country's plans for accession in 2007. EU membership means that Bulgaria must continue to reform its economy in terms of competitiveness, openness and corporate governance. Failure to make the grade with the EU will hinder membership. Bulgaria and other Eastern European countries clearly do not wish to be left out. One last link to the West is that Bulgaria has emerged as a close U.S. ally, providing bases for U.S. troops and equipment during the Iraq war. There is a growing possibility that the U.S. could make Bulgaria one of its new bases of operations for missions in the Eurasian landmass.

Bulgaria is gradually climbing toward investment grade. Tough challenges remain, but there is a lot at stake for the country in terms of improving the standard of living, the nation's industrial and communications infrastructures and the ability of Bulgarian companies to compete. Although we do not expect it to achieve an investment grade rating in 2003, if the reform process continues, we believe that would be a possibility in mid or late 2004.

Argentina: Have We Reached The Bottom Yet?

By Jonathan Lemco

For the past two years, Argentina's economy has been mired in a deep recession/ depression. One of Latin America's few economic success stories of the 20th century, the nation had experienced a tremendous economic meltdown that resulted in over half the population, including large numbers of the formerly middle class, relegated to the ranks of the poor. The reasons for this disaster are related to political mismanagement, bureaucratic inertia and corruption, inefficient industry, and bad luck. But amidst all of the gloom, there are some signs that the worst may finally be over.

Historically, the greatest economic fear of Argentines is that inflation will return. Many analysts predicted that inflation would surge following the 2002 financial collapse. But as of June 2003, inflation seems to be well behaved. In fact, consumer prices have actually fallen of late, as the Argentine public is willing to hold the local currency. Inflation is unlikely to exceed 10-12% in 2003, and may actually end in single digits, especially if utility prices are not increased.

Also industrial production is way up in the past three months and supply-side indicators and consumer and business confidence are improving. There is decent GDP growth as well, after 17 straight quarters of contraction. In the current quarter, Gross Domestic Product growth is 5.4% yoy, up 2.4% from the previous quarter. The currency devaluation has revived local industry and growing consumer confidence has bolstered spending. The IMF expects the economy, which shrank 11% last year, to grow 4% in 2003.

The fiscal situation is not as dire as it was three months ago either. In fact, fiscal policies at both the Federal and the Provincial levels reflect similar trends toward primary surpluses. Many analysts think the Kirchner administration has a good chance of achieving a primary fiscal balance that would surpass the IMF target of 2.1% of GDP for 2003. That is a very positive sign.

The external sector has improved as well. A huge trade surplus has resulted from a virtual collapse in imports during 2002. Export growth has been negligible and has been driven by higher commodity export prices. But exporters are slowly gaining access to bank credit. Equally important, Argentina's relations with its multilateral creditors are improving, although serious problems remain -notably the effort to restructure external debt. The government wants to move rapidly in this area, but we expect actual progress to be slow. Of the estimated US$160 billion in public sector debt, US$63.66 billion may be subject to restructuring.

Argentina has a newly elected President, Nelson Kirchner, whose policies are likely to be moderate and fiscally prudent. Many political observers believe that he will emulate the market-friendly policies (thus far) of President Lula in Brazil and President Lagos in Chile. The current economic team in place is experienced. That said, President Kirchner's priorities must begin with accelerating negotiations with the International Monetary Fund on a new medium-term arrangement. Argentina has to pay the IMF US$3 billion on September 9. We expect IMF negotiations to be very challenging, given where they fall during the electoral cycle. Other significant issues include banking sector restructuring and utility price adjustments.

We expect much attention will be devoted to the creation of an enlarged public works program as well, for the government argues this will play a key role in producing an economic recovery that reduces unemployment and poverty, led by a strong and efficient public sector. We think that government policy is leaning towards emphasizing government spending on infrastructure, and on consumption, as opposed to private investment. In the short run, this might be wise policy, particularly since the government needs to build support for its programs as the cycle of provincial and congressional elections conclude in the fourth quarter. But we would be very concerned if "priming the pump" continues into 2004, for then it would do real damage to the business environment.

Other concerns include the health of the banking system. It is very liquid, but many questions remain about its solvency. In addition, access to credit and especially to the global capital markets will remain problematic for some time to come. Argentina will have to do much to restore investor confidence. However, a satisfactory agreement with the IMF on restructuring its debt will be a major step in the right direction. On balance, we remain extremely cautious but we are impressed with the progress that Argentina's government has made thus far.

BUSINESS

Securities Valuation by Foreign Banks: What Do Bank Regulators Look for?

By Joseph Blalock, Senior Consultant

Editors Introduction: Regulatory supervision of banks around the world has evolved dramatically over the past 10-15 years. Rather than the static, audit-type oversight practiced years ago, today's bank supervisors in the U.S. and other countries are forward-looking, focused primarily on a bank's ability to identify, evaluate, and manage risk throughout their activities. And rather than intermittent contact with regulated institutions, today's supervisors are increasingly engaged in ongoing dialogue with them, moving toward a model that is sometimes called "continuous supervision."

Internationally, supervisory standards themselves have been raised and made more consistent worldwide – due importantly to "best practices" work by the BIS-sponsored intergovernmental Basel Committee on Banking Supervision. It's also true that intensified bank supervision is partly a product of notorious cases in the 1990s of inadequate or "evaded" supervision – think of BCCI, Daiwa Bank in New York, certain Asian and Russian banking problems a few years ago, and numerous money-laundering scandals.

For foreign banks operating in the U.S., the bottom line now is that they need to make a proactive, focused effort to understand what U.S. supervisors expect of them, and why – whether it be sufficient technical expertise in handling credit and market risk; a fully effective system of internal controls; or robust corporate governance throughout their organization. Their ability to build sound regulatory relations, through solid performance that wins the trust and confidence of supervisors, can now be one of their greatest assets.

As a case in point, the following article, based on the first-hand experiences of a bank consultant, examines the regulatory/supervisory dimensions for foreign banks in properly pricing non-U.S. securities held in their portfolios.

As part of prudent management and maintaining their profitability, banks must be able at all times to determine the current market value of securities they hold. Market prices on recent trades are typically the best indicators, but many factors can alter securities values over time, including fluctuations in the general level of interest rates, changed perceptions of the quality of businesses in specific industries or regions, and the changing creditworthiness of the securities issuer. Additionally, market liquidity is an important consideration, since a bank may have to sell some portion of its securities or loans to meet liabilities or other commitments. Since banks typically hold securities ranging from liquid, high-grade government and corporate paper to less liquid, unrated debt, bank regulators are naturally very interested in how well banks monitor and manage the quality of their securities and credit portfolios.

Many foreign banks and banking offices operating in the US are in the unusual position of holding obligations of home-country issuers that do not otherwise have a significant financial presence in the US. If they buy bonds or instruments such as a share of a loan syndication for a home country customer, the foreign bank must demonstrate to US regulators that it has the capability to verify the pricing of corporate debt and credit-related instruments of these home-country clients.

Among the illiquid and unusual financial instruments referred to are corporate and convertible bonds, and other credit-linked notes and derivatives. These instruments might be US dollar-denominated, but trade infrequently on US debt markets. Therefore, pricing information may be unavailable from standard services such as Bloomberg; and even if available, this information may be unreliable and/or volatile if the instruments are thinly traded.

To maintain adequate information, the foreign bank would typically have to augment market trade information with dealer quotations and "indicated" prices of these and similar securities. Indicated prices are approximations of what securities dealers expect market prices may be, but are not necessarily a firm price to buy or sell that security.

It is not uncommon for US regulators to scrutinize closely how a foreign bank evaluates both the pricing of obligations and their overall risk to counterparties that are clients, or affiliates of clients, of the head office. Two key areas of US regulatory concern include the foreign bank's internal controls related to pricing securities in general, and pricing of securities and other capital markets exposures of institutions that are also major loan clients of the head office.

In anticipating this concern, the bank – if it relies on updated dealer quotes for repricing – should have information from multiple dealers. This is especially true if the bank would otherwise be relying solely on quotes from the dealer from whom the banks purchased the security, since that dealer may be perceived as having a conflict of interest regarding securities it has underwritten or sold in the past. Nor should the pricing information come from the issuer. Regulators prefer there be at least three independent sources of prices, if possible. If it is not possible for the bank to reliably obtain prices using dealer quotes or a market data service provider, the bank may want to use a financial model, which, if properly documented and validated, can prove acceptable to regulators. (This model should be based upon the appropriate market interest rate or other underlying index for the security plus historical factors such as yield curve spreads to support the model's estimate proxies for market prices.) If the foreign bank is simply not able to periodically reprice certain unusual securities due to lack of information, then the voluntary establishment of a valuation reserve may be considered a prudent move by the regulator.

Whatever pricing regimen the bank chooses, another major control issue is that assumptions must be verified independently by the risk management or internal audit departments. Regulators expect to see there is a clear separation between the lines of business that trade in securities and those that do accounting or subsequent valuation. The internal third party should also be sufficiently familiar with these financial instruments to undertake the pricing verification, and, if necessary, to challenge assumptions about the prices paid. For example, the independent party should be able to understand the initial trading or hedging strategy and report to senior management as to whether these trades were done "at market" and, subsequently, whether the assumptions underlying the trades are still valid.

When purchasing securities from head office clients, and when evaluating whether to continue holding such positions, the US-based foreign bank should maintain documentation as to why they are holding these particular securities and how the securities fit within the US bank's risk and return objectives. Regulators look for assurances the US arm of the foreign bank is not buying securities of a head office client without undertaking adequate due diligence at the time of the initial transaction or initiating follow-up price monitoring to measure and manage risk exposure.

An issue of emerging regulatory, investor, and ratings agency concern is how financial institutions monitor concentrations of credit risk. The credit exposure of bonds, convertibles, and other credit-linked notes comprise part of the bank's overall risk exposure to a client, with remaining exposure stemming from lending and trade credit instruments to the same client, as well as the replacement cost of relevant market derivatives. Foreign bank offices in the US are often unable to manage locally their entire exposure to particular corporate clients, or to groups of affiliated clients ("names", in regulatory parlance), because their head office organizations control the global management of credit concentrations. However, the US-based entity should be able to demonstrate to its US regulators that it monitors its own total exposures to particular "names" so as not to have an excessive concentration within its US operations. The US-based bank would also want to demonstrate to its regulators that it effectively communicates with its head office in a timely manner about any increases and curtailments in overall exposure to the consolidated firm.

Since corporate debt increasingly takes the form of capital markets instruments, US regulators and many other interested parties – such as auditors, ratings agencies, and correspondent parties – are keenly interested in how well banking institutions are monitoring and measuring the value and extent of overall credit risk.

Foreign banks operating in the U.S. thus need to give full weight to understanding and dealing with these concerns, and should position themselves proactively to deal with them.

KWR Viewpoints

U.S.–ROK Economic Relations: Still Important?

By Caroline Cooper

President Roh Moo-hyun's May visit to Washington produced limited results on economic issues. A joint statement was signed, which committed both governments to renew support for expanded trade and investment ties; however, no formal commitment was made by either country to do anything specific on economic issues, such as completing a bilateral investment treaty (BIT) or negotiating a free trade agreement (FTA). Upon his return from Washington, Deputy Prime Minister and Minister of Finance and Economy Kim Jin-pyo was reported as saying that the time has come for the two countries to complete a BIT. This would be a positive step forward; however, it may prove difficult to enact because rescinding the screen quota is a politically sensitive issue in Korea, just as protecting the domestic steel industry is here in the United States. President Roh currently has his hands full in trying to quell labor strife, mediate between North Korea and the United States, and get the economy back on track. Maintaining strong bilateral economic relations also remains a priority.

Lingering Disputes Need Resolutions

The United States and Korea continue to enjoy a very fruitful trade and investment relationship. According to industry statistics, the United States remains Korea's single largest trading partner and second largest source of investment. Two-way trade totaled nearly $24 billion in the first five months of the year, according to the Korea International Trade Association (KITA). But new trends have emerged, which continue to influence the direction of Korea's foreign economic policy. China, including Hong Kong, is now Korea's largest export destination and Japan its largest source of imports. China is also Korea's primary destination for investment. President Roh recently held a summit with Japan's Prime Minister Koizumi in which the two leaders discussed expanding economic ties. Roh will meet next week with China's leader to possibly do the same.

Upon President Roh's entry into office, he committed to broad economic reforms, an encouraging sign to U.S. companies seeking to expand their business ties with Korea. But some companies now argue that the government is slow to fulfill these commitments, and they also remain frustrated with the lack of progress in resolving disputes in areas such as automobiles, pharmaceuticals, telecommunications, and intellectual property rights. Of particular concern are sectors such as agriculture, and the motion picture screen quota.

In its annual report to Congress on foreign trade barriers, the Office of the U.S. Trade Representative (USTR) also suggests that very little progress has been made to resolve other issues such as the auto trade imbalance. The deal completed last year by GM to acquire Daewoo and Hyundai Motor Company's announcement that it will set up a plant in Alabama are positive steps to improve overall bilateral trade relations. However, these efforts have done little to improve business conditions for foreign auto producers that are seeking to enter Korea. The U.S. government has therefore urged that Korea reduce its 8 percent tariff and streamline the special auto consumption tax. Although the ROK government has indicated a willingness to consider the latter, it will not reduce any tariff in negotiations outside of those sanctioned by the World Trade Organization (WTO).

The U.S. government and pharmaceutical advocates like PhRMA continue to complain that doing business in Korea is difficult, in large part because of inequitable pricing policy for foreign producers. Companies have been most concerned in the past year about efforts by the Ministry of Health and Welfare to resolve the health care crisis by changing the regulations under which foreign drugs are reimbursed under the national insurance system.

For the moment, U.S. companies remain optimistic about President Roh's engagement with the business community; however, this optimism is not likely to prove sustainable unless substantive progress is achieved on a range of important trade issues. Pharmaceutical producers, for example, are hopeful progress will soon be made to create an equitable reimbursement pricing policy in the bilateral health-care reform working group. Companies are seeking more intellectual property rights protection. The Motion Picture Association criticizes the increase in film piracy due to the limited power of the Media Review Board to verify movie copyrights. The U.S. government is concerned about a proposal by the Korean government to mandate one wireless telecommunications standard, called the wireless internet platform for interoperability (WIPI). However, attention to this issue has lessened in recent months in part because Sun Microsystems will be involved in the development of WIPI.

Korean Concerns

Bilateral trade disputes relate not only to "doing business in Korea" but also to doing business in the United States. Since 1998, Korean steel producers have been subject to many countervailing and antidumping duties and three safeguard actions—a number of which Korea has challenged in the WTO on procedural grounds and won. Politics has factored heavily into disputes associated with Korean companies doing business in the United States, especially relating to the steel and semiconductor industries. A case in point involves an ongoing investigation by the U.S. government into whether the Korean government has subsidized Hynix Semiconductor.

In 2001, Idaho-based Micron Technology alleged that Hynix was subsidized because the Korea Development Bank (partially government-owned) coordinated a scheme for underwriting the refinancing of its maturing bonds. The issue caught the attention of Idaho's two Senators Craig and Crapo, who pressed the U.S. government to raise its concerns at the WTO. WTO action by the United States never went beyond the initial phase because Micron announced soon it would purchase Hynix. That deal fell through in mid-2002, and in November Micron filed a petition seeking a countervailing duty investigation of Hynix. The Commerce Department recently made a final decision in the case, recommending that duties be imposed on imports produced by Hynix to offset the estimated 45% subsidy rate. The U.S. International Trade Commission (ITC) will make its own decision in the case in mid-July. If the ITC finds that material injury was caused to Micron, duties will be imposed on August 7.

Next Steps

The latest government economic indicators reveal that Korea's domestic economic situation is worsening. Domestic consumption and capital investment are down. Consumer debt is expanding and consumer sentiment remains weak, indicating that demand will not pick up any time soon. However, the current account balance reached $1.8 billion in May, thanks in large part to an expanding trade surplus, which preliminary statistics show reached $2.4 billion for June. According to MOCIE, this is "the largest surplus amount since December 1999." This is good news, but more exporting opportunities will be needed to expand growth.

Korea needs to balance its trade interests. Industry experts such as Morgan Stanley's Andy Xie, warn against Korea's overdependence on the Chinese market. Also, Korea remains fearful about expanding trade with Japan through an FTA, with concern that Japanese companies may undercut Korean firms. In the short-term, the U.S. market provides Korea with the best opportunity for export expansion. This fact should not be overlooked. The U.S. economy faces a bumpy road ahead, but the latest economic reports suggest it will improve in coming months. Korean companies would do well to continue expanding into the U.S. market, both through exports and investment. Korean products, especially consumer electronics, are highly competitive in the United States.

In the long-term, Korean companies might face greater obstacles in exporting goods to the United States. As the aggregate U.S. merchandise trade deficit grows, Korean producers will face even more scrutiny from domestic producers in sensitive industries who are fearful of increased competition. However, a more formal commitment by both governments to broaden trade and investment would go far to benefit companies in both countries. While an FTA may not be a realistic goal in the near term, completing a BIT is possible and something to which business groups in both countries agree is needed.

The U.S.–ROK economic relationship remains an important one for both countries. Neither should neglect the strength of their past half-century military alliance or their economic partnership. Maintaining strong bilateral economic relations, especially resolving lingering trade disputes, must remain a priority. Both countries have much to offer each other.

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Economic Institute (KEI) in Washington. The views expressed here are her own and not those of KEI or KWR International, Inc.

India Infoline

The Geopolitical Chessboard – African Adventure

By Scott B. MacDonald

In mid-July President George W. Bush conducted a five-nation visit to Africa, the first in his presidency. Why? The Bush trip reflects that Washington sees Africa as important in the war against international terrorism. The U.S. President visited some of the most significant African countries in terms of economic size and political influence in the region – Senegal, Nigeria, Botswana, South Africa and Uganda. Along the same lines, it is increasingly likely that the U.S. will lead a U.N. force into battle-torn Liberia to help restore order. Washington's main concern is that if the U.S. and its allies lack a forward thinking policy in Africa, al-Qaeda and its fellow-travelers will expand their bases and gain new supporters.

And al-Qaeda and radical Islamic groups are active. Since 9/11 they have conducted bombings in Tunisia, Kenya and Morocco. Terrorist cells have been broken up in Kenya and Tanzania and an Islamic-inspired coup was defeated in Mauritania following the government's crack down on possible al-Qaeda-linked groups. There are considerable discussions that al-Qaeda agents are active in West Africa, including Nigeria, which has a large Muslim population in the north. In East Africa, Somalia is also increasingly regarded as a base for al-Qaeda agents. Somalia lacks any coherent central government and is close to Yemen, which, in turn, has a porous border with Saudi Arabia – the main prize in al-Qaeda's holy war.

Sudan is now looming large in the intelligence community. In late June Greek authorities seized a merchant ship loaded with 680 tons of explosives and thousands of detonators. The ship was destined for Sudan – to a company that does not exist. Sudanese authorities denied any terrorist links and stated that the explosives were for road construction. Considering that the Sudanese government is strongly Islamic, that Osama bin-Laden once lived in the country and that vast regions of the country are out of government control, the road construction story does not carry much weight. It is thought by intelligence agencies that western Sudan has a number of al-Qaeda bases, which are being used to plan attacks against U.S., European and local government assets in the broad arc from Morocco's Atlantic coast through the Middle East and into Southeast Asia. Indeed, Sudan borders Egypt, which has its own number of radical Islamic organizations.

George Bush is only the third American president (Jimmy Carter and Bill Clinton being the others) to make an extended visit to Africa. Earlier in his presidency he launched a new policy against AIDS in Africa and promised greater amounts of U.S. assistance to the region. One of the countries on the Bush trip is Uganda – a country that borders Sudan and has a long history of supporting rebel groups in that country. Uganda's President Museveni is a shrewd geopolitical player. He has little desire to see the Islamists in Sudan gain greater power nor does he wish to surrender the buffer created by the largely Christian southern Sudan which has long fought the more Arab north. What may make geopolitical sense for Uganda may make sense for Washington.

While it is a positive development that the United States is taking a more committed stance on Africa, the challenges are substantial. The region has massive problems – of a human, economic and political nature. In a number of cases, the very survival of some form of central authority is at stake. Add to this Africa becoming part of the game map for geopolitical intrigue between al-Qaeda and the United States. All things considered, we could be hearing a lot more about Africa and the war against terrorism this summer. Although Africa is not a core area for U.S. national security, it is moving up the scale, requiring more time and effort. A U.S. military intervention into Liberia for the United Nations could be only part of what Washington may eventually be forced to commit in Africa.

Emerging Market Briefs

By Scott B. MacDonald

Argentina – Growth At Last: For the first time in 17 quarters Argentina experienced real GDP growth. Q2 real GDP expanded by 5.4%. Coming after a 10.9% contraction in 2002, this was long awaited good news. While manufacturing and construction were key factors in the growth spurt, the main driver was fixed asset investment, which grew 20.6% during the quarter. Exports were up 6.4% and imports were up 15.9%.

Brazil – Fitch Takes A Positive Look: On June 3, Fitch changed its outlook for its B rating on Brazil from stable to positive. The outlook change was based on optimism that President Luiz Inacio Lula da Silva will succeed with policies aimed at maintaining payments on the country's $207 billion in external debt. Since President da Silva, more popularly known as "Lula", won the October 27, 2002 elections the currency has risen close to 30% and stocks and bonds have rallied.

Hong Kong – Unemployment Blues: 2003 is proving to be a tough year for Hong Kong. The economy has failed to take off, having been beaten down by a combination of SARS and a weak global economy. In May, unemployment climbed to a record 8.3%. The main culprit was SARS, which cut into shopping and tourism. This, in turn, saw hotels, restaurants and stores fire employees. Unemployment was 7.8% in April. The expectation is unemployment has yet to peak – it could climb to 9% before falling to less painful levels.

Malaysia – Industrial Production Up: In April Malaysia's industrial production expanded at its quickest rate in 28 months. According to the Department of Statistics, factories, mines and power utilities increased production by 11.8% from a year earlier. The government had earlier launched a $1.9 billion stimulus package to help boost the economy, following a slump in exports of semiconductors and other goods. Electronics exports, which account for close to half of GDP, fell for a fifth month in April, compared to an overall rise of 5.7% in exports. Real GDP in Q1 was 4%, the slowest rate in a year. Although there remains some degree of caution, Prime Minister Mahathir is asserting that real GDP growth will be in excess of 4.5%.

Romania – Underrated: Following Bulgaria's two-notch upgrade by Moody's in early June, we regard Moody's rating for Romania as too low. The Balkan country's debt ratios are comparable to many low BBB rated credits and the EU reform program is moving ahead. Relations with the IMF are positive.

Singapore – Exports Fall: Singapore's exports in May fell by 6.8%, largely due to a poor performance by electronics and the SARS virus causing slower sales to China.

Total exports reached $5 billion. According to the city-state's trade promotion agency, SARS is curbing demand for computer chips and other components to China and other Asian markets, aggravating the impact on Singapore's economy from a downturn in retail and airline businesses. Singapore's real GDP is thought to have shrunk 1.9% in Q2. Although the outlook for the electronic industry remains gloomy, Singapore usually sees a seasonal pick-up in exports to the United States in Q3, when suppliers ship goods for Thanksgiving and Christmas. The United States accounts for a fifth of Singapore's exports.

Venezuela – How Grim Is It?: According to the Venezuelan government, the country's economy is in bad shape. Bad shape is defined as an expected 10.7% contraction in real GDP for 2003. Finance Minister Tobias Nobrega announced on June 22, that Q2 will see another contraction, following a 30% contraction in Q1 2003. In 2002, the economy declined by 8.9%. The root cause of the dismal economic news is a combination of ongoing political strife between the leftwing Chavez administration and its center-right opposition, which resulted in an extended and highly damaging oil strike.

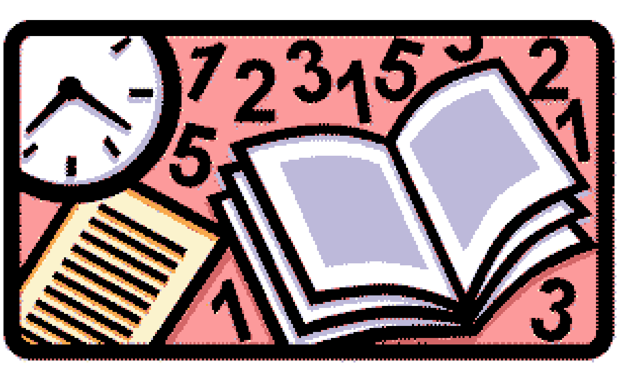
It is estimated the two-month long strike lost the government $7 billion in lost tax revenues. This, in turn, has caused the government to rely on borrowing in domestic markets. Domestic debt is now estimated at around $9.4 billion, close to 20% of all debt. In a high interest rate environment, this represents an ongoing bleeding of funds. In addition, government economic policy has not been stellar and the foreign exchange controls that were imposed earlier run the risk of strangling the private sector.

Although oil production appears to be reaching more normal levels and Venezuela should be able to service its external debt repayments for 2003, financial conditions will remain tight and dark clouds clearly hang over the economy. Indeed, the IMF expects tougher conditions and is estimating that 2003's real GDP will be around a 17% contraction. Rounding out the economic picture, unemployment is estimated to be somewhere between 20-25 percent of the workforce. This dire situation is reflected by the fact that around 2,000 private manufacturing companies closed during the first quarter of 2003.

Nor does the political situation promise much. Although Chavez and the opposition have come to a broad agreement on how to proceed to a referendum for new elections, Venezuelan society is highly polarized and tensions remain high. Complicating matters further, the opposition is badly fragmented. This would be to President Chavez's advantage as he retains a steady bloc of support of around 30 percent of the population. All of this suggests a great chance for more political turmoil in the months ahead. While we do not see a default on the country's external debt looming in 2003, as foreign exchange reserves remain adequate and oil prices remain relatively high, Venezuela's creditworthiness remains overshadowed by political concerns.

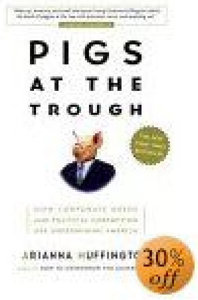
AsiaLinks

Book Reviews



Arianna Huffington, Pigs at the Trough: How Corporate Greed and Political Corruption Are Undermining America (New York: Crown Publishers, 2003). 275 pages. $22.00.

Reviewed by Scott B. MacDonald



Click here to purchase "Pigs at the Trough: How Corporate Greed and Political Corruption Are Undermining America " directly from Amazon.com

There is nothing better than a good double-barreled shotgun blast of moral indignation about corruption in corporate America. Indeed, throughout much of the 1990s, corporate America enjoyed excesses, which certainly went to the heads of a number of CEOs. The cases of Enron, WorldCom, Qwest, Adelphia and Tyco easily come to mind. Were these cases reflections of the overall nature of the U.S. business culture? Did they represent a dangerous, insidious force seeking to undermine and ultimately control America, much like the Dark Side of the Force in the Star Wars saga? Should we expect the horn-headed Sith demon face of Darth Maul among the photos of CEOs walking into the White House?

According to Arianna Huffington, herself in quite a huff in her book, Pigs at the Trough, the answer to all of these questions is a damning YES! The Dark Side of the Force has consumed corporate America and the souls of the American people are up for grabs. As she states in her chapter entitled "The Bloodless Coup: The Corporate Takeover of Our Democracy": "The financial scandals of our time were made possible by an unprecedented collusion between corporate interests and politicians that, despite all the breast-beating about reform, is still going strong. Together, these two powerful groups tore down hard-won regulations that restrained the worst capitalist excesses, leaving in their place a shaky edifice of feckless self-policing and cowed regulators, powerless to prevent the corporate Chernobyles."

She goes to say of Washington and lobbyists: "This is the nexus of corporate corruption; the source of all the swill. The unseemly link between money and political influence is the dark side of capitalism."

Indeed.

Huffington provides an acid-tongue criticism of corporate America and its main political allies – of course, the Republicans and mainly President George W. Bush and his White House team. (No surprise that the Democrats receive a lesser tongue-lashing.) While much of the book is entertaining – to a point and she does score points in looking at the most blatant cases of corruption, the ultimate product is a highly distorted view of the business world and the people that run it. Yes, there were horrible excesses that occurred during the 1990s, much as they did in other business and stock market booms, both in the United States and elsewhere. Certainly the 1870s through the early 1900s represented a period of robber barons – also captains of innovative American industry. American democracy managed to mature and adapt, much as it is doing this time around.

The fundamental problem with Huffington's book is that what she wants is innovation and economic growth without risk. Capitalism is hardly perfect, but it certainly beats the alternatives. And yes, capitalism needs some degree of rules and regulations. Some of her suggestions, such as lobbying law reforms, improving accounting standards and strengthening corporate boards all have merit and are being done. And there is an appeal to the Clean Money, Clean Election model, which limits access to funding beyond the government and the voter, eliminating hard and soft money and the endless dialing for dollars. However, Huffington clearly wants a heavy hand of the state to turn back the clock on such things as the end of the Glass-Stegall Act, which hobbled U.S. banking for decades. Her call to outlaw tax havens is hardly realistic, considering the international politics involved.

Ultimately the cure is for the American people to take back their political system, partially through becoming more active in the country's political life – including more letter-writing campaigns. As she clamors: "Well, the time has come for the shoppers to leave the malls and take to the streets – to go from invigorating our economy to reinvigorating our democracy." With unemployment over 6% and people concerned about their jobs, people probably are going to prefer to reinvigorate the economy. This book should be read, but only by those who have a degree of rectal fortitude.

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