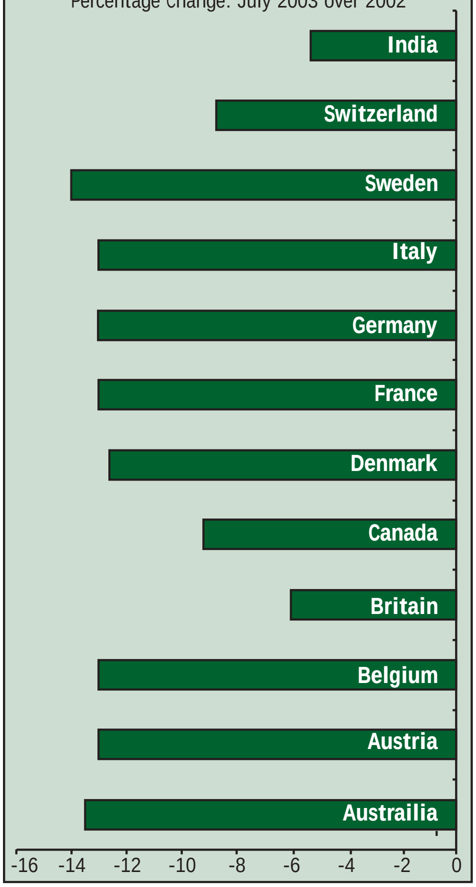
Briefings

US Dollar Fall and Its Consequences



G-49 **Currency Units Per US$**
Percentage Change: July 2003 over 2002

Briefings are on issues of major developments in the economy and capital markets during the year. These are excerpts from larger reports which are sourced from international resources and particular mention of grateful acknowledgements is made to International Monetary Fund, Asian Wall Street Journal, The Financial Times, London and The Economist, London.

A war of competitive currency devaluations is rattling the $1.2 trillion a day in global foreign exchange market with big implications for both economies and stocks. The aim of devaluing Governments is to steal growth and markets from others, while simultaneously exporting their problems which in this case is the threat to deflation. In the current environment of slowing inflation and outright deflation – when prices actually decline- it does not make any sense for a country to have a strong currency. The Bush administration's goal is to boost US exports and growth, battle deflationary pressures in the US economy, prodded the European Central Bank to cut short term interest rates and push Japan to overhaul its economy. Japan recently acknowledged that it had sold a monthly record of 3.98 trillion Yen ($33.8 bn.) in May to keep its currency from climbing. China has also struck with an Yuan, which is pegged to the sinking dollar and over the past decade, Canada's growth is also attributed to an undervalued Canadian dollar. The recent half percentage point interest rate cut by the ECB, signals that the Europeans have finally entered the fray. Until then, euro was roughly up 27% during the past one year, making European corporations less competitive. A too weak dollar could choke Europe's economy, its companies competitiveness and stock markets. While in theory, a weaker dollar should benefit US sales, profits and growth, there is also a risk that a cascading dollar will spook investors and generate into a "US Assets" scenario. There is another fear – a world of competitive devaluations that disintegrates into a protectionist slugest similar to that which engulfed the global economy in the early 1930s. The dollar recently hit a four year low in its value against the Euro, many experts believe that it will not regain its strength for some time. A US dollar whose value relative to the Euro has plummeted to about 40% since late 2000 and whose depreciation has sharply accelerated recently, will have serious consequences for both the economies. The first consequence is that Europe will be flooded by American exports, while US will see a surge of European tourists. The fall of the dollar will make life more difficult for European industries, while making American companies more competitive. The US private sector has already been sharpened by its ruthless and profound restructuring in response to the bursting of the stock market bubble, a slow economy, corporate scandals and the shock of tourism and war. In contrast, Europe's labour rigidities, heavy business regulation and closed corporate ownership structures have reduced the ability of many of its companies to react swiftly to changes in the global economy. Managers in the Euro-zone will face unprecedented pressures to cut costs, policymakers to save and create jobs and union leaders to protect the generous benefits that they have secured for their members over the years. A strong Euro could spur the creation of the collations needed to undertake long waited and so far postponed structure reforms. A weak US dollar may also dim prospects for trade liberalisation. If Europe deals with the strong

Euro by relying on protectionist measures, it will lead to more frequent and more acrimonious trade disputes. Some of this suggests a paradox – a weak currency is not always a sign of weakness. The US, seems well equipped to minimise the negative consequences of a sharp devaluation of its currency while taking immense advantage of the opportunity it creates. A big factor in that, is the flexibility and adaptability of the US economy particularly of a private sector that is less fettered by regulations rather than its European counterparts. Finally, the realignment of the exchange rates will change our thinking about international affairs. During the 1990s, finance became such a dominant factor in the world politics that some experts argued that traditional security issues were becoming less relevant. September 11 2001 showed the absurdity of this idea and generals, military experts and muscular international politics returned to vogue. Soon the focus of attention will shift again. The declining dollar will help rebalance not only the US trade deficit, but also the way we think about the world.

Equity Markets in China

The market capitalization of the Shanghai Stock Price Index stand at around CNY 2.9 trillion. China remains an attractive theme for regional Asian equity investors driven by two principal fundamental drivers. Strong economic growth both in absolute terms and relative to growth rates in the region. Political stability which is manifesting itself in goals like high growth, private sector development and external liberalization. The initial opening of China's domestic equity markets to foreign investors is positive. The A-share market, which is capitalized at nearly US$500 bn, is being made available to foreigners for the first time, though with certain restrictions. While this is significant from the standpoint of capital account liberalization, this new program is unlikely to attract meaningful equity fund flows in the near term for three key reasons, First, stock valuations for both the Shanghai – and the Shenzhen-listed shares are high. Both indices rose substantially from 1996 to mid-2001 (roughly fivefold for the Shanghai and sevenfold for the Shenzhen), and even after subsequent declines they are still three to four times above their respective early 1996 levels. Not surprisingly, trailing P/E multiples are a daunting 109X for Shenzhen A- shares and 38X for Shanghai A shares. Medium to long term, it is expected that A-Shares are likely to be included in benchmark indices, which would result in China's weightage in MSCI benchmark indices going up. For the time being, however, China play listed outside of China remain the best way for most investors to gain exposure to China mainly given attractive valuation. Second, there are meaningful restrictions on capital repatriation that are likely to dissuade most investors from applying for QFII status, which in itself is demanding, Moreover, the State Administration of Foreign Exchange (SAFE) has the express right to change the rules of capital repatriation, which adds a measure of regulatory risk to the mix. Third, many investors express concerns over the current state of accounting and corporate governance for the A-share companies. Although China's regulatory framework is evolving rapidly, current accounting practices vary meaningfully from global norms.

Highlights of China's Equity Investment Universe

China's A-share market cap and turnover are large compared to most Asia-Pacific markets. A -shares make up 54% of the China universe market cap and 65% of the trading A -share sectorial distribution is more balanced than non-A-share distribution, which is tilted towards the communication sector. The A-share market is fragmented: the bottom half of the market cap is populated by 77% of the roughly 1,200 listed companies. This makes efficient market coverage difficult for investors. The "marketable" market cap of the A-shares (the traded portion of the issued shares) has remained steady at roughly 30%. There is a continuing potential overhang of state-owned stock. There is a good level of primary supply in the pipeline for both the domestic and the overseas China equity markets. A-share valuations are expensive, even after share prices declined during the past two years. B -shares, H –shares, and red chips are much cheaper. There could be good opportunities if A-share short selling is permitted. For the A-share universe, sales growth has been consistently positive for the past eight years. Earnings, however, have been much more volatile and ROEs have fallen. The decline in A-share ROEs is mainly due to lower margins and higher tax and interest burdens. In contrast, Hong-Kong-listed China shares (H shares, red chips) have seen good recovery in ROEs as asset returns have remained steady and margins have firmed. The combination of high valuations, low ROEs, and primary overhang points to a cautious investment approach toward A shares. There is no single preferred benchmark for the China investment universe. This hampers the development of risk management instruments, such as futures and options, as well as investment vehicles like index funds (which could be a good way for non-marketable shares to be disseminated).

Sarbanes Oxley Effect

Effect of Sarbanes Oxley

Worldcom, Xerox, Globalcrossing, Tyeo, Enron, Merck, Arthur Andersen, etc., to name a few organizations, whose corporate frauds, accounting discrepancies, led to the passing of the Sarbanes Oxley Act in the US, which tightened the grip on corporate disclosures. CEO's & CFO's were made liable for the companies' statements of accounts. Corporate governance was tightened. President George W Bush went all out to penalize the perpetrations. The effect of the Act is being felt across the world. All countries are making corporate governance norms more stringent. Any company, which has been making changes in its top management has been restating its accounts and is being investigated by the SEC. Freddie XXXX is a case to point. The C.E.O. was sacked and the Chief Executive & Finance Director, abruptly left the company. The C.E.O. is purported to have removed pages from a diary. The company was also restating its accounts for 2000, 2001 and 2002. The SEC has ordered an enquiry into the company. Six former senior executives of Xerox have agreed to pay $22 mn in settlement over civil fraud allegations as US regulations continue their wide ranging investigation of accounting at the copier company. Stringent rules have been brought into separate investment banking and research. Ten top Wall Street firms have arrived at a $1.4 bn settlement in restitution and to supply independent research to investors. The deal also urges the banks to separate further their research analysts from their investment banking colleagues. The settlement did not include any sanctions against top bank executives. However, the US lawmakers expressed doubts that the deal would cure the securities industry's conflicts of interest.

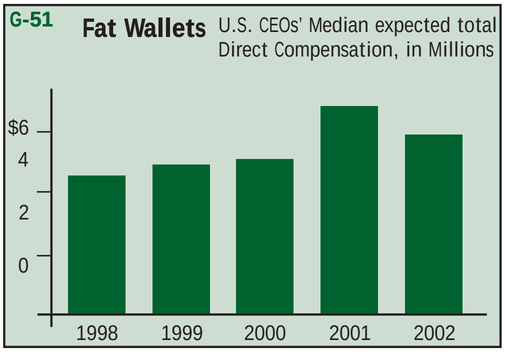
Monsoons and the Indian Economy

Sector	Growth with average monsoon	Growth with bad monsoon
Agriculture	3.0%	0.0%
Industry	5.8%	5.3%
Services	6.9%	6.7%
Overall GDP	5.7%	4.8%

Note: Figures are for fiscal year ending March 31, 2004
Source: Citigroup Global Markets

Indian investors used to check the skies for rain every morning at this time of the year, knowing that the monsoon's timely or delayed arrival could make or break their portfolios. While looking up continues, many times it is to see whether they would need an umbrella. While Indians greeted the late arrival of the monsoon with a sigh of relief this week, investors say that the annual rains aren't as crucial as they used to be for the stock market. That's because agricultural production and the rural consumer aren't as crucial to the Indian economy as they used to be 5 or 10 years ago. With vital industries such as software and pharma powering India's growth, investors don't have to worry as much about whether a drought will dry up village demand for motorcars or shampoo. Five years ago there was a lot more analysis of the monsoon by investors because there were lot fewer stocks and most of these were affected by rural demand. Investors waning interest in the weather illustrates the evolution of the Indian market. The monsoon arrives every year with uncanny regularity, dousing the nations' Southern tip around June 1 and pattering down on Mumbai streets by mid-month. This year the arrival in the South was about a week late. In the next four months, the monsoon will give India, 80 % of its annual rainfall, which most Indian farmers depend for irrigation. More than a fifth of India's gross national product is from agriculture and more than 60 % of Indians are dependent on agriculture for their livelihood, so for 600 million people, the monsoon is very important. Bad rains meant bad harvest which in turn reduce rural income, consequently demand from everything right from tiers to tractors to tobacco. Today, these companies are only marginally affected by the rains. The annual ritual of market speculation about the monsoon is a relic of the past, as economic realities have significantly changed in the recent years.New growth drivers have emerged in the Indian economy and agriculture is unlikely to play a significant role in incremental growth as it did in the past. With the growth of industry and services in India, agriculture has thinned to a 22 % slice of the country's GDP down from 34% only 10 years ago. While the 600 million rural consumers still have a significant effect on national consumption, the urban consumer is increasingly important for many products as more people move to India's sprawling cities and earn higher salaries. The Government has also become a much more important consumer, spending the equivalent billions of dollars annually to upgrade the country's roads, ports and power plants. Last year's monsoon, the worse in 15 years, shows how much less the rainy season means to stocks these days. While the Mumbai's benchmark index gave up about 10 % as the news about the 2002 monsoon got worse, it still performed better than markets in Japan and USA. While a bad monsoon can knockout a percentage point or so from India's GDP, analysts feel that it wouldn't derail India's economic growth. Instead, annual GDP growth would only slow to below 5% even on an impact of bad monsoons of two consecutive years.

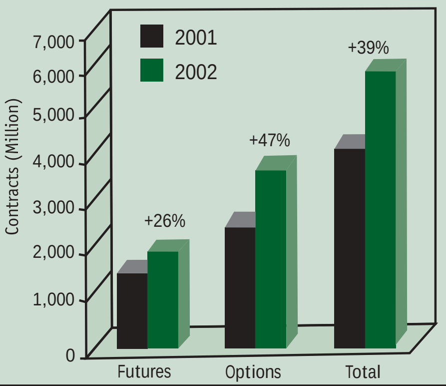
Investors Oppose CEO Payrises



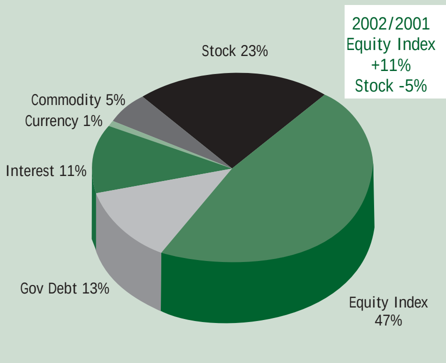
US investors are growing restive over lavish boardroom pay. Demands for greater transparency and accountability over the rewards enjoyed by corporate leaders are ringing out at annual meetings across the US. The shareholders are registering their distress about excessive executive pay in even greater numbers. Accounting regulators are proposing changes to the treatment of stock option costs. Even some executives are renouncing bonuses and reining in benefits. Yet although executive compensation was one of the first targets that critics of corporate America attacked after the spate of scandals last year, it is still proving the toughest to reform. The past few weeks have brought both good and bad news for those who advocate change. On April 25, Don Carty was forced out as the Chief Executive of American Airlines, after drastically misreading the sensitivity of the Unions about the executive compensation package the carrier had agreed on for top managers, while simultaneously persuading employees to accept and 1.8 bn. of annual wage concessions to avoid bankruptcy. Meanwhile, at annual meetings across the US, activist shareholders have won majorities, or near-majorities for resolutions on compensation, stock options and severance benefits. Most of such proposals are non-binding, and the complete official figures for US companies will not be known for sometime, but the votes are likely to make executives and directors pay attention to issues they might have previously shrugged off. At Apple's annual meeting, shareholders dared to confront Silicon Valley's opposition to any change in stock option accounting by voting that the computer company should treat option costs as expenses. Investors at IBM just fell short of a majority on a similar resolution. The Investor Responsibility Research Centre says 30% of all resolutions submitted to companies for this year's annual meetings related to executive pay. The strong votes recorded this year is an indication that a silent group of private-sector fund managers – who normally prefer to vote with management – are beginning to throw their weight behind activists such as the union and state pension funds. The mix of executive pay is also changing, with restricted stock becoming more popular. But, even if they received a different-shaped package, US chief executives were still easily the best paid in the world; they received median total compensation, which includes salary, and bonuses of about $6.8 mn. Last year, down from $7.6 mn. a year ago, but higher that in 2000. In the past, attempts by politicians to force change in the US executive pay practices was backfired. When, in 1983, Congress capped at $ 1 mn. The part of an executive's salary on which a company could claim tax deductions, it in effect laid down a minimum cash salary and triggered a boom in the award of non-cash incentives, including stock options. Stock option accounting rules then made it less attractive to use performance options by treating them as expenses, whereas plain vanilla option costs need to be declared only in footnotes. Stock options are now moving out of favour- partly because accounting regulators are working on new rules that could force companies to deduct the cost of all option grants from profits.

Derivatives Markets

G-52 **2002 Derivative Volume Growth**

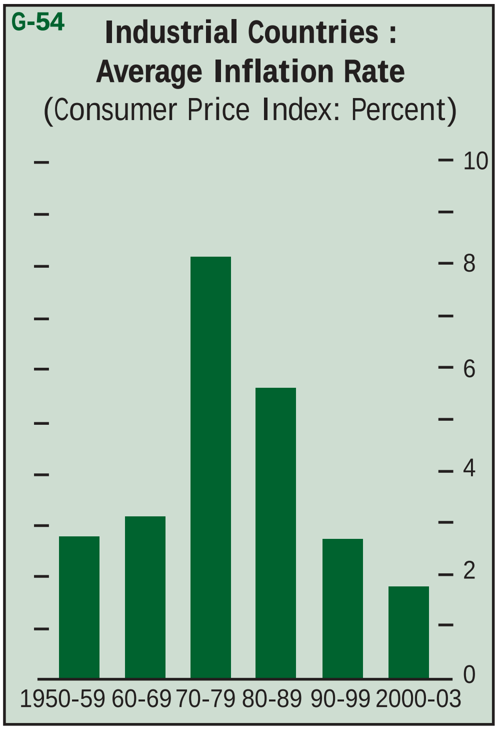


G-53 **2002 Total Worldwide Derivative Volume by Asset Class**



Total contracts traded in 2002 exceeded 6 bn. For the first time, representing a 39% increase over 2001. Options were up 47%, futures 26%. Excluding the Korea Stock Exchange (KSE), which saw a doubling of its already large index option volumes, all derivatives increased to 18% in 2001. Options increased 10% and futures 26%. Equity index products represent an increasing share of total contract volumes, 47% in all. This was up from 35% in 2001, mainly as a consequence of the very significant growth at the KSE in Seoul. The portion of the individual stock products was down by 5% (from 28% to 23%). Stock options are the largest segment among equity derivatives in North America, South America and Europe whereas in Asia Pacific it is index options. Thus options market is more predominant in other exchanges. Stock futures are evident only in two regions Europe and Asia Pacific and their share is the lowest among other equity derivatives in both the regions. Of the total derivatives volumes, Asia Pacific dominates with 36% share, followed by North America (32%), Europe (28%), South America (3%), Africa and Middle East at 1%. In 2002, total worldwide exchange traded derivatives volume is 6 billion contracts. Of which, 3.9 bn. are in options and 2.1 billion in futures. In 2002, total derivatives showed a growth of 39%, with options posting a higher growth of 47% as compared to 26% by futures. Equity Index constitutes 47% of the total worldwide derivatives volumes, followed by stock at 23%, Government debt (13%), interest (11%), commodity (5%) and currency at 1%. Of the total volumes in options, equity index accounted for 60%, stock (33%), interest (4%), Government debt (2%) and commodity at 1%. Of the total volumes in futures, the largest component is Government debt at 32%, equity index and interest (25%), stock (3%), commodity (13%) and currency at 2%. In 2002, NSE emerged as an exchange which posted the biggest jump (615%) in derivatives in the world. Next to NSE, are the RTS and MexDer. NSE is the 11th biggest in the world as per increase in number of contracts in 2002. MexDer posted the biggest jump in interest/ bond Derivatives followed by Malaysian Derivatives Exchange.

Fear of Deflation



Recently, there has been a marked increase in concerns of a generalized decline in prices in both industrial and emerging market economies. With Japan, China, and several other Asian economies already experiencing declining prices, the worry has been that deflationary pressures could deepen, and even spread more widely. This is against a background of massive decline in global equity markets; significant excess capacity and widening output gaps; repeated disappointments over the pace of global recovery; geopolitical uncertainties; and the impact on activity of higher oil prices. This is the second time in the past five years that widespread concerns about deflation have come to the fore – the first being during and in the aftermath of the Asian crisis. Public discussion in many countries, including the US and Germany, has centred on risks of the onset of deflation, with increasing attention levied to such risks by policymakers. These developments are notable given that for over four decades markets and policy makers have been more concerned about inflation rather than deflation. Both demand and supply shocks can lead to deflation. However, in the former case, declining prices are likely to accompany falling demand for goods and services, while in the latter, declining prices might be accompanied by increases in output. Nonetheless, deflation is seldom benign. Regardless of the source of the shock, it leads to a redistribution of income from debtors to creditors. In addition, credit intermediation can be distorted as a collateral loss value. Given the zero interest-rate floor, the effectiveness of conventional monetary policy is curtailed – of particular concern when output is weakening. Persistent deflation risks turning into a deflationary spiral of falling prices, output, profits, and employment. Deflation can be costly, and is difficult to anticipate. Deflation was not uncommon in the 19th century, but even then its duration was often unanticipated. In the late 1920s and early 1930s, US policy makers exacerbated deflation by underestimating its consequences and by failing to take aggressive action. In contrast, countries that exited the gold standard earlier, such as Sweden and Japan, recovered from deflation relatively quickly. Historically, deflation generally muted growth prospects, although it was mainly during the Great Depression that the most severe effects of deflation were felt. Based on the Index of Deflation Vulnerability, the risk of an onset of deflation in a number of economies is seen to be relatively high and has drifted upwards over the past several years. The risk occurs against a background of post-war low inflation rates; large output gaps; bursting of the equity price bubble; rising banking sector stresses in some economies; and declining credit growth. Asian economies, Japan in particular – but also Hong Kong and Taiwan – are at worsening risk of deflation. Deflationary expectations appear to be entrenched, and in Hong Kong, policy is constrained. In China, the strong pace of activity and policy stimulus already in the pipeline are likely to contain deflation. However, strains may arise in China from the large pool of underutilised labour and excess capacity in many sectors. In the Euro area, core inflation has been slow to decelerate, and except for Germany, risk of deflation remains low in the major countries. Germany suffers from a weak macroeconomic environment, large and increasing output gap, high unemployment, and banking sector strains, with limited policy options. Outside the euro area, Switzerland appears to have a moderate risk, but unlike Germany, there is a greater scope for policy measures. In the US, despite the lingering effects of the bursting of the equity price bubble, risk of deflation appears relatively low. The lower risk reflects an expected narrowing in the output gap, relief provided by a recent depreciation of the US dollar, the resilience in the financial sector, the availability of policy stimulus, and the explicit willingness of policy makers to take preemptory action. There is not much evidence to support strong concerns of a generalised global deflation. It also did not see any compelling evidence of widespread international transmission of deflation. However, the high correlation of business cycles across countries creates a non-zero, but still low, probability of a simultaneous decline in prices. Policies can be effective in warding off deflation, but only if preemptive, forceful, and sometimes unconventional steps are taken.