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A New Taiwan Crisis?

By Scott B. MacDonald

The international political system in Asia remains unsettled and the potential for a new crisis is growing. As the United States remains pre-occupied with the Middle East and Afghanistan, relations between China and Taiwan are increasingly strained. Taiwan's political situation is undergoing an important change, as the issue of declaring "independence" from mainland China is a growing possibility. In turn, China is deeply concerned that Taiwan would declare its independence, uprooting the fiction that the two parties will eventually be re-unified. From Beijing's standpoint any departure from the "two Chinas" script is cause for war. If Taiwan can be allowed to "leave" the Chinese nation-state, then so to will Tibet or the Muslim dominated northwest be tempted. While much of the world's attention is closely focused on the daily bombings and assassinations in Iraq and Saudi Arabia, the pieces are falling into place for another major international crisis in Asia.

The root of the problem is that China regards Taiwan as a breakaway province. Taiwan and the mainland have been separated since the Nationalists retreated to the island in 1949, establishing a rival regime to the Communists in Beijing. Over time, the power of the Nationalists gave way to a younger generation, many of whom place a greater significance on being Taiwanese than Chinese. Today a large number of Taiwanese increasingly see themselves as a separate country, with a working capitalist economy and democracy. China in comparison is ruled by the Communist Party, is not fully capitalist and political freedoms are few. Indeed, China's recent efforts to suppress Hong Kong's political freedoms does not send a positive message to the Taiwanese, who are looking for reassurances that if re-united to the mainland their political rights would be upheld. Recently re-elected President Chen Shui-bian is taking advantage of these concerns, having embraced the doctrine of independence. He has called for a referendum on whether a new constitution should be drafted in 2006, for adoption in 2008.

Anything that looks like independence for Taiwan has a poor reception in Beijing. The Chinese establishment has repeatedly indicated that if President Chen embarks upon this course of action and declares independence, it will be forced to invade. In the meantime, the Chinese military has been active with war games, practicing to invade Taiwan. At the end of July, Chinese militias staged a two-day weekend exercise off the southeastern coast, following up on drills by the People's Liberation Army earlier in the month. With an eye to the United States, Taiwan's major ally, China also recently revealed a new submarine class. The message is simple - if the U.S. seeks to come to Taiwan's aid in the event of a crisis, the new submarines will be waiting.

China's leadership is carefully weighing four things. First and foremost, Taiwan's President Chen is seeking to change the status quo. China does not have de facto control over Taiwan. What is does have is a territorial claim that the island is part of the Chinese nation, something that is widely recognized. In reality, Taiwan runs its own affairs, but has traditionally maintained the façade that it will seek an eventual re-unification between the two lands. Chen now threatens this façade.

Second, the Bush administration has slightly shifted policy on Taiwan. In particular, President Bush signed legislation on June 14, supporting Taiwan's efforts to gain observer status in the World Health Organization (WHO). Although such a decision is not an abandonment of the official U.S. policy of one China, any such move as what the Bush administration did in regard to the WHO is seen as having some recognition of Taiwan's right to exist an independent state.

Third, the U.S. government earlier agreed to an $18 billion weapons upgrade package for Taiwan. Those weapons are now starting to arrive. They include Patriot anti-missile systems and P-3 anti-submarine aircraft. Such armaments could reduce the capacity of the Chinese military to launch what it calls a decapitation strike, based on missiles and paratroopers hitting Taiwan's national leadership in the capital Taipei. We expect tensions to rise as new weapons are delivered.

On July 8, National Security Advisor Condoleezza Rice was sent to Beijing to help smooth over relations. She met with former President Jiang Zemin and Foreign Minister Li Zhaoxing. During the meeting, Jiang asserted to Rice that the "Chinese people are seriously concerned and dissatisfied about U.S. selling of advanced weapons to Taiwan." The next day President Hu Jintao also indicated that Taiwan's status was the key to Sino-American relations. In response, Rice was reported to have stated that the U.S. would continue selling arms to Taiwan to provide a healthy "balance" of power with China.

Fourth, a crisis over Taiwan could come at a good time for China's leadership, itself struggling to deal with massive economic challenges. As Beijing seeks to cool the Chinese economy, there is always the danger of social unrest, something that the leadership deeply fears. Playing the nationalism card could refocus people from problems with the economy at home to an issue in which China's honor and standing are perceived at risk. Considering Washington's preoccupation with the Middle East and the stretched nature of the U.S. military, China's leadership might calculate they could actually get away with "retaking" Taiwan.

At the same time, China's leadership should not be treated as a monolith. There are differences of opinion and emphasis between former president Jiang and his successor, Hu. The former has traditionally taken a hard line on Taiwan and retains his post as Chairman of the Central Military Commission. He is also reluctant to leave the political scene and tensions have risen between Hu and Jiang.

Hu appears to be a little more cautionary, largely for concerns that an arms race with Taiwan would be costly to the Chinese economy at a time when slowing growth to a more manageable pace is critical if inflationary pressures are to be checked and a hard landing avoided. Along these lines, Hu stated in the overseas edition of the official People's daily that China "must unwaveringly walk the path of peaceful development". Consequently, Hu is more concerned about the impact of a new crisis over Taiwan, especially with a view to the economy.

However, even Hu is vulnerable to the Taiwan issue, as it would very difficult for him to allow an official declaration of independence to go unanswered.

There may not be a crisis in the Straits of Taiwan, but the chances are increasing. This issue should gain greater attention in Washington, but also from Tokyo. Considering China's greater weight as a global trade partner and as a holder of large foreign exchange reserves (including dollars) and U.S. Treasuries, a Taiwan crisis could disrupt world economic growth and, of course, ripple into U.S. stock and bond markets.

Japan – Measuring Success

By Scott B. MacDonald

Although there has been considerable discussion about the "beating" that Prime Minister Koizumi's Liberal Democratic Party (LDP) took in the July 11th upper house of the Diet elections, the economy is in about the best shape it has been since the 1980s. The restructuring of the banking sector (as reflected by the UFJ and Bank of Tokyo-Mitsubishi merger) is moving ahead. Economic growth looks sustainable. This was reflected by the government's upgrading its real GDP growth forecast to 3.5% from its previous estimate of 1.8% for the year to March 31, 2005. Moreover, Japan's economy expanded at an annualized rate of 6.1% in the first three months of the year, the strongest among major industrial countries.

We think the current growth pattern is sustainable – at least through next year. Beyond that our outlook is more cautious. The Japanese economy initially gained momentum from exports. It then benefited from corporate capital investment, with personal spending providing the last stimulus for growth. Ongoing strength in world trade and steady increases in domestic demand as well as some improvements in the labor market should provide the foundation for next year's expansion. It will also help bring deflation to an end.

Yet, Japan still faces substantial challenges. These include the fall in land prices (still going on outside of Tokyo), weak bank lending, the ongoing challenged nature of many regional banks, and the potential for the Chinese economy to hit a hard landing. The last is important considering that China is a major factor in the strong expansion of exports, accounting for two-thirds of the rise in 2003. There is also the problematic nature of government's finances – the fiscal deficit was 8% of GDP in 2003 and is expected to decline to 7.1% in 2004. Public sector debt reached a massive 144% of GDP in early 2004.

Considering the pluses and negatives of the Japanese economy, it can be said the short-term is positive, but the long-term is harder to forecast. Government finance is a major concern. According to the Organization for Economic Development and Cooperation (OECD), public sector debt is projected to surpass 160 percent of GDP this year. Related to this is the ability of the Koizumi government to continue its economic reforms. There remains considerable work – deregulation of agriculture, medical services and education, reform of the postal bank system and restructuring regional banks.

Ongoing and broadening economic growth means an eventual return of inflationary pressures. In turn, the Bank of Japan will at some point have to abandon its zero interest rate policy and raise rates. If done too quickly, a number of large companies that are struggling would be plunged into having serious problems. If so, that could once again cause problems in the banking sector.

Koizumi (and the return of global growth) have helped put the Japanese economy on the right track, but much more work is required. That requires strong political will. Along these lines, we fully agree with the OECD's assessment: "Over the longer term, failure to press ahead with structural reforms would limit Japan's growth potential." More significantly, failure will limit Japan's future, holding the door open to a possible major economic crisis linked to massive public sector debt. Having survived the July 2004 elections, Koizumi has a window of opportunity to push ahead over the next two years, which should be free of any new electoral challenges. The stakes of making further reforms could not be higher. We wish Prime Minister Koizumi well.

Mexico: Still A Good Investment Bet

By Jonathan Lemco

In the past few months, the US press has devoted a great deal of attention to the challenges faced by Mexican workers. The media has stressed that China will compete ferociously for Mexico's export markets, and that the Mexican labor force will be a big loser. Also, it is noted frequently that Mexican educational levels have not improved appreciably in recent years. Many critics stress that vital fiscal and other structural reforms will not pass the Mexican legislature, and this will severely crimp economic policy-making. Others note that the revenue base remains too small. There is truth to these allegations, but they do not tell the whole story.

According to the Mexican Finance Ministry, Mexico's GDP growth rate is expected to be in the 4% range in 2004. Inflation is likely to remain a moderate 3.6%. The Mexican private sector is demonstrating higher levels of confidence in the economy going forward. Although China is a meaningful economic threat, it is also the case that China is buying Mexican commodities in substantial amounts. Trade is a two way street, despite all of the attention devoted to Mexico losing jobs and investment. It is also the case that the China threat has been less severe than some expected because of currency depreciation. Fewer businesses have left Mexico than one would anticipate, given the space devoted to this issue in the US media.

Further, and more important, Mexico's economic future has far more to do with the fortunes of the United States than the fact that Mexico competes with China. The US is Mexico's largest export market, and the two economies are substantially integrated. Over the past six months, the US manufacturing sector has expanded at an annualized rate of 7.1%. Mexico's manufacturing sector seems to be keeping pace, and in fact has been growing faster than the US. The February trade report showed Mexican manufacturing exports up 10% on a yoy basis. It is important to note that this does not include the trade that will come from the 1% rise is US manufacturing in February. Investors should look for stronger output from Mexico in March/April as the effects from that strong US month are felt by its southern neighbor. In a very meaningful way, as the US economy goes, so goes Mexico's.

In addition, in 2003, Mexico enjoyed the benefits of free trade agreements with the NAFTA nations, as well as Europe and Japan. Several multinational corporations are putting new money into Mexican industry. Volkswagen has recently announced a US $2.6 billion investment in new plants, with Mexican operations now acting as an export platform to Europe, taking advantage of the weak dollar. Japanese companies have made new investments, based on similar strategic thinking. Wal-Mart announced at the end of March that it would invest US $600 million in the next few months. BBVA's decision to acquire Bancomer's remaining shares should also deliver a substantial inflow. In short, Mexican entities are engaged in deepening financial, productive and trade links.

On the fiscal side, the Mexican Central Bank continues to guide the economy with strong budgetary discipline. The budget deficit is on target for the year at an acceptable 0.3%/GDP. The surplus in February was 8.1 billion pesos, with the year to date surplus of 35 billion pesos. That compares to a surplus of 18.4 billion pesos in the same period in 2003. Further, in February, recurring revenues expanded by 1.5% in real terms. That includes a 5.3% rise in tax revenues. The major reasons for this improvement were reduced spending, higher oil price revenues, and improved levels of VAT tax receipts. Overall, this improved fiscal performance also reflects the fact that Mexico should be better able to withstand external shocks or economic contagion.

We do not mean to dismiss Mexico's problems however. There has been little progress on passing meaningful structural reform legislation in the Mexican Congress. Until that occurs, there will be limits on the economic progress that Mexicans can expect. Also, the Mexican political system now consists of three viable parties. That is good for democracy, but it makes policy-making that much more difficult. President Fox appears politically weak relative to the Congress. Furthermore, Mexico's infrastructure needs are tremendous and its level of economic inequality substantial. But there appears little that the government can do to address these development issues in the short-term. None of this is new, of course. But what is different is that popular expectations for the success of the Fox government have been especially high, and many observers have been disappointed.

All this being said, Mexico continues to grow at a decent level. Its fiscal performance has been excellent such that the credit ratings agencies have steadily upgraded the credit in recent years to an investment grade level. Thus far in 2004, Mexican bonds have been among the best performers in the entire corporate bond universe. We conclude by noting that we expect that Mexico will remain an attractive investment opportunity for the foreseeable future.

Outsourcing U.S. Jobs: Economic Boom or Political Bust?

By Caroline G. Cooper, Willkie Farr & Gallagher, LLP**

These days it seems that almost every political analyst in Washington is writing about the "growing phenomenon" of outsourcing U.S. manufacturing and service sector jobs overseas. Although outsourcing is not new and has been going on for decades, the issue has garnered much political attention in the past year in large part because manufacturing job losses were so great.

In recent months, the negative political rhetoric on outsourcing has focused more on job losses in the services sector, especially in the information technology (IT) industry--a driving force behind America's renewed economic growth. The reasons are two-fold. First, politicians claim that IT jobs are being shipped overseas in droves, and subsequently, America is losing her technological edge; and second, American consumers are not happy with the customer service they receive from foreign call centers. GalleryWatch.com reports that in the next ten years, researchers predict that nearly 5 million service sector jobs will be shipped overseas.

That many Americans are concerned about the increase in outsourced U.S. jobs is understandable; they want to ensure that skilled employment opportunities are not taken away from future generations of Americans. But an analysis of the current political debate on outsourcing and some proposed policy solutions reveals that politicians are more concerned about the politics of outsourcing than they are with the economics of the issue. Politicians should avoid prescribing short-term political fixes to what could become a longer-term economic problem.

Deconstructing the Political Debate on Outsourcing

As political interest in outsourcing has grown, so has the debate. Essentially, three schools of thought on outsourcing have emerged representing the interests of the far right, the far left, and centrists.

The Bush Administration and conservatives in general represent the far right school of thought on outsourcing. They argue that outsourcing jobs is not an economic problem; rather, it is a boon for the economy, as shipping low-skilled jobs overseas enables U.S. companies to reinvest in the economy and create higher-skilled jobs at home.

The Administration's position on outsourcing was outlined in the Economic Report of the President released last February. In the report, U.S. officials downplayed the contribution of outsourcing to job losses by finding that the decline in manufacturing jobs last year resulted in small part from the transfer of low-skilled manufacturing jobs abroad and more to rising demand for workers in the services sector. Shortly after the report was released, Gregory Mankiw, Chairman of the Council of Economic Advisors, received harsh criticism for his widely reported characterization of outsourcing as beneficial for the U.S. economy.

U.S. business groups have defended the Administration's position on outsourcing, claiming that too few facts and too much rhetoric have played into the political debate on the issue. In the April edition of Asia Insider, Thomas Donohue, President and CEO of the U.S. Chamber of Commerce, outlined a number "Facts About Outsourcing." Donohue argued that U.S. job losses were associated more with increases in productivity and slow growth in the economy than outsourcing. He opined that the biggest threat to future employment is a shortage of workers--not jobs, and that future jobs will not be created by protectionist policies. Donohue disavowed the notion that outsourcing IT jobs is causing America to lose her technological edge, and he pointed to expert's opinion that jobs sourced overseas "amount to a small fraction of (the United States) workforce."

On the last point, Donohue was proven correct. A report published in June by the Department of Labor, Bureau of Labor Statistics (BLS) on extended mass layoffs associated with domestic and overseas relocations determined that in the first quarter of 2004, only 4,633 jobs of the 239,361 jobs lost from lay offs were due to the movement of work overseas.

Donohue's arguments point to the fact that while outsourcing may not be an immediate economic problem, preventing it from becoming one in the future requires that politicians reduce their political rhetoric and enact the right policies. According to Donohue, the right policy mix would encourage the government to "open markets and enforce trade agreements; improve the skills of our workforce and expand the labor pool; modernize our transportation, energy, and technology infrastructure; and reduce the legal, regulatory, tax, and health care costs."

Analysts from the Progressive Policy Institute (PPI) correctly argue that the second school of thought on outsourcing, as advocated by far left Democrats, emerged in response to the Bush Administration's inattention to the issue and suggestion that cutting taxes will keep businesses at home. In reaction, left-leaning Democrats have introduced legislation, both at the state and federal level, that "inspires a retreat from globalization," according PPI head Will Marshall.

A survey of legislation on outsourcing compiled by GalleryWatch.com and MultiState Associates, Inc. shows that members of the second school of thought want to restrict companies from sourcing work overseas in two ways: by protecting labor interests and by protecting consumer interests. One notable example of legislation proposed to protect labor interests is an amendment offered by Senator Christopher Dodd (D-CT) to S. 1637, the American Jobs Act. Dodd's amendment would preclude the federal government or any state government from receiving federal funds for a specific project to outsource federal contracts overseas. One example of a bill introduced under the guise of protecting consumer interests is H.R. 4366, the Personal Data Offshoring Protection Act of 2004, sponsored by Representative Edward Markey (D-MA). H.R. 4366 would preclude companies from sourcing work overseas that involves a consumer's private information without prior notification to and consent from that consumer. This is required for countries that do not have adequate privacy protection laws. Although a number of state governments have proposed, and in some cases, passed outright bans on the outsourcing of U.S. jobs, no such legislation has been approved by either chamber of the U.S. Congress.

On July 20, PPI introduced a new policy paper on "Meeting the Offshoring Challenge," hoping to shift the debate on outsourcing to the center and create a third school of thought on the issue. Although PPI is affiliated with the New Democrat faction of the Democratic Party, many of the policy proposals advocated by the organization are endorsed by centrist members of the Republican Party and many businesses. PPI's Robert Atkinson promotes the following three-pronged strategy to confront the outsourcing challenge:

- boosting innovation and worker's skills by providing federal funding and tax credits for research and development, promoting education and training programs which emphasize math and science, and easing immigration restrictions on Ph.D. graduates in those fields;

- leveling the playing field on trade by eliminating currency manipulation, enforcing U.S. trade agreements and opening markets, and encouraging U.S. companies to stay home by eliminating offshore tax shelters; and empowering U.S. workers by requiring companies to give advance notice that jobs will be outsourced, extending trade adjustment assistance to workers in the services sector, and providing wage insurance, to name a few.

Finding the Right Solution

As the debate on outsourcing enters the realm of Presidential politics, it is important that both candidates, President Bush and Senator John Kerry (D-MA), put aside their personal politics and consider the economic facts associated with outsourcing before recommending policies to address the issue.

First, outsourcing jobs does not pose an immediate threat to America's economic growth. The data concludes that fewer jobs have been lost to outsourcing than predicted; however, without the right policies to promote better math and science education, foster innovation, and reduce some labor costs here at home, more jobs could be lost in the future, and America's competitive edge could begin to wane.

Second, consumers continue to demand quality, low-cost goods, many of which are produced overseas. By restricting trade to curb the outsourcing of U.S. jobs, American consumers would be deprived of product choices, and in turn, economic growth in developing countries could be threatened. At the same time, companies must not sacrifice quality in terms of the products they make or services they provide just for cheaper factors of production. The right policy mix will ensure that consumers continue to have quality, low-costs goods and services produced both at home and abroad.

Both candidates must face facts to effectively confront future economic challenges associated with outsourcing. If President Bush is elected to another term in office, he must not dismiss the notion that outsourcing high-skilled jobs could have a negative impact on the U.S. economy in the long-term. If Senator

John Kerry (D-MA) is elected President, he must consider a more balanced policy approach to outsourcing, not one that aims at restricting trade. **Please note this article reflects the views of the author, and is not an expression of views on behalf of Willkie Farr & Gallagher LLP or KWR International, Inc.

The Philippines: Outlook for Arroyo's second term

By Stephen F. Berlinguette

On June 30th, Philippine President Gloria Macapagal-Arroyo was declared the winner of the May 10th national elections and inaugurated for another 6-year term in Manila. The president returns to office with a strong support base in Congress, the business community, the armed forces, and the Catholic Church. Her first term was characterized by both domestic security distractions and policies that improved fiscal discipline in Manila, supported central bank efforts to stabilize the peso, and stressed privatization of major state holdings. President Arroyo is now expected to exploit her recent victory by bolstering her administration's pro-business stance.

Economic management will be a critical determinant of Arroyo's effectiveness in her second term. Markets are expecting the government to make significant progress on its vows to reduce the budget deficit and take long-term steps to decrease public sector debt in order to strengthen the peso and drive down interest rates. With a Philippine budget deficit of 4.6% of GDP and total government debt at 126.2% of GDP in 2003, Manila presently spends approximately one-third of its budget on debt servicing. Arroyo has prioritized increasing government revenues to improve Manila's fiscal position and enhance investor sentiment: the administration's successes in this area will depend on a mix of effective policy, political stability, and security over the coming 1-2 years.

Central to the Arroyo's two-track fiscal reform program is a drive to increase tax revenues. The government currently has a debt burden of approximately U.S. $61 billion, as compared to an annual GDP of about U.S. $79.3 billion. Tax takings in the Philippines typically hover around 15% of GDP, though this figure has been even lower in recent years. Past Manila attempts at improving this ratio have emphasized enacting new and unpopular taxes, but Arroyo has stated that the government will focus on reducing tax evasion and developing its revenue collecting abilities in her second term. The administration's achievements in this decisive policy area will lay the groundwork for deficit reduction and unlock funds for badly needed infrastructure investments.

The second pillar of Arroyo's deficit policy concerns power sector liberalization. This campaign has centered on the state-owned utility National Power Corporation (NAPOCOR), which has been an enormous weight on public sector resources and in 2004 is expected to exacerbate its six-years of severe underperformance with a 100 billion peso loss. Though Arroyo unsuccessfully attempted to sell off

NAPOCOR assets in her first term, her reelection improves Manila's prospects for revisiting the problem and unloading the utility to infuse fresh revenues into government coffers. Privatizing NAPOCOR will be a decisive indicator of the president's fiscal discipline in her second term.

Reconciling debt reduction with pro-poor election promises will be one of the administration's greatest challenges in its second term. In campaigning against the film star and populist Fernando Poe Junior, Arroyo sought to offset his appeal to the poor with pledges to create 6 million new jobs and 3,000 new schools, bring clean water to every village, and make fresh technology investments in the countryside. Clearly, the government's poverty reduction strategy is contingent on its capacity to escalate tax revenue collection and reinvigorate public investment. Given the obstacles in this sphere, Arroyo will have to carefully square the demands of its economic revitalization program with maintaining her delicate political support among disadvantaged Filipinos.

In the aftermath of the extremely close May 10th election, many Poe supporters accused the president of widespread fraud and initiated sporadic street demonstrations on his behalf. This defiance also found reverberation among a minority of restive elements in the armed forces, which produced whisperings of a coup later in the month. Much of this disquiet has now abated, but new questions have emerged as to the effect that the government's withdrawal from Iraq after the July hostage incident will have on Arroyo's support among the military's top brass, many of whom advocate close ties with the United States. New threats to political calm in the Philippines during the coming months could also surface from other quarters, such as renewed Abu Sayaf militant activity in Mindanao. Barring unforeseen developments such as the above, however, it looks as if Arroyo's popular support will rest primarily on her government's performance on its reform and investment agenda. It is widely believed that the president's reelection has stabilized politics in the Philippines for some time to come.

Assuming that this political equilibrium holds, there is a strong likelihood that the president will have the flexibility to eventually take up other restructuring proposals currently on the table, including efforts to lower tariffs, liberalize foreign investment restrictions, and eliminate monopolies. The administration also stands to benefit from steady and moderate economic growth. On Arroyo's watch the Philippines has shown notable resilience to internal pressures and the global economic downturn. Driven by strong inflows from overseas worker remittances and good agricultural performance, the economy grew by 4.7% in 2003. Inflation has been low despite high energy import prices and a weak currency, and international conditions are expected to improve in the coming year. An export recovery and higher private consumption levels in 2004 are together projected to raise GDP growth to 4.8% this year. Many Philippines observers agree, however, that growth rates of 7% or higher are necessary to support the administration's restructuring and reform ambitions.

By all appearances, President Arroyo's agenda for her second term promises sound economic management aimed at both fiscal reform and economic growth. Yet past events in the Philippines have shown their ability to derail the visions of the country's most prudent planners. With the reelection victory behind her, the president's objective now is to avoid political conflicts and contain militants in the south for a period long enough to lock in effective tax collection and privatization programs during the coming year. This will be the key test of the new administration's fitness for skilled economic stewardship in the Philippines.

Special Energy Roundup

The Sweet Smell of Oil

by Scott B. MacDonald

Oil prices reached record highs in August and could keep going up. The reason is a combination of worries about terrorist attacks on oil infrastructure in the Middle East (including foreign experts and pipelines in Iraq and Saudi Arabia), political tensions in Venezuela (an upcoming referendum) and Russia (Yukos Oil), and on-again off-again labor problems and ethnic turmoil in Nigeria. There are also concerns about the ability of oil producers to meet upcoming winter demand. Furthermore, foreign workers must decide whether or not to return to Saudi Arabia after their summer holidays (we think that many will not for personal safety reasons) and terrorists could start to attack tankers (they have already attacked foreign workers and pipelines).

Although oil's price increases may peak in the short-term, the global energy industry is in the throes of a structural transformation. On the demand side, the longstanding U.S. role of being the dominant consumer of hydrocarbons is being challenged by China. Since 1978, when China began its growth spurt, the Asian country shifted from being an oil exporter to a major oil importer. Not far behind China is India, also energy hungry. India's real GDP growth is expected to be around 7 percent this year. Between China and India there are over 2 billion people, working and living in rapidly growing economies, with expanding middle classes with automobile-oriented consumer cultures. That means more oil demand.

At the same time as demand is on an upward swing, there is growing concern about supply, including the aging Saudi fields and their ability to meet global demand. Production is slumping in long-time OPEC member Indonesia, which in 2004 became a net oil importer for the first time in 100 years. In addition, supply from the OECD (Organization for Economic Cooperation and Development

Countries) has probably peaked. Any additional oil to be squeezed is likely to come from Russia, Brazil (offshore) and Africa.

There is a growing possibility that we have made a structural adjustment to a period of higher oil prices - hanging in above the $30 a barrel market, possibly above $35 through 2004 and probably 2005. We would not rule out a spike to $50 a barrel, but that would be entirely related to a serious disruption of supplies from the Middle East. Barring any such disruption, oil prices should remain under $40 a barrel.

Previous cycles of high oil prices have usually ended in global recessions and ultimately lower oil prices that have hurt oil producers. Although we do not see a collapse of oil prices back down to the low $20's in the medium term, it is in the interest of OPEC and other major oil producers to help manage a lower, more digestible price that does not kill global economic growth. Saudi Arabia is bringing on two new oil fields in the near future in an effort to bring prices back into line. Despite all of the oil being pumped, fear remains the dominant factor, with worry over sabotage and supply ruling the market. We don't see this stopping any time soon.

To help our readers keep abreast of of the implicastions of these important trends, the KWR International Advisor brings you the following three articles concerning energy developments in Africa, Russia and India.

Sub-Saharan Africa Still Matters – Life in the Age of High Oil Prices

By Scott B. MacDonald, Ph.D.

Apprehension over new terrorist attacks, sabotage strikes on oil infrastructure in the Middle East and the Yukos affair in Russia have helped drive oil prices to a peak and threaten to bring on the dreaded scenario of the precious black fluid selling at $50 a barrel. The Organization of Petroleum Exporting Countries (OPEC) is already pumping at it highest levels for a quarter of a century and only Saudi Arabia is thought to have any significant spare capacity to boost production. In a world where geopolitical uncertainties and oil prices and supplies are closely entwined, Africa's star may be rising. Considering the ongoing dependence on foreign oil, this development is clearly in U.S. national interest.

Africa's growing importance as an oil supplier comes at a time when the global energy industry is in the throes of a structural transformation. On the demand side, the longstanding U.S. role of being the dominant consumer of hydrocarbons is being challenged by China. Since 1978, when China began its growth spurt, the Asian country shifted from being an oil exporter to a major oil importer. Not far behind China is India, also energy hungry. India's real GDP growth is expected to be around 7 percent this year. Between China and India there are over 2 billion people, working and living in rapidly growing economies, with expanding middle classes with automobile-oriented consumer cultures. That means more oil demand.

At the same time as demand is on an upward swing, there is growing concern about supply, including the aging Saudi fields and their ability to meet global demand. Production is slumping in long-time OPEC member Indonesia, which in 2004 became a net oil importer for the first time in 100 years. In addition, supply from the OECD (Organization for Economic Cooperation and Development Countries) has probably peaked.

Africa has around 33 percent of the world's proved reserves. That includes OPEC members Libya, Nigeria and Algeria. Sub-Saharan Africa supplies about 15 percent of U.S. oil, of which Nigeria is the leader. Indeed, the West African nation is the world's sixth-largest exporter of oil and the fifth largest supplier of the United States. Bonny Light crude from Nigeria has a highly desirous low-sulfur content that is easily converted into gasoline.

It is in the non-OPEC members where the most significant future gains are expected. In particular, the Gulf of Guinea is estimated to hold up to 10 percent of the world's oil reserves. That region encompasses the Ivory Coast in the north down to Angola in the south. East Africa is also looming large as a potential area for oil extraction.

Africa's oil will never duplicate the Middle East's massive supply. In 2003, the Middle East accounted for 63.3% of proved reserves. Africa's share was a much more modest 8.9%, the same as South and Central America and a little behind Europe and Eurasia (Russia). However, it does represent an alternative source. Considering that foreign oil workers have become targets in Saudi Arabia, Iraq's oil pipelines are constantly being sabotaged, and politics are casting a shadow over the local oil industries in Russia and Venezuela, Africa has become more attractive.

Since 9/11 part of U.S. energy policy has been to diversify away from the country's dependence on Middle Eastern oil. Transport from West Africa to the U.S. is far shorter than from the Middle East and avoids chokepoints such as the Persian Gulf and Red Sea. Along the same lines, much of the oil is being pumped from offshore oil fields, which could make transport easier in the case of onshore political turmoil. Equally important, the sub-Saharan oil producers, with the exception of Nigeria, are not OPEC members, reducing the complexity of pricing. For many of the U.S. oil companies the region is also attractive in that large amounts of oil have been discovered and there is a scarcity of big new oil projects elsewhere.

The growing importance of Africa as a source of oil was reflected by the visit of U.S. President George W. Bush in July 2003 to a number of countries in the region, including Nigeria. According to the National Intelligence Council, the United States is expected to buy as much as 25 percent of its oil from Africa by 2015, an amount that would put the region ahead of Saudi Arabia. But the quest for African oil is becoming competitive. The United States is not alone in appreciating Africa's oil as many other countries have sent their oil companies hunting for new, non-Middle Eastern sources of oil, including China and India – Asia's two "new Tigers".

Despite the lure of Africa's oil, there are considerable challenges. These include corruption, political violence and banditry. HIV AIDS kills thousands of people a year, while the medical infrastructure is weak and in some places virtually nonexistent. Human rights groups have rightfully criticized the widespread lack of democracy and accountability in much of the region. The billions of petrodollars coming into the region are not translating into better livelihoods for the vast majority of people. Oil companies have a mixed record in dealing with the region – the wealth they generate has not trickled down to the general population and in many cases, there has been long-term environmental damage as in the Niger Delta. There is a very strong possibility that oil-led development can serve only to reinforce authoritarian rule, corruption and environmental destruction.

Yet, the change in international oil markets represents an opportunity for Africa and those involved in the continent to do something better than in the past. And the stakes are high. The poverty that afflicts even the oil-producing countries creates the ideal breeding grounds for the penetration of al-Qaeda and its allies and if nothing else perpetuates weak civil societies dominated by lawlessness. The resentment felt by local people who have failed to share fully in the benefits of the new oil bonanza have sparked violence by ethnic militias in Nigeria's Niger delta region and a separatist movement in Angola's oil enclave of Cabinda.

The world of higher oil prices is likely to last through much of the decade; the trick is for African governments and their people to capitalize on that trend. This represents a major challenge – oil wealth could provide a major opportunity to break the chain of failed governments and economic experiments – or another round of dashed hopes for a better future. For the United States, more attention will have to be given to Africa, especially if there is a concerted effort to reduce the dependence on Middle Eastern oil. This also means paying closer attention to finding a balance between extracting the oil and helping provide for a sounder socioeconomic infrastructure in those countries involved in selling their oil to keep the American economy running.

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Russia’s Run on Deposits and Yukos Demands: Ominous Signs for the Global Economy?

By Sergei Blagov

MOSCOW (KWR)—Despite high crude prices Russia’s largest oil firm drifts towards insolvency and the country is experiencing the biggest run on deposits since the 1998 financial meltdown. It remains to be seen whether events in Russia will have wider repercussions.

Russia's recently acquired image of order and stability became shaky in early July as bailiffs began dismembering the once-profitable oil giant Yukos and panicked depositors staged a run on several of the country's top banks.

Russia proved to have too many small, unstable banks and not enough large ones with transparent operations. Cracking down on even the smallest sends shockwaves through the system. Russia’s Central Bank revoked Sodbiznesbank's license in May for laundering what it said was some $1 billion of suspicious funds. CreditTrust went bankrupt in June.

Reports of a central bank list of banks under scrutiny were repeatedly denied by authorities. In early July, ratings agency Moody's said it had put 18 banks under review for possible downgrades. Banks have also begun closing lines of credit on each other, creating a climate of distrust along with a liquidity problem.

Among the worst hit was Alfa, the country's largest private bank. After what its directors called a black public-relations campaign by competitors, it had withdrawals of $100 million in the first week of July - 10 times more than normal - based almost entirely on rumors. Some branches had waiting lists to close accounts, leading the bank to introduce a temporary 10% commission on early withdrawals.

Largely unsourced media reports suggested that Alfa Bank, the nation's largest private lender and the third-biggest bank by personal deposits, might be next triggered a panic-driven run that saw Alfa clients pull some $160 million from their accounts in just three days. Alfa lashed out at the media for fueling fears of a full-blown crisis, in particular Kommersant daily and its owner, disgraced tycoon Boris Berezovsky, who is wanted by Russian authorities for alleged tax fraud and is living in self-imposed exile
in London.

However, Alfa Bank reiterated that all withdrawals would be honored. State-owned Vneshtorgbank has agreed to buy out Guta, thereby rescuing its depositors. The Central Bank cut the minimum reserve held by banks against ruble deposits to 3.5% from 7%. By halving mandatory reserve requirements for banks to 3.5%, it freed up some 130 billion rubles ($4.5 billion).

The State Duma on July 9 passed a bill guaranteeing deposits in uninsured banks that fail. It will apply to all banks that go under after February 2003, when the Law on Insurance Deposits was adopted. All deposits up to 100,000 rubles ($3,350) will be returned within six months. This means that clients of two failed second-tier banks, Sodbiznesbank and CreditTrust, will be covered.

Adding to the unease was a statement by international ratings agency Moody's that it would review 18 Russian banks, including Alfa, MDM, Bank of Moscow and Russian Standard, for possible downgrades. "The review will focus on the capacity and willingness of Russia's central authorities and other banking-market participants to provide prompt liquidity support to the solvent banks in need of such aid," Moody's said in a statement.

Moody's rivals, Fitch and Standard&Poors, however, both said they saw no reasons yet to review their ratings of Russian banks. S&P said it has already factored the "institutional weakness of the Russian banking sector" into its ratings of 21 banks, while Fitch noted that Alfa's liquidity is "consistent with its ratings." "While the current retail deposit runs and interbank market turmoil may end very quickly, institutional weakness in the sector will remain," S&P said on July 9. "Russia will not enter a banking crisis on the scale of the one seen in 1998," S&P said in a statement.

On the other hand, Russia now faces its oil major Yukos's imminent bankruptcy. Finance Minister Alexei Kudrin said on July 9 that Yukos had run out of time for striking a deal with the government on restructuring a $3.4 billion back tax bill for 2000, making asset seizures inevitable. His statements came a day after Yukos sent a proposal to the government offering to voluntarily pay more than $8 billion in additional tax payments for 2000 to 2003 on condition it was given three years to do so. The company has received another claim for $3.4 billion for 2001 and could face further sanctions for other years.

Last June, Russian President Vladimir Putin indicated the Kremlin did not support the bankruptcy of Yukos, however, courts have frozen the company's assets, leaving it without the funds to pay the back-tax demands and hence opening a way for the company’s formal insolvency.

"The actions of representatives of the Russian government have led Russia's best and most creditworthy company to the brink of an unintended and artificial situation of insolvency and bankruptcy, creating an unthinkable default situation with its bank lenders, all at a time when the company is experiencing the best results in its history," Yukos chief financial officer Bruce Misamore said in a statement.

The firm was dealt another blow when a syndicate of Western banks led by France's Societe Generale declared it in default of a one billion-dollar loan. Misamore said the consortium of banks was not demanding immediate repayment of the $1 billion yet, but could do so now at any time following the company's formal notification by the banks on July 2 that it was in default. As of July 8, "some action could be taken against our assets," Yukos's CFO Misamore admitted to investors during a conference call on Tuesday. Unless a negotiated solution is reached, the government will have "the full right to come in and try to realize the value of assets to pay the tax bill. This could be sale of assets conducted by the bailiffs ... either through an auction or direct sales," he said.

Yukos said the move to freeze its Russian bank accounts could force it to halt production because it would not be able to make the payments required to continue operations. Yukos could slash some of its 400,000 barrels per day of oil and products exported by rail and river in July as it struggles to find cash for core operations with its bank accounts frozen, according to media reports. Yukos' pipeline exports to destinations such as Poland, Slovakia and Hungary, much of which are committed under long-term deals, could also come under threat as soon as August, forcing the firm to declare force majeure.

Western institutions have been reportedly buying Yukos stock thinking everything is going to be fine because President Vladimir Putin said there would be no bankruptcy. Meanwhile, a group of minority investors has called on Russia to re-think the assault on Yukos. "A climate of fear and uncertainty has descended upon the market regarding the state's ultimate intentions toward Yukos," the group, which includes Deka, Germany's second- biggest mutual fund and Janus, the ninth-largest U.S. stock and bond mutual fund manager, said in a letter to Putin quoted by The Moscow Times. The group has requested a meeting with Putin to discuss the affair.

Another group of minority shareholders is suing Yukos for allegedly deceiving investors on the true state of affairs at the company from Feb. 13 to Oct. 25, 2003, the day Khodorkovsky was arrested. A lawsuit was filed at a New York court on Friday via the law firm Lerach Coughlin Stoia and Robbins, Vedomosti daily reported.

Last year, Yukos had been rumored to be considering selling a major stake to world oil No. 1 ExxonMobil, in an apparent bid to ward off official pressure by linking up with a foreign partner. Prior to flying on his last trip to the U.S. in October 2003, Yukos former head Mikhail Khodorkovsky announced he would rather go to jail than leave the country as a political emigre and abandon his fight with the Kremlin.

Western governments are warning Russia that its aggressive legal assault on the country's largest fully private company risks souring relations. New European Union member Lithuania on Jul 7 said that "all of Europe" would have to respond if Russia forces Yukos into bankruptcy. "Economic and trade matters can't be separated from politics and foreign policy when deciding the fate of such a huge company with assets in Lithuania and other parts of Europe," Lithuanian Prime Minister Algirdas Brazauskas told reporters in Vilnius. Lithuania owns 40.7% and Yukos 53.7% of Mazheikiu, the nation's biggest company by revenue. Mazheikiu operates the only refinery in the Baltics and owns an oil terminal and pipelines.

"The Yukos affair is being monitored carefully" by the British government, visiting

British Foreign Secretary Jack Straw told reporters July 7. "We have some direct British interests in this," Straw said after meeting Foreign Minister Sergei Lavrov. “Many Yukos shareholders are British”, he stated.

The United States lashed out at Russia's judiciary, saying the case appeared to be lacking due process and was discouraging investors. "We've been concerned about this case all along, and will continue to follow it closely," State Department spokesman Richard Boucher said in Washington. "We haven't taken a position on the merits of this specific case, but we have been concerned about how this process is unfolding and the effect it might have on investment," Boucher said.

As the crisis around Russia’s banks and leading oil company, Yukos, unfolds, it remains to be seen how it can end without wider repercussions and whether these events will create new anxieties in global business and financial markets.

Sergei Blagov is a Senior Consultant at KWR International

Power Sector in India

By Kumar Amitav Chaliha

For a time, it looked as if India’s new Congress party-led government might bring the recent resurgence of investment in the country’s power sector to an abrupt halt. When it was reviewing the Electricity Act 2003 — legislation passed by the previous government that laid out a framework for restructuring and privatizing the debt-laden state electricity boards that long dominated transmission and supply — share prices in India’s increasingly active private power developers collapsed. This now looks to have been an over-reaction.

Programs to reduce heavy transmission and distribution losses, and the theft of as much as 35% of all generated power, are expected to continue even if the state governments retain ownership of the network. Investors’ concerns were further assuaged when the new government announced plans to offer fiscal incentives, including lifting of all import taxes for new power plants smaller than 1,000 MW, and approved ten power projects. So, it now appears that some 10,000 MW in planned new generation capacity will go forward after all.

Firdose Vandrevala, managing director of Tata Power, summarized the view of many power project developers in a recent interview: "By itself, the Electricity Act was not going to achieve much," he explained, as action to improve the distribution system was also needed at the state-level. He said that Tata Power would go ahead with investing in generation facilities even if the distribution network remained in state hands, so long as the state electricity boards "become productive and their payment capacity improves." He added, "we are not worried whether [the distribution network] is in private or public hands, so long as it is efficient and has the ability to pay."

Foreign power developers, which all pulled out of India in the wake of the collapse of the Enron-led Dabhol project due in part to non-payment by the Maharashtra State Electricity Board, are still absent. But domestic Indian conglomerates and trading houses are piling into the sector, along with upstream major Oil and Natural Gas Corporation (ONGC) and gas operator GAIL.

AsiaLinks

Emerging Market Briefs

By Scott B. MacDonald

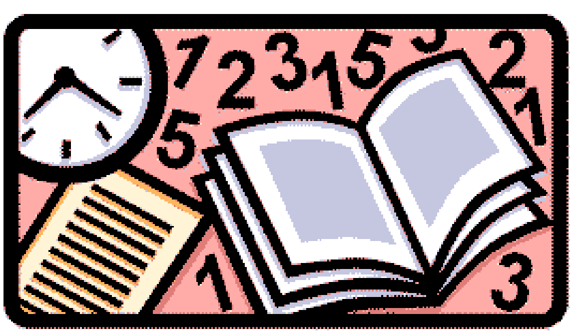
Czech Republic – Government Falls: In late June the government of Prime Minister Vladmir Spidla fell, prompting the likelihood of early elections. Spidla quit when his government lost the support of his Social Democrats in the three-party ruling coalition on June 26. This left President Vaclav Klaus to negotiate with other parties, with the probable exception of the Communists, who constitute the second largest bloc of seats in the parliament. Thus far it appears that the old coalition will reform for another government, but with a one-seat majority of 101 seats out of 200. The outgoing and possibly incoming government consists of the Social Democrats, Christian Democratic Union-Czechosolvak People's Party and Freedom Union. If the new old team reforms it will probably not be official until early August.

Indonesian Privatization: Economic observers have indicated that privatization of state-owned enterprises by the government of President Megawati contributed substantially to increasing the country's foreign exchange reserve to US$37 billion, the highest ever recorded by the country. According to Mumtaz Malik of the Total Reform Monitor Presidium, management of state enterprises is far more efficient under the present government than during the New Order under president Suharto. Under the administration of Suharto, the highest foreign exchange reserve ever recorded was US$24 billion, Malik said. “Despite criticism and sell-out accusation the fact is privatization of state enterprises has contributed substantially to our foreign exchange reserve," he stated.

State Minister for State Enterprises Laksamana Sukardi has been accused of selling state companies at cheap prices. He was even accused of selling the state by political opponents. The present government has also succeeded in increasing revenues in taxes and dividend from state enterprises, he pointed out. Revenues in taxes and dividends from state enterprises totaled Rp52 trillion (US$5.77 billion) in 2003 or the highest ever recorded compared with only Rp15 trillion 1999.

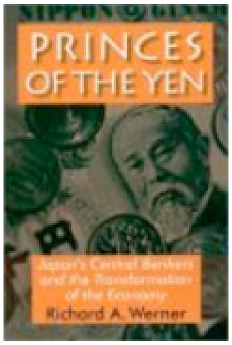
Indonesia – Power Plant Construction: In late July it was announced by the Canadian government that it will build a 200-megawatt mini- hydropower plant worth Rp2.2 trillion (US$250 million) in Kanawa village, Tanatoraja district, South Sulawesi. The Canadian government will undertake the project in cooperation with a Canadian private company, Excort, but 70 percent of the plant's equity will be owned by the government and 30 per cent by Excort. The project would be carried out in three stages with the use of high technology from 2005 to 2007. The project would not use a water dam as other plants but would pump water to a reservoir. It will then distribute water to a turbine to generate electricity. The Canadian government was forming a team to conduct a feasibility study from September to October 2004.

Book Review: Princes of the Yen: Japan's Central Bankers and the Transformation of the Economy



Richard A. Werner, Princes of the Yen: Japan’s Central Bankers and the Transformation of the Economy (Armonk: M.E. Sharpe, 2003). 362 pages.

Reviewed by Scott B. MacDonald



Click here to purchase Richard A. Werner's book, "Princes of the Yen", directly from Amazon.com

Richard A. Warner has no doubt written a fascinating book. Whether or not one concurs with his views, it is worth reading. The fundamental thrust of his argument is that the Bank of Japan is the dominant force behind Japan's wrenching economic transformation over the last decade. As he states: "This book shows the Japanese recession was indeed due to the main force driving the business cycle – money. It is not by coincidence that the main proponents of structural change are precisely those who are in control of Japan's money." The proof is that the central bank has consistently defied calls by the government to create more money to stimulate the economy and end the long recession. Indeed, the Bank of Japan has intentionally left Japan in the economic wilderness to make certain that the government and politicians had no other path but to make painful changes.

What elevated the Bank of Japan over its rival, the Ministry of Finance (MOF)? A long series of painful scandals hurt the MOF, while the BOJ remained largely faceless to the public. Over time, the Bank of Japan emerged as the most powerful financial actor, all "because of a lack of transparency and a lack of meaningful accountability by the central bank for its monetary policy." Werner's view is that the central bank is supreme: "It is not the government but the BoJ that decides whether we will have a boom or recession."

At the end of the day, Werner's book is about competing capitalist economic models. The message is ultimately that the Anglo-American model founded more on deregulation and liberalization of markets (in a sense more rough-and-tumble economics) is inferior to the more state-guided German/Japanese/Korean models. In the case of Japan, he asserts: "If anything, structural reform toward deregulation and liberalization has been accompanied by reduced economic growth, both in the short term and in the long term." He concludes his book by noting: "Finally, a comparison of the longer-term macroeconomic performance of the German, Japanese and Korean economies in the twentieth century suggest that economic structures that do not conform to the U.K./U.S. model can be highly successful, or surpass the U.S./U.K. model, especially when measured by certain indicators of social welfare (such as indicators of inequality, social stability, or basic needs, including access to health services, welfare, and education)."

While there are certain parts of Werner's argument that are persuasive, the simple equation that deregulation and liberalization are bad and state-guided capitalism is good, is a weak argument. Certainly anyone looking into the German economy through the last 10 years is keenly aware that the German model is deeply troubled, reflecting that the system ultimately is not affordable. Both the U.S. and U.K. made painful structural changes during the 1980s and 1990s to make certain their economies remained highly competitive. While these systems are not without their own set of problems, they still provide a much better living for their citizens than most other countries on the planet. Could they be better? Absolutely. Yet, they still attract foreign capital and individuals that find the risk/reward system to be worth the venture.

In Germany and Japan the old systems were tinkered with, but the major gut-wrenching changes were avoided. Now demographic and financing problems are mounting. If the vaunted German model is so great, why then has its major bank, Deutsche Bank,openly talked of re-locating outside the country to avoid heavy social costs and an inflexible labor market?

Werner's book was popular in Japan because it is supportive of the status quo. Let's avoid those painful decisions, neuter the power of the Bank of Japan, and return to a system based on greater social equity. Nice sentiments, but hardly realistic for a country with public sector debt expected to reach 160% of GDP in the near future. Moreover, with the demographic clock ticking, who will pay the bills for such a system in the future?

Recent Media Highlights

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- Nagase-Kenko Corporation Helps to Sponsor Tee-Ball to Schools Program in the Czech Republic
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