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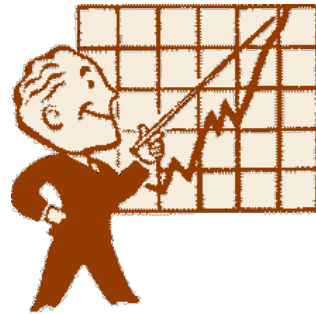
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U.S. Economy - Another Boom?

By Scott B. MacDonald



NEW YORK (KWR) -- Anyone looking for evidence that the U.S. economy is recovering did not have to look too far beyond the recent flow of data. The third quarter real GDP number was 7.2% -- the fastest pace of growth since Q1 1984. It clearly had the flavor of an economic boom number. Full year real GDP expansion is likely to be over 3%. The consumer, of course, played a major role in pumping up the economy, partially due to the impact of the federal government tax rebates. The excitement about the strength of the Q3 real GDP number, which easily surpassed the consensus estimate of 6%, is understandable. Adding to the excitement, unemployment for the month of October fell from 6.1% in September to 6.0%, largely driven by greater employment in the services area.

Most people (except those heavily invested in gold) want to believe the worst is behind them – the recession is becoming a distant memory and the good times are about to roll again. Are we on the edge of a new economic boom? Although we see a pick up in growth in 2004 (in the 3.3%-3.6% range), there are a number of nagging issues that could function as a brake to another boom.

First the good news. What was the most encouraging about the Q3 GDP figure was that it included corporate equipment purchases. Business investment in equipment and software rose at a 15.4% annual pace, the fastest since Q1 2000. Indeed, total corporate spending rose at 11.1%. Equally important, inventories in many sectors were depleted and now need to be replenished – something that will continue to fuel growth. Other news on the U.S. economy was generally upbeat. This included durable goods orders, construction, consumer confidence and manufacturing. Adding to positive sentiment is that corporate earnings are doing well. There have been fewer major disappointments and most companies appear to be on track for a better year compared to 2002.

Where do we go from here? We expect the economic data will continue to be generally positive, with 4th quarter real GDP around 4%. More importantly, we expect there will be a slow improvement of the unemployment numbers, which

will become more pronounced in 2004. We do not see much of an improvement in U.S. unemployment below 6% in 2003. What will make the difference will be the shift in the driver of the economy from consumer spending to corporate spending. Q3 2003 corporate spending numbers were encouraging and we expect Q4 numbers will reflect the continuation of this trend, reinforcing recovery.

Although there is concern about the growing nature of the U.S. fiscal deficit, we see this more as an issue for 2005. While the build-up of red ink is potentially problematic, the deficit must be put in historical perspective. In the past two recessions, the fiscal deficit as a percent of GDP was much larger. In 1983, the deficit was 6% of GDP; in 1992, it was 4.7%. As of September 30, 2003, the federal deficit was 3.5% of GDP (it will probably be over 4% by year-end). The point here is that the federal deficit is manageable – thus far. If the U.S. economy has hit a period of sustainable growth (which is likely) the revenue base should improve. Consequently, the deficit is not a concern for 2004. However, if revenues do not recover and costs are not brought under control in 2004, the deficit could become a more pronounced negative factor in 2005. Indeed, a voracious federal borrower could crowd out private sector companies in credit markets, undermining the sustainable nature of the recovery.

What makes us somewhat cautious about jumping on the robust growth bandwagon is that we see consumer spending and housing demand tapering in Q1 2004 as the federal economic stimulus fades. This is not to argue that we see a collapse in either consumer spending or housing, but a marked slowdown as American households do a little consolidating of their own high debt numbers. If corporate spending does not pick up the slack, then the economic activity could slow. Instead of looking at 4% growth, the number could be closer to 3%, which would still be relatively strong, but a disappointment to the stock market.

There are two other potential spoilers sitting out in the reeds like alligators in 2004 – the potential for a faster than expected rise in interest rates (if economic growth continues at a fast pace) and a geopolitical tremor (another major al-Qaeda attack on the United States or North Korea).

Although the most recent Federal Reserve meeting left rates at 1% and the language was neutral on inflation, that dynamic could change if the pace of U.S. growth stays at a higher level. Consequently, the Q4 real GDP number will be closely watched. Only a few months ago many analysts expected that the Fed would maintain no change in rates through most of 2004. That consensus is changing. In November 2003, both the Reserve Bank of Australia and the Bank of England, two countries that often run on the same business cycle as the United States, raised rates for the first time in a long while. A shift in interest rate policy – especially one that comes quickly – could have a negative impact on the stock market and would certainly ripple through the financial sectors – banking, brokerages, insurance companies and credit card companies. It could also put many individual buyers under pressure – something that could trickle into the general economy and make the tapering of the consumer into a crumbling of the consumer. We do not see this as likely – at this point, but it is a possibility that should be carefully watched.

The other issue is that of a major geopolitical incident. This could come in the form of a terrorist attack on the United States by al-Qaeda, which is constantly threatening, or from a potential outbreak of war in Korea. North Korea clearly remains a wild card in the geopolitical game, a situation made that much more dangerous considering the high probability that the Kim Jung-il regime possesses nuclear weapons. Even if war does not occur, North Korea could provoke an Asian financial crisis if it collapses and forces the South to pick up the costs of reunification. An implosion of the Kim regime could be bloody, economically costly (estimates for rebuilding the North range from \$500 billion to \$1.75 billion), and highly dangerous in terms of international relations, drawing in not just South Korea, but the United States, Japan, China and Russia. It would also make a bet on Asian equities a bad decision.

Consequently, we see the U.S. economy on a roll – good economic data is likely to continue, interest rates are under control and corporate earnings have generally been good. The Dow should end 2003 a little over 10,000. That takes us through the end of the year and into 2004. Once into 2004 a new set of variables, as outlined above, takes on greater significance. A new game will be afoot – there is an economic turnaround and faster growth, but how fast and how does it measure with expectations is the unanswered riddle.



Asian Business Watch

Japan Views You Can Use

The Next Big Step: Monetary Tightening

By Darrel Whitten

A 180 ON INFLATIONARY EXPECTATIONS...

TOKYO (KWR) -- The sharp but brief 825-point sell-off in the Japanese market in late October had within it hints of what investors can expect when the Bank of Japan (BOJ) is eventually forced to abandon its zero interest rate policy (ZIRP), or even when the U.S. Federal Reserve (FED) moves first.

By sector, the biggest losers were the financials, including the banks, securities companies, other financials and insurance. There has been some serious foreign institutional money coming into the banks during this rally, in addition to short covering by the hedge funds.

As long as foreign investors keep buying, the market technicals of the financials should provide support. Conversely, any correction that causes a serious breakdown in the market technicals of the financials is a warning sign of a significant shift in sentiment. That would bring about an extended correction, one that could be instigated by perceived changes in monetary policy—ostensibly first by the US FED, and then by the BOJ.

Actually, such a move by the central banks would be good news for the US and Japanese economies, as it would signal that central banks were confident enough in the sustainability of the economic recovery to begin pulling some liquidity off the table. However, if the moves are more aimed at pre-empting inflation -- i.e., primarily because of commodity price movements and the weak dollar -- market liquidity could dry up before earnings are strong enough to drive the market rallies.

...HAS THE CENTRAL BANKS TRYING TO KEEP IT SUBDUED

The sudden improvement in the U.S. employment picture has some economists scrambling to revise their views on when the Federal Reserve will raise interest rates, but the FED for its part is trying to play down these fears. According to Alan Greenspan, "in these circumstances, monetary policy is able to be more patient." Fed Governor Ben Bernanke acknowledged some improvement in the labor market, but emphasized there was considerable scope for policy to remain accommodative. However, financial futures markets, regardless of what the FED was saying, had the fed funds contract showing a 90 percent chance of a 25 basis point rise after the strong jobs report, up from 70 percent before the statistics were released. Presently a rate rise appears fully priced in for May of next year.

Japan's economic growth probably slowed to an annualized rate of 1.5 percent in the third quarter, but there has been a substantial improvement in business sentiment. A stronger stock market, evidence of economic recovery and reduced financial sector and corporate bankruptcy risk have all contributed to the improvement in sentiment. This has the Japanese press and investors already speculating about when and how the BOJ would abandon its ZIRP.

The BOJ has responded by releasing its medium-term outlook for inflation, which saw Japanese consumer prices remaining minus through FY2004, implying no change in the BOJ's quantitative easing until March, 2005. This notwithstanding, the debate about how and when to "normalize" monetary policy is already underway within the Bank, while it is taboo to mention this debate in public circles.

The BOJ itself and Japan's economy as a whole can ill-afford to have market expectations about inflation get out of hand. As the BOJ itself holds JGBs worth JPY64 trillion versus capital of JPY5 trillion, the Bank would have negative net worth should a renewed surge in bond yields wipe out 10% of the value of their JGB holdings. As they continue buying JPY1.2 trillion of JGBs every month, this exposure continues to grow. Thus in the words of BOJ governor Fukui; "It is necessary for the BOJ to keep the current easy policy in order to ensure an economic recovery and to develop (read protect) the role of the financial system."


FOREIGN INVESTOR PERCEPTIONS WILL LEAD

Foreign investors remain the main driving force of the Tokyo market, although their buying has slackened noticeably in October, and there is some evidence of profit taking. On the other hand, there is no sign that the net selling by domestic institutions is abating. While individual investors have been very active traders (accounting for more of the value of shares traded than foreign investors), they are not exactly buying and holding. Moreover, their sentiment has been positively stimulated by active foreign buying.

But a major change of direction (i.e., from providing as much liquidity and monetary stimulus as possible to an increasingly tight monetary policy) has historically led to an interim correction in stock prices, as investors adjust to stock prices driven by excess liquidity to stock prices driven by earnings fundamentals and valuations. This is why stock prices tend to perform best in the early stages of an economic recovery, while monetary policy is still focused on trying to stimulate the economy, rather than trying to inhibit growing inflationary pressures.

If foreign investors perceived that a move to tighten monetary policy by the FED was imminent, it may have the same effect as move by the BOJ, as the expectation would be that the US move would eventually be followed by a move by the BOJ, assuming of course that the Japanese economy is indeed now in a sustainable recovery phase. A perceived change in monetary policy would prompt portfolio re-positioning to cope with the impact this would have on asset allocations and sector selection.

Already, the larger capital, international blue chips as reflected in the Topix Core 30 recently corrected more even though the index has lagged its smaller capital peers during the rally. These stocks of course are more sensitive to foreign investor perceptions. Conversely, the small-cap JASDAQ has outperformed the Topix by nearly two-fold, and could withstand a shift in monetary policy that did not seriously inhibit the economic recovery.

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Russia's Tycoon Detention Highlights the Country's Endemic Risks

By Sergei Blagov

MOSCOW (KWR) - Controversy over continued detention of Russia's richest man Mikhail Khodorkovsky arguably served to emphasize the country's endemic investment risks. On November 4, embattled Yukos said it had appointed a new chief executive to replace Mikhail Khodorkovsky, who has been jailed on charges of fraud and tax evasion since October 25. Simon Kukes, formerly president and chief executive officer of the Tyumen Oil Company, or TNK, was given the job. A Russian-born U.S. citizen, he was elected chairman of Yukos' board of directors in June.

On November 3, Khodorkovsky resigned, saying he wants to deflect the blows from his company, and Yukos said Khodorkovsky would not seek any executive position within YukosSibneft, the world's fourth-largest oil company, which will be created by Yukos' agreed takeover of Sibneft.

The company also appointed Steven Theede, an American, as executive director of Yukos-Moscow, a subsidiary under which many of Yukos' central corporate functions are incorporated. Bruce Misamore, also a U.S. citizen, remains the group's chief financial officer. The appointment of foreigners was seen as a further attempt to protect Yukos from Russian prosecutors.

The Russian government also announced on November 5 that it was "practically inevitable" that production licenses to an unspecified number of oil fields will be taken away from the company. "The ministry's actions against Yukos will be swift and precise," Natural Resources Minister Vitaly Artyukhov told the official government newspaper Rossiiskaya Gazeta. "Full or partial noncompliance with license obligations -- and in the current situation it is practically inevitable -- will immediately lead to license-revoking," he said. "If need be, we will act pre-emptively. The reasons are obvious: The company, whose controlling stake is under arrest, is not likely to be a suitable partner to work with a federal licensing body."

In a conference call with Western investors, Yukos' chief financial officer Bruce Misamore called the development "extremely strange," adding that he didn't know if it were a reason for concern.

However, President Vladimir Putin said on November 6 that he was against taking away Yukos' operating licenses because it "would give the impression that the state was trying to shut down the company." Putin said the economic consequences of such a move "would be negative and would have no basis in law."

If Artyukhov's threats are realized, particularly in light of the fact that Khodorkovsky resigned as head of Yukos in early November, the blow to Russia's investment climate could be considerable.

Prosecutors last week sequestered a 39.6 percent stake of Yukos as "collateral" for the \$1 billion Khodorkovsky, Platon Lebedev and other Yukos shareholders allegedly cheated the state out of via tax evasion, fraud and forgery.

Meanwhile, Russia has accused the US of meddling and double standards approach following Washington's expression of concern over continued detention of Khodorkovsky.

The State Department's comments on events surrounding Yukos amount to "interference in Russia's internal affairs," Russian Foreign Minister Igor Ivanov said. The United States practices a policy of "double standards," he told the official Russian RTR television.

State Department spokesman Richard Boucher has warned against the Khodorkovsky case's implication for the rule of law in Russia, "raising serious questions" about the independence of the Russian judiciary and the country's commitment to free markets.

Yet apart from the State Department's measured criticism, Moscow was also

presumably unhappy over Richard Perle's call to expel Russia from the Group of Eight industrialized countries over Khodorkovsky's arrest. "Russia should be excluded from the G-8 as no G-8 country is allowed to treat its leading businessmen the way Khodorkovsky was treated," Perle was quoted as saying by Russia's Kommersant daily.

Moscow has rejected the US criticism. "It is, at the very least, tactless and disrespectful toward Russia," Foreign Ministry Spokesman Alexander Yakovenko told Russian television Saturday. He further stated that the US military actions in Iraq and pre-trial detention of suspects at the Guantanamo base in Cuba were also far from a notion of human rights being respected.

Russian prosecutors accuse Yukos top executives of tax evasion, fraud and embezzlement of state property, which allegedly cost the Russian state coffers \$1 billion. Prosecutors also accuse Khodorkovsky of a failure to pay \$2 million in taxes in 1998-1999.

The prosecutors froze 44 percent of Yukos, still worth of some \$15 billion. Although the 4.5 percent stake was eventually unfrozen, the move was understood to be aimed at preventing the sale of a strategic stake in Yukos to ExxonMobil or ChevronTexaco.

Dmitry Medvedev, the new Kremlin chief of staff, told the Russian RTR television channel that the "legal efficiency of this seizure of Yukos stock is far from certain." He also talked of the "full economic consequences of these actions," in what seemed to be veiled criticism of Khodorkovsky's detention.

Meanwhile, last October Yukos and Sibneft completed a merger, creating a company worth \$50 billion and with oil and gas production of 2.35 million barrels of oil equivalent per day, making it the world's fourth largest private oil producer. It is due to become a new entity after a November shareholder meeting, but it remains to be seen whether the meeting can take place with Yukos' two major shareholders behind bars.

In late October, President Vladimir Putin's chief of staff Alexander Voloshin resigned, reportedly in protest against Khodorkovsky's arrest. He was replaced by Dmitry Medvedev, Voloshin's first deputy.

Prime Minister Mikhail Kasyanov has also said he was against the detention of businessmen on economic charges and criticized the freeze of Yukos shares. As Kasyanov disregarded President Putin's direct order to the government not to be involved in Yukos case, Russian media speculated that Kasyanov might follow Voloshin.

However, according to VTsIOM-A polling agency, the crackdown on the country's oligarchs received a 73 percent approval among 1,600 Russians polled Oct.24-28. According to the poll, increasing numbers of Russians believe that the action against Yukos would improve the political situation in Russia.

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What's in a Name? The Shifting Role of the Asia-Pacific Economic Cooperation

By Jonathan Hopfner

BANGKOK (KWR) -- Given the diversity that exists under the umbrella of the Asia-Pacific Economic Cooperation (APEC) – its 21 member countries range



from prosperous nations with free-market economies to socialist states in the first throes of development – it was perhaps inevitable that the grouping would suffer an identity crisis. At no time was this more obvious than this year's summit of APEC leaders, which wrapped up in Bangkok Oct. 21. For despite the convivial back-slapping that accompanied the joint communiqué released by the heads of state after their talks, APEC as a whole rarely seemed as far from the goals that founded it.



Established in 1989 to promote an aggressive agenda of trade liberalization, APEC agreed at a 1995 summit in Bogor, Indonesia to set target dates for free trade in the Asia-Pacific Region. It called on its developed economies to eliminate trade barriers by 2010 and its poorer members to do the same a decade later. With the collapse of September's World Trade Organization (WTO) ministerial talks in Cancun, Mexico, in September, there was much optimism that the forum would take the lead in salvaging international trade negotiations. The summit in Bangkok was the first high-level meeting devoted to commerce after the Cancun fiasco, and it was greeted with high expectations that the leaders would chart the future of the global trade process.

The heads of state tried hard not to disappoint, devoting much of their communiqué to endorsements of the WTO's Doha agenda. The "Bangkok Declaration on Partnership for the Future," asserted "strong support" for efforts to push forward the Doha Round as early as possible. It also committed APEC members to work toward "the abolition of all forms of agricultural export subsidies, unjustifiable export prohibition and restrictions," while advancing free trade "in a coordinated manner."

Noble sentiments, to be sure, but the declaration fell short on specifics – concrete measures to advance the Doha round and liberalization targets are conspicuous by their absence.

This is even more evident when compared with the provisions of the agreement dealing with security, which – despite the "economic" part of APEC's moniker – clearly dominated the Bangkok talks. Leaders pledged to secure weapons stockpiles and to take immediate action to "regulate the production, transfer and brokering" of portable missiles, as well as to "dismantle, fully and without delay, transnational terrorist groups that threaten the APEC economies by establishing "a regional trade and financial security initiative with the Asian Development Bank, to support projects that enhance port security, combat terrorist finance and achieve other counter-terrorism objectives."

US President George Bush thus left Bangkok with further promises of international solidarity for the US-led war on terrorism – though many observers argued that he and his counterparts chose the wrong forum in which to cement these pledges.

Representatives of the global business community meeting at the related APEC CEO Summit criticized the leaders for failing to adequately address pertinent economic issues, including the reduction of tariffs and China's continued reluctance to devalue the yuan.

Michael Drucker, executive vice president of FedEx International, told reporters the grouping needed to "rethink and restate its objectives," keeping the economic principles on which it was founded in mind.

The chairman of Chile's Association of Banks and Financial Institutions, Hernan Somerville, meanwhile expressed disappointment that despite the sentiments expressed in the communiqué, APEC leaders had so far failed to "work out a common position" in global trade talks.

There was also widespread speculation that WTO head Supachai Panitchpakdi, in Bangkok to address the CEO summit, had requested and was denied the opportunity to address APEC leaders, raising further questions about the

group's commitment to involvement in trade issues. It is perhaps just as well that the meeting never took place, for the leaders may not have liked what Panitchpakdi had to say. His continued warnings that the relatively recent profusion of bilateral and regional trade agreements may divert much-needed attention from multilateral negotiations may not have gone down well in a forum where discussions on bilateral and regional pacts -- between Thailand and the US, the US and Australia, and Thailand and China, among others -- have received so much attention.

It could be argued that in Bangkok, APEC not only failed to rally behind its cause celebre of global economic integration, but also failed to showcase the integration of APEC itself. With smaller-scale political issues -- Bush's discussions with new Chinese president Hu Jintao on North Korea, the stance of members of the Association of Southeast Asian Nations (ASEAN) on moves, or the lack thereof, toward democracy in Myanmar, and Malaysian Prime Minister Mahathir Mohamad's exit from the world stage as he prepared to transfer power to his deputy -- dominating headlines, the group's progress toward the goals set out in Bogor barely merited a mention.

None of this is to say that the Bangkok meet was entirely unproductive -- delegates struck a blow for intellectual property rights by endorsing an anti-piracy plan under which the regulation of disc production facilities will be tightened and it will be illegal to export disc production parts or raw machinery without government approval. Previous meetings throughout Thailand resulted in agreements to establish an international network to deal with Internet crime and wide support to a Thai-backed effort to launch an Asian bond fund.

It is clear then that APEC still has an important role to play in the global economy, but after the Bangkok meet many, particularly from the business community, may be wondering what that role is. APEC leaders would do well at their next session to reclaim the organization's heritage as a body devoted to championing trade dialogue and economic liberalization at a time when one is so clearly needed.



Achieving Economic Stability in Asia: How Will the Bush Administration Act?

By Russell L. Smith and Caroline G. Cooper
Willkie Farr and Gallagher, LLP

WASHINGTON (KWR) -- The meetings of the Association of Southeast Asian Nations (ASEAN) and Asia-Pacific Economic Cooperation (APEC) forum last month ended very differently, and sparked concern among trade watchers as to the future role played by the United States in Asia. The ASEAN meeting concluded with a stronger commitment by member countries and observers--Korea, China, Japan, and India--to integrate the region more fully by 2020, suggesting that Asia is once again pursuing an economic path that excludes the United States. This development should be particularly pleasing to Former Malaysian Prime Minister Dr. Mahatir Mohamed, as it harkens back to the days when he first proposed an East Asian Community.

But the APEC Leaders' meeting revealed a much different picture: the United States still wields much influence in Asia, especially when President Bush puts Asia high on his policy agenda. Despite strong protests from Dr. Mahatir, the United States was successful in winning support among APEC leaders to restart WTO trade talks using the Derbez text from Cancun. President Bush kept the talks centered on security, and strengthened support for his war against terrorism. Some of this apparent inconsistency could be attributed to Asian embarrassment over Mahatir's blatantly anti-Semitic comments at a recent

forum of Muslim countries, and his attacks on both the United States and the WTO.

The result of the ASEAN and APEC meetings last month were similar to those from summit meetings held in November of 2000. However, Asian regionalism appeared more imminent and formidable then: China was beginning to exert more economic influence in the region, the United States was less engaged in Asia, and only a few countries were giving real consideration to FTAs as alternatives to the WTO. The re-emergence of Asian regionalism appears less threatening today in large part because in recent months the United States has displayed more interest in regional economic dynamics, especially those involving China. Problems may arise in the future if U.S. officials do not continue to expand their focus in Asia.

Since September, U.S. officials have stepped up pressure on Chinese officials to float the yuan and comply more fully with China's WTO commitments. The results have been mixed. Chinese officials have committed to move gradually towards a more flexible exchange rate. Japan has provided some limited and very carefully worded support for this effort. As a first step, the Chinese government decided to relax some controls on the outflow of capital. Both USTR Zoellick and Commerce Secretary Evans, during their trips to China in October, pressed Chinese officials to implement fully China's WTO commitments relating to the protection of intellectual property rights (IPR), fair distribution and trading rights, and market access in agriculture. But industry groups and some Republican and Democratic Members of the U.S. Congress are not satisfied; they complain the Administration's handling of the issue has included "too much rhetoric." They want President Bush to consider undertaking a Section 301 unfair trade investigation of China and/or confront China on the issue at the WTO.

While the Bush Administration works to placate domestic interests on the China issue, they may not be sufficiently sensitive to China's popularity is growing in Asia. U.S. officials forget that countries in the region welcome China's stable currency, as it helped to mitigate contagion during the Asian Financial crisis. The need to maintain stable regional currencies has prompted countries to enter into bilateral currency swaps with China, and to consider a more cooperative regional financial framework. U.S. officials also fail to consider why China has been so successful in expanding its economic ties with the ASEAN countries; for most countries in Southeast Asia, China is now a more important economic partner than the United States. The least developed countries of Cambodia and Laos depend heavily on China's foreign economic development assistance, and the former Asian Tigers are hopeful that completion of the China-ASEAN FTA will bring about a return of investment to the region and increased access to the Chinese market.

China's success in expanding its economic influence has often come at the expense of the United States. Chinese officials displayed shrewd diplomatic skills at the WTO Ministerial at Cancun in September, currying favor with developing countries on specific issues while taking care to demonstrate to industrialized countries a willingness to make concessions in other areas. These same diplomatic skills were employed at the recent ASEAN summit, where Chinese officials moved forward with their efforts to integrate China within the region by agreeing to the Treaty of Amity and Cooperation, while at the same time considering broader economic ties with Japan, South Korea, and India. At the APEC meeting, President Hu Jintao used diplomacy to encourage countries to maintain stability in the region and to counter efforts by the United States to increase economic ties with non-Asian members of APEC. Like the United States, China has proposed an expansion of trade ties with Australia.

The United States does remain important to many Asian countries, both as an important economic partner and regional stabilizer. Singapore was the first Asian country to complete an FTA with the United States, and now Australia and Thailand are following suit. But FTAs with the United States are only one part of their strategy. They also seek to balance their regional interests by negotiating agreements with other large economies in Asia--Japan and Korea.

The Bush Administration would do well to take a lesson from these countries regarding future U.S. Asia trade policy.

Under President Bush, U.S. trade policy in Asia has centered around FTAs with specific countries that USTR Zoellick has said meet certain criteria, and which offer economic advantages to U.S. exporters and strategic advantages to the Administration. But truth be told, U.S. FTA policy in Asia has been driven by one factor--support for U.S. foreign security policy. Asian countries which have been selected as viable FTA partners ("can do") support the war in Iraq, and are considered essential partners in the war against terrorism. Australia and Thailand are two cases in point. Whatever the criteria, U.S. FTA policy so far has overlooked two of the United States' most important trade and security partners--Korea and Japan--both of whom supported President Bush's war against terrorism and contributed to the Iraqi invasion and occupation.

The Bush Administration must do more to engage Asian partners to ensure a fair balance of both economic and security power in the region. Asian regionalism by default centers around China, as countries depend on China's market for economic survival. Much of this has resulted because of lack of full engagement by the Administration in the region. Indeed U.S. FTAs with Singapore, Australia, and Thailand as well as continuing dialogue in APEC will help to balance regional interests in the short-term. But the United States will have to think outside the box to achieve a balance over the long-term. Economic stability in Asia will require more active, positive economic engagement by the United States with Japan and Korea.



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Insurgencies in North-East India

By Kumar Amitav Chaliha

NEW DEHLI (KWR) -- The seven states of north-east India have witnessed insurgency and ethnic strife since the Naga tribes revolted against the first independent Indian government in 1947. The region, bordering Myanmar, China, Bhutan and Bangladesh, has always remained on the fringes of mainstream India. A continuous influx of illegal immigrants from East Pakistan (and later Bangladesh) to the sparsely populated area, and an unwillingness by successive Indian governments to check this inflow, has led to alienation among the local population. The people have also felt that while mainstream India has been exploiting its rich mineral resources, economic benefits have never accrued to them. These factors, together with historical distrust among various ethnic groups, have resulted in innumerable insurgencies in the north-east.

ASSAM

After Tripura, Assam has seen the largest influx of illegal Bengali-speaking migrants from East Pakistan, and later Bangladesh. In 1979, the All Assam Students Union (AASU), the premier student body in the state, and the All Assam Gana Sangram Parishad (AAGSP), an amalgamation of ethnic Assamese political parties, started a mass movement for the detection and deportation of illegal migrants from the state. The agitation soon took a violent turn and began to display secessionist tendencies. A militant organization, the United Liberation Front of Assam (ULFA), was set up in 1979 to "liberate Assam from Indian colonial rule" and to form a "sovereign Socialist Assam".

In 1985, the AASU-AAGSP signed an accord with the Indian government to end the agitation, and subsequent elections saw this combined group coming to power as a new regional party, the Assam Gana Parishad (AGP). Under a sympathetic AGP state government, ULFA ran a parallel administration and created terror in Assam disrupting communications and hitting economic targets, kidnapping businessmen for ransom, and killing government officials. As the AGP lost control of the situation, the Union government dismissed the state government in 1990 and called in the army. Nearly 2,500 militants were killed and arrested. In 1992, the Congress government in power suspended army operations and announced a general amnesty. Over 4,000 ULFA cadres surrendered to the authorities. Since then, hundreds have been killed in internecine encounters between surrendered ULFA members, known as the SULFA, and ULFA militants.

The ULFA, however, has proved resilient and continues its activities in the state. It now has around 2,000 members in 36 camps in Bhutan's Sandrup Jongkhar bordering Assam's Nalbari district. Chairman Rajib Raj Konwar - alias Arabinda Rajkhowa - and commander-in-chief Paresh Barua lead the organization.

The outfit shifted its base to Bhutan in the early 1990s for strategic reasons. At the insistence of India, Bhutan has now started pressuring the ULFA to move out of the country. The group is reportedly looking for alternative sites to relocate. Besides Assam, ULFA has become active in Meghalaya, Arunachal Pradesh, and north Bengal where it has been aiding nascent local insurgent groups.

The outfit has also been running training camps in Bangladesh since 1989. It operates several profitable business ventures in the country to finance its activities. Sympathetic Bangladesh regimes, especially the anti-India Bangladesh Nationalist Party, have always patronized the ULFA and other north-east insurgent groups. The ULFA is also suspected to have close links with Pakistan's intelligence agency, the Inter-Services Intelligence (ISI).

The other major insurgency in Assam is by the Bodos, a major plains tribe. The Bodos have always resented the hegemony of the non-Mongoloid Assamese and have been demanding better social, political, and economic conditions since India's independence in 1947. In 1989, the militant Bodo Security Force was formed to secure a "sovereign Bodoland" in the areas of Assam north of the river Brahmaputra. It was later renamed the National Democratic Front of Bodoland (NDFB) with Ranjan Daimary as the chairman.

The 1,500-strong NDFB has been involved in widespread killings, bombings, and extortions, often in collaboration with the ULFA. It is active in Assam's Bongaigaon, Kokrajhar, Dhubri, Barpeta, Darrang, and Sonitpur districts. It has bases in Myanmar and has set up 21 camps in southern Bhutan.

Another terrorist group, the Bodo Liberation Tiger Force (BLTF) headed by Prem Singh Brahma, was set up in 1996 to fight for a separate "Bodoland" within the Indian Union on the north bank of the Brahmaputra. The 800-strong BLTF signed an agreement with the government in February for the creation of the Bodoland Territorial Council, a reserved area for the Bodos.

The NDFB and the BLTF have frequently fought each other. Both have also resorted to ethnic cleansing of non-Bodos in Bodo-inhabited areas.

The Kamatapur Liberation Organization (KLO), the Dima Halong Daoga (DHD), and the United People's Democratic Solidarity (UPDS) are three other terrorist organizations active in Assam. The KLO wants a separate Kamatapur state for the Koch-Rajbangshi tribe comprising Assam's Goalpara district and six districts in north Bengal. The DHD and the UPDS are fighting for separate homelands in the North Cachar Hills and Karbi Anglong districts. The three are small outfits with limited areas of operation.

In 1997, a unified command was set up by the state government to counter insurgency in the state, which continues to date. It comprises 40,000 army, paramilitary, and state police personnel.

NAGALAND

The Nagas were the first to revolt against the Indian government with Angami Zapu Phizo's Naga National Council (NNC) in 1947. In 1956, Phizo formed an underground government and an armed wing. The Indian army was deployed to crush the insurgency, and Phizo escaped to East Pakistan and later to exile in London.

In 1975, the NNC signed an accord with the Union government and surrendered. But a group of 140 NNC activists repudiated the accord and set up the National Socialist Council of Nagaland (NSCN), a terrorist organization, under Thuengaling Muivah, Isak Swu, and S.S.Khaplang. In 1988, the outfit split along tribal lines with Khaplang setting up the NSCN (K) with Konyak Naga tribe members and Muivah and Swu forming the NSCN (IM) with Tangkhul Nagas. Since then, hundreds of cadres have been killed in inter-factional clashes.

The 3,000-strong NSCN (IM) has been demanding an independent "greater Nagaland" comprising Nagaland state and Naga-inhabited areas in Assam, Manipur, Arunachal Pradesh, and Myanmar. It is aided by the ISI and is active in parts of Nagaland, the North Cachar Hills, and Karbi Anglong districts of Assam, Tirap and Changlang districts of Arunachal Pradesh, and in the Naga-inhabited northern districts of Manipur.

The NSCN (IM) has been observing a ceasefire with the security forces for the past four years and has been holding peace talks with the Indian government.

The NSCN (K) has 2,000 armed cadres and its organization and aims are similar to those of NSCN (IM). It is active in parts of Nagaland and the Naga-inhabited areas of Myanmar. It signed a ceasefire agreement with the Union government in 2001 and has agreed to hold peace talks. Despite the ceasefire and the presence of over 5,000 army, paramilitary, and police personnel, extortion and kidnappings by both NSCN factions have continued.

MANIPUR

Internecine conflicts among Manipur's ethnic groups and tribes are common. The Hindu Meitei majority in the Imphal valley have long resented the reservation of jobs and land for the other tribes in the state's five hill districts. Disillusionment with the Indian government has led to secessionist sentiments among the Meiteis and several separatist groups have emerged.

The United National Liberation Front (UNLF), the oldest Meitei insurgent group, was set up in 1964 to establish "an independent Socialist Manipur". The UNLF, with about 800-armed cadres and training camps in Myanmar and Bangladesh, has close ties to the NSCN (K).

The People's Liberation Army (PLA) was established in 1978 by N Bisheshwar Singh to unite all ethnic groups in the state for "liberating Manipur from Indian rule". It has a "government in exile" in Bangladesh, and has two camps in Myanmar and five in Bangladesh where about 700 recruits have received training in guerrilla warfare.

The People's Revolutionary Front of Kangleipak (PREPAK) was formed in 1977 for the expulsion of non-Manipuris in the state. It has 400 cadres trained by the NSCN (IM).

While Meitei outfits are active in the Imphal valley, the NSCN (IM) is strong in four of Manipur's five hill districts. For most of the 1990s, the NSCN (IM) fought with the Kuki National Army and the Kuki National Front over the control of narcotic traffic from Myanmar, leaving over 1,000 people dead. The Kukis are an avowedly anti-Naga tribe in the state.

After Assam, Manipur has the largest deployment of security forces to counter insurgency. Nearly 20,000 army, paramilitary, and police personnel are stationed in the state.

TRIPURA

The indigenous Mongoloid people of Tripura, who accounted for 95 percent of the population in the 1931 census, were reduced by successive immigration from East Pakistan and Bangladesh to 31 percent in the 1991 census. This unchecked migration has led to widespread discontent among the tribal population and subsequently to militancy.

The first terrorist outfit in Tripura was the Tripura National Volunteers (TNV) set up in 1978 to fight for a separate tribal state. To counter the TNV, immigrant Bengalis formed the militant Amra Bangali. In the ensuing violence about 1,800 people were killed. The TNV surrendered in 1988.

Some former TNV cadres formed the National Liberation Front of Tripura (NLFT) in 1989 to carry on the TNV cause. It has an estimated strength of 800 cadres, and its headquarters is in the Khagrachari district of Bangladesh. The Communist Party of India-Marxist (CPI-M), which controls the state government, has been the chief target of NLFT attacks.

Another group of former TNV cadres formed the All Tripura Tiger Force (ATTF) in 1990. The strength of the outfit has been considerably reduced after 1,600 cadres surrendered in 1994. It has 400-armed members now, and its headquarters is in Tarabon, Bangladesh. It has strong links with the CPI-M party and the ULFA.

MEGHALAYA

Two local militant groups are active in the state. The demands of the smaller Hynniewtriep National Liberation Council (HNLC), a Khasi tribal outfit, are not clear. The larger 350-strong Achik National Volunteers Council (ANVC) is fighting for a separate state for the state's Garo tribe. Both have set up bases in Bangladesh and are being aided by the NSCN (IM), ULFA, and the NLFT.

THE FUTURE OF INSURGENCY IN THE REGION

Many see the peace overtures by major militant outfits such as both factions of the NSCN, and sporadic surrenders by disillusioned militants, as signs of the rest of the region going the Mizoram way. There has been complete peace in the region's Mizoram state since the Mizo National Front laid down arms in 1986 after two decades of insurgency.

However, the widening network of extortion and criminal activities by militants is increasingly having a corrupting influence on government officials, politicians, and society. It would be difficult to easily shake off this influence. Also, the fissionary trend of every tribal, linguistic, cultural, and religious sub-group demanding separation from the others, and radical demographic shifts and the record of poor governance, makes north-east India a potential source of increasing mass strife in the future.



VIEWPOINTS & INTERVIEWS

Global Overview: Interview with Ambassador Donald P.

Gregg

By Keith W. Rabin, KWR International, Inc.

Following his graduation from Williams College in 1951, Donald P. Gregg joined the Central Intelligence Agency (CIA), and over the next quarter century was assigned to Japan, Burma, Vietnam and Korea. Gregg was seconded to the National Security Council staff in 1979, where he was in charge of intelligence activities and Asian policy affairs. In 1982, he was asked by the then Vice President George H. W. Bush to become his national security advisor. He then retired from the CIA, and was awarded its highest decoration, the Distinguished Intelligence Medal. During his six years with Vice President Bush, Gregg traveled to 65 countries. Between 1980-89, Gregg also served as a professorial lecturer at Georgetown University, where he taught a graduate level workshop



entitled "Force and Diplomacy." From September 1989, Gregg served as ambassador to Korea for three and one-half years. Prior to his departure from Korea in 1993, Gregg received the Department of Defense Medal for Distinguished Public Service, an honorary degree from Sogang University, and a decoration from the Prime Minister of Korea. In March 1993, Gregg retired from a 43-year career in the United States government, and assumed his current position as the president and chairman of The Korea Society in New York City. He is a member of the Council on Foreign Relations. Recent awards include an honorary degree from Green Mountain College (1996), the Secretary of Defense Medal for Outstanding Public Service (2001) and Williams College's Kellogg Award for career achievement (2001).

NEW YORK (KWR) –

Thank you Ambassador Gregg for agreeing to speak with us today. Before proceeding with our questions, can you tell us a little about your background and current activities?

I first went to Asia in March of 1952, spent ten years in Japan, shorter periods in Burma and Vietnam and six or seven years in Korea, first as CIA station chief and later as Ambassador. Since early 1993 I have been Chairman of the Korea Society. In this capacity I travel to Korea three or four times a year and last year traveled twice to North Korea.

Despite its clear potential and achievements, Korea has lagged behind many other Asian countries over the past year, at least in terms of its equity indices. Many investors mention problems with the North, heightened labor tensions, high consumer debt and the emerging competitiveness of China as reasons for their ambivalence. Are investor's right to be concerned and what should they be keeping in mind about Korea and the future course of its economy?

The Korea Society recently featured Hogan Oh as a speaker about a month ago. He is a highly successful Korean banker who managed debt restructurings under Lee Hung Jae during the Kim Dae Jung regime. This included the makeover of Daewoo. His feeling is the Koreans are still learning the power of the marketplace, and they are still moving away from the period where government made decisions which he believes are better left determined by

the private sector. He was asked what he would do if he were king now and noted he would work through the banks to make sure they would play their role in making things transparent and that borrowing is conducted in satisfactory fashion. He is quite bullish on the future of Korea but admits that questions on North Korea act as a deterrent to investors and hopes very much that the American role in dealing with North Korea will become clearer than it is at the present time.

One Korean official recently noted to me their belief that some of the current anxiety over Korea is reflective of its having become a more advanced participatory democracy. As a result, a wider range of stakeholders are now voicing and learning how to advocate their opinions. Their thought was while this was creating some concern in the short-term it was a long-term positive. Do you share this view and what are your own thoughts on the current administration in Korea and its policy agenda?

I think that South Korea is probably the most vibrant democracy in Asia and President Roh has said to some of his confidants that governing South Korea is much more difficult than he thought. I think this is a very healthy remark and is similar to what American presidents used to say about the difficulties they found in governing this country. I think that President Roh is caught in almost a zero sum game between the over 60s-set and the younger people who played such a major role in electing him. Memories of the Korean War have faded in the younger peoples minds if they ever knew about it in the first place. They tend to see the U.S. as an obstruction to North-South reconciliation. The older generation, however, remembers the horrors of the war and remains grateful to the United States. They are also very skeptical of the Sunshine Policy. I think it is a very difficult task for Roh Moo Hyun to thread his way between these very different sets of perceptions. I think he leads a forward-looking administration and remain confident in the end he will emerge as a constructive president, who will advance South Korea on its role to become the hub of Northeast Asia.

Recently, Japan has been receiving a lot of positive attention for the first time in many years. Some people believe this is simply a cyclical upturn and others that this marks the start of an economic recovery. What are your thoughts about Japan at the present time?

The Japanese economy is something almost beyond comprehension in how it has floundered over the past dozen years. I draw some hope from Prime Minister Koizumi's reelection and some of his cabinet appointees, including Mr. Takenaka as evidence they are going to push forward with genuine reformation. It still has a long way to go but I think that Koizumi is one of the better leaders Japan has produced since the Ron-Yasu (Nakasone) relationship during the time of President Reagan.

A Financial Times reporter recently described Europe as the past, the U.S. the present and China the future leading force in the world economy. How do you view the emergence of China and what will be the implications for Americans and other nations over the next few decades?

I only have a superficial response to that. I was in Qingdao in September for a six party meeting and was astonished by the development of the city and the construction along the beach. It looked almost like Southern California with every kind of car in the world in the streets. The Chinese diplomats dominated the meeting. Their sophistication was notable and they are on the rise. But - inner China is still very much lagging behind. There are still huge problems with corruption, unemployment and highly inefficient public sector industries that have yet to be dealt with.

Last year I heard you speak at the annual Foreign Policy Association conference and was intrigued by your comments on Iraq and the global war on terrorism. Now that we have gone to war, what are your

current views on Iraq and the global war on terrorism? Are we striking the right balance between military-, diplomatic- and socially-oriented means to deal with these problems?

I was very much impressed by Retired Marine General Anthony Zinney's recent comments on the war. He felt the actual battle plan had been brilliantly conceived and carried out but there had been far too little anticipation to what would follow at the end of the full-scale military engagement. I think this is a very difficult situation for the United States, but that it is something from which we have to emerge successful. I draw some comfort from things that were written about the U.S. occupation of Germany in 1946 and 1947, which were filled with skepticism about our ability to reconstruct a nation that had been devastated by our making war upon it. Germany was a tremendous success as was Japan but whether Iraq will emerge in those terms remains to be seen. However, there is a tendency in the press to focus on the bad news. I am guardedly optimistic but still appalled at the costs.

One issue you've spent a lot of time focusing on is the future course of North Korea and the heightened security tensions that have emerged since the nation was included in the "axis of evil" by President Bush in 2001. How do you view the current situation in North Korea? Do you think that current concerns can be resolved through diplomatic means and is the U.S. administration taking the right course of action?

I think there is a growing body of evidence that North Korea is making a serious effort to change the way it deals with economic issues and that it wants to become a nation that is qualified to deal constructively and effectively with western markets. This is a very difficult transition to make. The South Korean Minister of Unification at the end of September said at the Korea Society that North Korea has moved from symbolic change to serious change in economic terms but has not yet reached irreversible change. For that to occur North Korea will need outside economic assistance. He hopes it will be forthcoming from donors including the U.S. At this point the Bush administration still seems to be divided. The President is making the right noises when he says we are pointed toward a peaceful solution. But strident voices within the administration and some of its outriders are expressing a very different line talking about the possible need for force and their interest in regime change. So I think the administration still hasn't made up its mind whether to negotiate seriously offering something in the way of security guarantees before North Korea completely steps away from its nuclear program. I hope very much that serious negotiations occur between the U.S. and North Korea because I believe North Korea will give up their nuclear programs in return for a security guarantee and promises of continuing economic assistance.

There has been a lot of talk over the past year or two about the U.S. shift toward a policy based on preemptive rather than retaliatory action and anticipatory/unilateral decisions, rather than multilateral consensus. What is your view on this change in orientation?

I think one of the central issues in the next presidential election will be a very spirited debate on the role of the U.S. in the world and how we respond to it. President Bush's team has brought with it a more aggressive hard edge approach to our role, which he inherited from a policy group that called themselves the "Vulcans " before the election. They go back to the Wohlstetters and Professor Strauss from the University of Chicago. The events of 911 seemed to validate much of what they had said. Whether or not the elements of unilateralism, preemption and regime change will remain central to the way we play our role is a great question that I think will be debated vigorously in the next election and I think that issue will have a profound impact as to who will emerge the winner in November of next year.

During the lead-up to the Iraq war, we saw heightened tensions between the U.S. and its traditional allies in Europe. In this regard, Secretary of Defense Rumsfeld highlighted differences between the

views of "Old" and "New" Europe. Do you have any thoughts you can share with us on the European Union and its place in the world, the contrast between old and new Europe and their relationship with the U.S.?

It is certainly true that some European countries such as Poland are emerging in a new light and I am glad to see that. I am concerned however that our traditional friends Germany and France are still not comfortable with the approach we have taken in Iraq and to some extent so is the U.K., our closest supporter and ally. The key is some new formulation that will give the UN a greater role in Iraq that will allow France and Germany to be involved. This seems to be in the works although it is a difficult procedure given the facts involved in the run up to the American invasion earlier this year.

I have heard you mention your belief that the Middle East is at the forefront of U.S. concerns and that if you were just starting out your career you would likely choose to focus on this region. What are your views on the seeming intractability of problems within the region? Are we destined to see accelerating amounts of violence? What are the prospects for diplomatic and political solutions to these problems?

We are more ignorant of Islam and the Middle East today than we were of Asia 50 years ago. We do not know the language, the religion and the psyche. I admire the job our troops are doing in Iraq but it is an extraordinarily difficult one. The Israeli-Palestinean problem is central and the complications there are obvious for everyone to see. I think it is imperative that we maintain and strengthen our relations with traditional friends in the Middle East including Egypt Oman, Jordan and Morocco and through these relationships do everything to demonstrate our interest in helping that entire region develop economically.

One area of the world that has become increasingly important is Russia and Central Asia, which possesses a wealth of minerals, energy and other natural resources. As a former cold warrior, can you talk a little about this area of the world and its prospects for the future?

As someone with a long CIA background who saw Russia as the main opponent during the Cold War, I am convinced that a positive U.S.-Russia relationship is vital if the 21st century is to be better than the 20th century -- and god help us if it isn't. I think that President Putin is more or less what Russia seems to need at the moment. I am glad to see that he and President Bush have developed a good personal relationship and one that allows Putin to speak very frankly about areas where he disagrees with us. I hope that eventually we can reach the same degree of intimacy and honesty with the Chinese leadership.

Thank you so much Ambassador Gregg for sharing your views with us. Before concluding do you have any final thoughts you would like to leave with us?

I am more generally optimistic about the how the American system is working in October than I was 2-3 months ago. I think a serious run-up to the election has commenced and that all the things that have been mentioned in this brief overview will be debated in a healthy way. This will enable the American people to make an enlightened choice about the ongoing political leadership of this country.

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Question of the Month:

What is your view toward the global economy over the coming year?

Drawing upon the wisdom and impressive credentials of our readers, the KWR International Advisor is seeking to introduce a new feature. We will include highlights from the responses received in our December edition next month. Please let us know whether you would like to be quoted by name or identified anonymously (e.g., "London-based Fixed Income Analyst", "Tokyo-based Investment Banker", "Fortune 500 CEO", "N.Y.-based Fund Manager", "Government Official", "Latin American-based Journalist", etc. Thank you for your support and cooperation.

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At the Devil's Gate – Observations of the Koizumi "Revolution"

By Scott B. MacDonald

On November 9th, 2003 Japanese voters went to the polls to elect their next government. Although the opposition Democratic Party of Japan (DPJ) achieved substantial gains (winning 40 additional seats to end up with a total of 177), Prime Minister Junichiro Koizumi's Liberal Democrats won 240 seats, which with its coalition allies, gives it a secure majority of 278 seats in the lower house of the Diet. Koizumi now starts a second term with a popular mandate to implement the so-called "Koizumi revolution." But is it really a revolution? Is the Prime Minister really capable of moving Japan into a new era of sustainable economic growth, supported by a restructured economy?

The expression "Devil's Gate" came up during a conversation in Tokyo in 2003 about President George W. Bush's decision to invade Iraq. The Japanese speaker indicated that by invading Iraq, the President put himself at the Devil's Gate – at the door of considerable potential troubles. Simply stated, on one side of the Devil's Gate all was well; on the other side were the demons of treachery, war and deceit. For many reasons President Bush walked through the Devil's Gate and the United States entered unknown country. In the same respect, Junichiro Koizumi's decision to become Japan's prime minister in 2001 took him to the Devil's Gate. While Japan can hardly compare to Iraq in terms of political chaos, the East Asian country was in a troubled state – the economy was suffering from over a decade of stagnation, the political will for change was largely lacking, and society was adrift, transfixed by the dilemmas of an aging population and a sense of unease over the economic malaise. In addition, there was a sense that Japan's place in the world was slipping, especially before the rising economic power of China and, to a lesser extent, South Korea. For a combination of reasons, Koizumi decided to walk through the Devil's Gate into the unknown.

Since 2001, Koizumi has given the world the image of Godzilla, the famous screen monster, always rising out of the sea and fighting over Japan, usually against bad monsters. In a broad sense, Godzilla represented the Schumpeter-like forces of creative destruction. Although Godzilla often destroyed Tokyo (while fighting the bad monsters), this caused the inhabitants to rebuild their city – at least the city was always brand new in each successive movie. In the same sense, Koizumi projects an image that he too is releasing

creative destruction and from the ruins of the old Japanese economy, a new stronger and more modern economy will emerge. Consequently, Koizumi is credited for launching a "revolution" of economic change in Japan. He has made proclamations of his willingness to shake up Japan, uproot the political order and bring the economy back to a period of sustainable economic growth. All of this, of course, will help restore Japan's role in the world.

There is little question that Koizumi is a breath of fresh air in what had become a stale world of Japanese politics. His proposed reforms to overhaul the state sector (with an eye to reducing wasteful spending), to privatize parts of it (mainly the postal system and highway corporation), to clean up bad bank debt, and reform the taxation, medical care and public pension systems, all promised much to an increasingly cynical and frustrated public. After two years, much of Koizumi's program remains unfulfilled. The rhetoric of revolution remains in place, but the results seem lacking.

The Koizumi revolution confronts considerable opposition, both within the government and out. Members of Koizumi's own Liberal Democratic party (LDP) have fought hard against reform as have business leaders from the protected and often inefficient domestic sector – agriculture, retail and construction. Koizumi's supporters have been under fire for pushing reforms and in some cases there have been sustained efforts to force them to resign.

Additional opposition to the Koizumi reforms comes from the banks, many of which carry bad debts from what have come to be known as the zombie companies. It is no mistake that most of the zombies are in the retail, agriculture and construction sectors. Many of the same companies have long held close political ties to the ruling LDP. LDP members have not been shy about seeking ongoing government and bank forbearance for dead-beat companies. Adding another layer of opposition to reform comes from within the bureaucracy, where certain factions have been ill at ease at the idea of allowing bankrupt companies to actually go bankrupt. This also implies that the banks should stop providing loans and begin calling non-performing loans what they are – lost money.

All of this means that Koizumi coming to power in 2001 faced a Gordian Knot of the Japanese political economy, an intricate system created in the aftermath of the Second World War to help Japan catch up with the West economically. The system placed an emphasis on business, government and the LDP working together to expand and upgrade the country's industrial infrastructure geared for export markets. In essence, the government guided the nation's development, channeling credit to key sectors through the financial system.

The high level of success of that development model in the 1950s and 1960s, however, guaranteed that making any substantial changes would be difficult. While the global economy changed and Japan's major exporting companies adapted, the rest of the development model did not. It was politically easier to tinker around the edges than it was to make a meaningful overhaul. While the 1980s showed a highly dynamic Japanese economy to the world, the structural weaknesses inherent in the system, in particular the stunted role of the banks, the shallow nature of capital markets, and poor corporate governance were all to be revealed in the "lost decade" of the 1990s.

The consensus-driven nature of Japanese society and the factional nature of its politics made the arrival of a strong leader, willing and able to cut the Gordian Knot of the political economy, difficult. Throughout much of the postwar era, Japanese prime ministers have operated with far less power than their Western counterparts, considering that they often had to play to a number of factions within the LDP. Achieving consensus was time-consuming and opaque, allowing considerable latitude to the bureaucracy in how policy should be implemented. It was therefore a surprise in 2001 when Koizumi, one of the country's more colorful leaders, emerged as the head of the LDP and became prime minister. Regarded as handsome, with wavy hair and slender build, he became well known for being an Elvis fan and for having something lacking in earlier leaders, flamboyance.

The reality of the Koizumi revolution is that is really more of an evolution. For all the marketing of Prime Minister Koizumi as a revolutionary, he is more of a reformer and a master manipulator of the press. Simply stated, Japan under Koizumi since 2001 is seeing an evolution of reform, not a revolution. One of the definitions for revolution is "any complete change of method or conditions". This implies sweeping changes in how things are done. Japan after two years of Koizumi is not at this stage.

From an Anglo-American standpoint this evokes a sense of disappointment, that Japan is forever condemned to the promise of reform, but a reality of inaction and ultimately economic decline. From the standpoint of many Western analysts, Japan has seen too many failed reformers, heard too many claims that reforms will now work; and observed too many policy dead-ends. Koizumi initially had considerable goodwill, but patience has been eroded as the Prime Minister's promises have not fully matched expectations. Deflation is still a problem, the banking sector remains wobbly, and the domestic sectors contain many of the same pitfalls that characterized them pre-Koizumi. And, behind all of this is a stark demographic reality – Japan's population is aging, which will place that much more pressure on the economy. Accordingly, the Nikkei Newspaper recently noted a National Institute of Population and Social Security report that households headed by those aged 65 and older are projected to increase 65 percent from 2000 to 18.43 million in 2025, accounting for nearly 40 percent of the all Japanese households.

From a Japanese standpoint, what Koizumi is pushing is radical – he is calling for and, in a piecemeal fashion, breaking up the old political economy. He has adopted the mantra of "structural reform" or *kozo kaikaku* to sum up his agenda and to signal his commitment to radical change. For conservative members of the LDP, the many special interest groups in the domestic economy and parts of the bureaucracy, any change is dangerous as it represents a loss of power, the strong potential of more business failures, and an overall loss of control over the economy by the bureaucracy.

Somewhere between the Western and Japanese views sits reality. Japan is making changes and reforms are occurring, but the process is slow, convoluted, and at risk of slippage back to inaction. Because of this, it is difficult to measure the progress that has been made. It is also difficult to gauge the role of Koizumi and what his long-term impact will be on Japan. It is therefore important to underscore that the two issues are entwined – Koizumi's place in Japanese history will be judged by how much he changes his country. Stated in another fashion, Koizumi will be judged on his ability to halt the decline of Japan.

Although there is frustration about the gradual nature of reform, Koizumi is changing Japan. The domestic sector is being forced to embrace structural adjustments, some companies are being allowed to fail, and others are coming under much greater pressure from their bankers to restructure with a coherent and more transparent plan. There has been some creative chaos as reflected by the high levels of bankruptcies in the 2001-2003 period. The banks have made an effort to reduce bad loans. In two cases (Long-Term Credit Bank and Nippon Credit Bank), Japanese banks have been sold to foreigners, and one major bank, Resona, was taken over by the government after it failed to have adequate capital ratios. Legislation has also moved forward pertaining to the privatization/overhaul of the postal system and the highway corporation.

Currently Koizumi appears as a transitory figure. Within the lexicon of historical figures, he sits somewhere between the Soviet Union's Mikhail Gorbachev and the United Kingdom's Margaret Thatcher. The former understood the need for reform and started the process, but was unable to bring it to a successful conclusion. Once started, reform quickly overcame Gorbachev's ability to control the process and his base of support – the Communist Party and the state – proved wholly inadequate to accommodate change and ultimately brittle, destined to fragment. In 1992, the Soviet Union ceased to exist and Russia emerged as the major successor state, commencing a long and difficult

process of economic reform.

In sharp contrast to Gorbachev, Thatcher was able to advance her revolution, which entailed the radical overhaul of the British economy. Thatcher was abrasive and ruthless in executing her reforms and the opposition was weak and ultimately lacked widespread public support. By the time Thatcher was ousted from power by her own party, she was largely successful in reversing decades of decline and a profound sense of national drift. Today the United Kingdom is one of the world's healthier economies.

As Koizumi embarks upon his second term in office he must give serious consideration to his place in history. Thus far he has lasted longer in office than many other Japanese prime ministers in recent history. However, lasting in office is not making a revolution. Much has been promised. He now has a popular mandate to make good those promises. In a sense, Koizumi has pulled Japan across the Devil's Gate threshold, but not moved much beyond. Does he have the strength to take Japan further into the unknown country, where there are tough challenges and very likely considerable rewards? If so, he will be remembered as one of his country's exceptional leaders. If not, he will be seen as a man with vision, but limited by his inability to implement badly needed changes – a transitory figure, waiting for another more capable (or maybe luckier) figure to come along. Only time will tell.



Emerging Market Briefs

By Scott B. MacDonald



Guatemala – Presidential Elections: On November 9th, 2003 Guatemalans went to the polls to elect a new president. Former Guatemala City Mayor Oscar Berger received 47.6% of the vote, while center-left candidate Alvaro Colom finished second with 26.4%. Retired General Efraim Rios Montt came in third with 11.2%. To win the election, however, a candidate must gain more than 50% of the vote. Consequently, the top two candidates face each other in a run-off election December 28.

Korea - S&P Warning: S&P announced that it thinks it is more likely that the North Korean government led by the colorful Kim Jong-il would collapse rather than gradually reform itself. The ratings agency also urged South Korea to build the financial reserves that will be required once the Northern regimes collapse takes place. S&P noted that the North Korean collapse was only a matter of time and when it comes it will cause a greater shock to the South's economy than the 1997-98 Asian financial crisis. Although the North has started to reform its command economy over the past year by liberalizing wages and prices, the regime is simply too rigid to emulate the market openings adopted by other communist governments in China and Vietnam. As the rating agency stated: "Although some other Asian nations that used to have centrally planned economies have successfully moved to a market-based system, the North Korean leadership probably lacks the flexibility and vision to undertake such a change." To this we would add, there are elements within North Korea's leadership that clearly have a vested interest in no change, rather maintaining the status quo, which allows them to make a lot of money from trading in narcotics and weapons, including the transfer of nuclear technology. The North is constantly short of food and fuel and it is desperate to develop a more solid bilateral relationship with the United States in order to exact more aid and stave off becoming more dependent on China. In a sense, the North's view is

better to become a U.S. client state with Washington far away than a client state of China next door.

Jordan – Changing the Guard: King Abdullah II changed his government in October by asking Ali Abu Ragheb to step down as prime minister and Faisal al-Fayez to assume that post. Ragheb was the prime minister since June 2000 and presided over an opening of the country to greater foreign trade, including a free trade agreement with the United States. During his period in office Ragheb allowed U.S. troops to deploy prior to the start of hostilities in the last Iraq war, something that did little to endear him to the majority of Jordanians. Ragheb also had problems with the economy. He came into office promoting reforms that aimed to reduce poverty, unemployment and corruption. Unfortunately, the Jordanian economy was hard hit by the effects of the regional security situation on tourism, a major source of foreign exchange. Growth fell from 4.9% in 2002 to a more modest 3%, which is slower than the country's population growth rate. Al-Fayez is the former court minister, has a close working relationship to the King and is regarded as both pro-reform and pro-U.S. His new cabinet is smaller, shrinking from 29 ministers to 20, and is supposed to be more focused on reform. At the same time, al-Fayez should benefit from stronger economic growth expected in 2004, with the IMF forecasting 5.5% real GDP expansion.

Oman – ratings Affirmed: In November 5, 2003, Standard & Poor's affirmed Oman's BBB rating, with a stable outlook.

Poland: In early November, Fitch has changed the outlook for Poland's BBB+ sovereign rating from stable to positive, reflecting improvements in foreign exchange reserves. In addition, Poland's financial position will be reinforced by its just announced sale of 7.5-8.5% of TPSA (it now currently owns 14% of the Polish telecom). The sale of TPSA shares is expected to raise Euro 376 million, which will help finance the fiscal deficit and make up for lower tax revenues related to slow economic growth. We do not expect the sale of state shares will have any adverse impact on TPSA as the ratings were not dependent on state ownership. This was confirmed in conversations with both rating agencies. Indeed, it is felt that the government's intention to move ahead with the share sale will reduce volatility in the company's stock.

Russia– GDP Up, But Politics Hangs Like a Dark Cloud: Russian real GDP expanded 6.5% percent in the first nine months of 2003, compared to 4% growth over the same time in 2002, Russian Prime Minister Mikhail Kasyanov announced on Oct. 23. Kasyanov added that the GDP is expected to grow 6 percent overall in 2003, largely fueled by higher energy prices. Despite the strong nature of the economy, the political situation turned problematic in early November when the Putin government arrested Yukos oil Chief Executive Officer Mikhail Khodorkovsky on charges of fraud and tax evasion. Moody's had only the month before generously raised Russia sovereign ratings from Ba2 to Baa3, a two-notch upgrade. Now, Standard & Poor's, which rates Russia BB, is thinking of a possible downgrade, stating: "Although we do not expect it at this point, if the Yukos affair leads to a significant outflow of capital and ensuing deterioration in economic activity, then we would consider an outlook change or downgrade." The fundamental problem is that Russia's recent strong spurt of growth has been based on higher oil prices and a substantial inflow of foreign capital, largely attracted to opportunities in the hydrocarbon sector. The issues concerning Khodorkovsky are directly related to the fact that he refused to back out of being involved in the country's political life, in particular, ahead of the upcoming Duma elections. Other Russian oligarchs have either opted out of Russia (taking some of their money with them to London and continental Europe) or have quietly joined ranks with Putin, who appears to have the support of the old security crowd in Russia. None of this is positive for Russia and it makes a mockery of Moody's two notch upgrade.

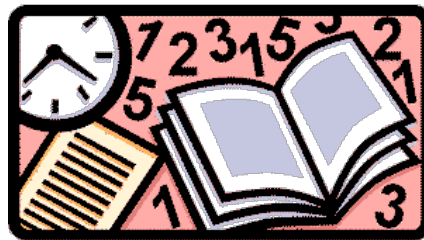
Thailand – On Review for an Upgrade: In early October Moody's placed Thailand's Baa3 ratings on review for a possible upgrade. If the upgrade occurs, which is widely expected, Thailand will be climbing back up the ratings ladder from which it fell in the aftermath of the Asian financial crisis in 1997-98. Backing up the upgrade tide, the government raised its estimate of how fast the economy will grow over the next five years to 6% annually, up from 5%. In addition, the nation's budget is close to being balanced for the time since 1997 and investors have made the stock-market in Bangkok the best performer in Asia. It is no surprise that Thai stocks are at six-year highs.

Vietnam – A Warning from Fitch: On November 6, Fitch sent a warning to Hanoi about the country's sovereign rating. Although it is maintaining the BB-rating, it changed the outlook from positive to stable and, if present trends continue, we would not be surprised to see the outlook go negative in the months ahead. The rating agency changed its outlook on concerns about the widening trade and current account deficits, excessive domestic credit growth and a dispute with the International Monetary Fund. Vietnam has enjoyed fast economic growth over the last couple of years: 5.8% real GDP expansion in 2002, with 6% expected in 2003. Rapid growth, however, has fueled demand for imports, both as consumer goods and industrial inputs. The trade deficit in 2003 could be a record \$4.5 billion, putting pressure on the current account balance, which could top 7% of GDP, well above IMF projections of 3.6% of GDP.

At the same time, credit at Vietnamese banks has increased by an annual rate of 30% for the first half of the year. Even for a more developed banking system this would place the banking system under pressure. In Vietnam, the banking system still has considerable bad debt on the books, especially at the state-owned banks that are still the dominant players. Public nervousness with the banks is already evident as there was a ruin on a private-owned bank, largely due to rumors. The message from Fitch is that while strong economic growth is great, it must be balanced with ongoing structural reforms and proper regulation and supervision in the financial sector. Without a balanced approach, Vietnam could be heading into trouble.



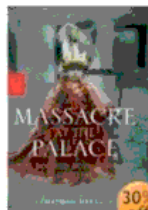
Book Reviews: The Tragedy of Monarchies



Jonathan Gregson, Massacre at the Palace: The Doomed Royal Dynasty of Nepal (London: Fourth Estate, 2002).

Jason Tomes, King Zog: Self-Made Monarch of Albania (Gloucestershire, UK: Sutton Publishing Limited, 2003).

Reviewed by Scott B. MacDonald



Click here to purchase "Massacre at the Palace: The Doomed Royal Dynasty of Nepal" directly from Amazon.com

Click here to purchase "King Zog: Self-Made Monarch of Albania" directly from Amazon.com

There is often an air of tragedy surrounding the history of

monarchies. This is certainly the cases of Albania and Nepal, the subject of two new books. The first book is by Jason Tomes, *King Zog: Self-Made Monarch of Albania* and the second is Jonathan Gregson's *Blood Against the Snows: The Tragic Story of Nepal's Royal Dynasty*. For anyone with an interest in the history of two countries a bit off the beaten track, Tomes and Gregson address a gap in the literature, providing very readable accounts. Tomes, a lecturer in modern history and politics, presents a more traditional history (complete with footnotes and a bibliography), full of primary sources, reflecting considerable attention to detail. Gregson's approach is more journalistic, but benefits from contacts among the surviving courtiers and members of the Nepalese royal family. He also has spent a fair amount of his time with his subject, including being one of the few journalists to be granted an interview with the late King Birenda. In both cases, the authors are sympathetic to the countries and peoples, they are portraying, though neither shrinks from telling the historical story as they see it.



Tomes' *King Zog* could have easily been titled *Everything That You Want to Know About King Zog*. With a well-told sweep of Albanian/Ottoman/Balkan history, the author traces the roots of King Zog's family in the Mati region, the rise of Ahmed Bey Zogolli, first as a military leader and later as a prime minister, then president and finally as king. King Zog's reign lasted from 1928 to 1939, when it was brought to an end by Benito Mussolini's Fascist legions. Zog was to leave his country in 1939 never to return. He eventually died in 1961 in France of cancer after having lived in exile in London and Egypt prior. Long years of hoping for a return to power proved to be futile. Ultimately, King Zog's dreams came up against the harsh Stalinist reality of the new communist despot, Enver Hoxha, who was to rule Albania with an iron fist until his death in 1986, leaving behind an isolated and amazingly backward country in the midst of a Europe that long since had bypassed it.

Where then did all this leave King Zog in the great flow of history? Tomes asks the question of Albania's one and only king: "Adventurer or patriot? Hero or scoundrel?" On the scoundrel side, he regards Zog as a self-made monarch, shifting from being president to king with relative ease, willing and able to eliminate or buy off/exile any opposition, channel what revenues the state generated into his own coffers, and being dependent on Italian assistance (much of went into his own pockets). Indeed, he notes other writers "detect nothing worthy of praise and dismiss the appalling Zog as an unsavory tyrant." He adds: His personal wealth sham elections and political murder feature prominently here."

Yet, Tomes contends Zog came to power over a backward, tribal-like society, riven by regional and religious differences. In addition, Albania's neighbors were not thrilled with the birth of the new country, considering that Yugoslavia, Italy and Greece all held territorial claims and/or overlapping populations. Indeed, Albania was a small, poor nation caught up in the power politics of a Europe heading into the Second World War, a situation which left her with few international friends and at the mercy of Italy, already the mainstay of the economy in terms of massive amounts of foreign loans. Consequently, Tomes makes the point that before Zog Albania largely existed as an idea, but central authority was weak and in many parts of the country, nonexistent. In two decades, Zog managed to consolidate the Albanian state and provide a more enduring foundation for the country's future as a nation-state with respected international borders. Tomes concludes his masterful treatment of King Zog with the following assessment:

Soon Albanians will be able to look dispassionately at their history in the twentieth century: liberation, instability, occupation, instability, Zogist dictatorship, occupation, civil war, Stalinist dictatorship, and more instability. When they do, they may will count the reign of King Zog among the good times. It is a sobering thought.

At the other end of the Eurasian landmass, the trials and tribulations of the

Nepalese royal family represented a very different historical track record in terms of longevity of royal rule, but similar in terms of a small, relatively backward nation, surrounded by larger more powerful neighbors (China and India). Like Albania, Nepal was a very tribal surrounded, divided by tough mountainous terrain. It was in this environment that the Shah dynasty came to power over a united Nepal in 1769. That same dynasty was almost snuffed out of existence in June 2001, when the Crown Prince Dipendra shot and killed most of his immediate family, including his father, King Birendra and his mother, the Queen. Armed with a 9 mm Glock pistol, MP5K sub-machine gun, Colt M-16 and Franchi twelve-bore pump action shot gun, the Crown Prince ultimately killed 12 members of the royal family in a cold-blooded and methodical fashion and then turned the gun on himself, only to linger a couple of days before succumbing to his wounds. In a hastily-organized coronation, Prince Gyanendra, a brother of the deceased King, became the new king, a strange twist of fate considering that he had at the age of three been crowned monarch, serving a brief three month period in 1950 before a popular coup ousted the then overly powerful prime minister.

The immediate cause of the 2001 palace massacre was a bitter conflict between Queen Aishwarya and the Crown Prince over whom he would marry. Indeed, the Queen was known for her unbending will and for being unable to bear any snubs, especially from any commoners. The Crown Prince's preference, Devyani, was the daughter of a wealthy and well-placed Indian family. The Queen, however, was anti-Indian, having earlier gotten herself embroiled in a tiff with the Gandhi family. In addition, Gregson also believes that the Queen "would not tolerate a woman as independent and tough-minded as Devyani becoming her daughter-in-law." Consequently, the Queen did everything possible to ruin the relationship between her son and the woman he loved. Adding to what was to be a volatile mix, the Crown Prince was prone to mood swings and used drugs. On the night of June 1st, the Crown Prince apparently decided that he had taken enough from his parents, feeling a strong sense of betrayal from his father and deeply resentful of his mother.

Although much attention is given to the events leading up to the June 2001 palace massacre, Gregson does an excellent job in telling the story in the context to Nepal's dynastic history, especially since the Shah family came to power in the 18th century. In large part, he notes that the role of the royal family at the apex of Nepal's political culture and society played an important role in setting the stage for the June 2001 bloodshed. The royal family had long ruled, often through absolutist prime ministers, apart from the rest of Nepalese society - the vast majority of whom were poor, yet reverent of the king. In this regard, politics in Nepal were limited to a handful of royal families and the families of the prime ministers. Significantly, differences of opinion were often settled by violence. As Nepal advanced into the 20th century, there developed a gap between the relatively isolated royal family (living a rich lifestyle behind the walls of their many palaces) and the vast majority of Nepalese. The 1990 pro-democracy riots cut into the royal family's base of power, but the lifestyle of privilege continued unabated. In this light, the unbending nature of Queen Aishwarya is portrayed as a lynchpin in undermining the Shah dynasty as it was opposition to the Crown Prince's love and triumphal nature caused the Crown Prince to resolve matters in what manner such affairs had been resolved in the past - violence.

Nepal was left "bereft and confused" by the palace massacre and the new king sits uneasy on the throne. Covering a third of the country, a Maoist insurrection challenges the royal government, grappling to respond. *Blood Against the Snows* provides a useful reference point to the ills that are confronting Nepal, a country that is usually beyond the general media scope. Although the Maoist insurrection is not discussed in any detail, Gregson does provide insight into part of the country's ruling elite - a partial cause for the insurrection. It is little wonder that the end of the monarchy is one of the major objectives of the Maoists. *Blood Against the Snows* is highly recommended.

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