

Leaders study Asian version of euro

REUTERS

Hyderabad, May 4

FINANCE MINISTERS from China, Japan, South Korea and Southeast Asia endorsed plans on Thursday to examine the idea of regional currency units, which could one day lead to European-style financial integration.

The ministers — in Hyderabad for the annual meeting of the Asian Development Bank (ADB) — also called for the strengthening of a regional scheme to prevent currency turmoil and for the development of immature bond markets in Asia.

A study led by a Japanese research institute would explore "steps to create regional monetary units", they said in a joint statement.

The ministers also said high oil prices, widening global imbal-

ances, rising interest rates and a potential bird flu pandemic could pose downward risks to the region's economies.

The Association of Southeast Asian Nations (Asean) groups Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. Asean+3 takes in these states plus China, Japan and South Korea.

A plan by the Manila-based ADB for several types of theoretical Asian currency units (ACUs) has not got far, with some Asian countries doubtful that the development bank is the right body to explore the idea.

Given the political sensitivities involved, the ADB had recently stressed that an ACU, which would be made up of a basket of currencies, would not be traded and would simply be an indicator

region's financial crisis in 1997-98 made them realise that cooperation was important.

Kwon Te-kyun, director-general at the South Korean finance ministry's international finance bureau, said teams from Japan, China and South Korea planned to hold their first meeting on currency integration some time this year. "The ACU idea will be taken into account but, basically, today's agreement means that discussion over the single currency unit will now be brought in to the Asean+3 regime," he said. "It took 30 years for Europe (to launch the single currency) but it'll take less for Asia because Asia has the textbook from Europe to use."

A Japanese finance ministry official said Asian countries would work with the ADB to explore the idea.

Masahiro Kawai, head of the ADB's office of regional economic integration and the driving force behind its ACU plan, welcomed the decision. "We'll support the Asean+3 governments in any way possible," he said.

Some analysts remain sceptical. "I think it's a pipe dream," said Nick Bibby, a strategist at Barclays Capital in Singapore. "We occasionally see calls for this but it never goes anywhere and I expect the same to happen this time."

Others saw more merit in studying European-style integration. "While the goal of creating a single Asian currency may be a long way off, it makes sense for the region to move in that direction," said Kevan Watts, chairman of Merrill Lynch International, who was in Hyderabad for the ADB meeting.



South Korean finance minister Han Duk-Soo (left) shakes hands with his Japanese and Chinese counterparts, Sadakazu Tanigakki (centre) and Jin Renqing, in Hyderabad on Thursday.

of the stability of participating currencies. Asian countries now seem ready to develop the work together, despite political tensions among Japan, China and South Korea, because the re-



FF 14 A united Asia India Needs To Be More Proactive

DESPITE Dr Manmohan Singh presenting a vision of a Pan-Asian Free Trade Agreement, the signals from the Asian Development Bank meeting in Hyderabad are a reminder that India remains some distance away from finding a place at the heart of the movement towards a united Asia. The sidelines of the ADB meet have been used to pursue the dream of an Asia that is as united as Europe. Tentative steps have been taken towards a common Asian currency. The currency is itself still a long way from becoming reality. But China, South Korea and Japan have decided to coordinate their foreign exchange policies. This should speed up the progress towards the ADB-sponsored idea of an Asian Currency Unit, whose value would be based on an index of the participating currencies. And the whole process is currently to be confined to these three countries and Asean, the so-called Asean Plus 3. Consequently, the closer relationship India seeks with Asean would be restricted to FTAs. India can then at best hope to be at the periphery of the thrust towards a more unified Asia. And that role too may require working together with Australia and New Zealand to create an Asean Plus 3 Plus 3.

The difficulty in finding a place at the core of a unifying Asia no doubt has a lot to do with the tariff barriers that India had built around itself in earlier decades. This has prompted the PM to point out that Indian duties are coming down to Asean levels. But the problem is not one of tariffs alone. India has tended to be much more suspicious of strengthening local ties across its borders than the Asean nations, and even China. Beijing built on the links its Yunan province had with other nations along the Mekong river to make the province one of the original members of the Greater Mekong Sub-region alongside other nations. India tends to be much more sceptical about cooperation between local cultures across national boundaries. Being on the fringes of the move to rapidly unify Asia thus fits in with the general political mood within the country. And unless that mood changes dramatically India would be unwilling to pay the price that has to be paid for an Europe-like Asia.

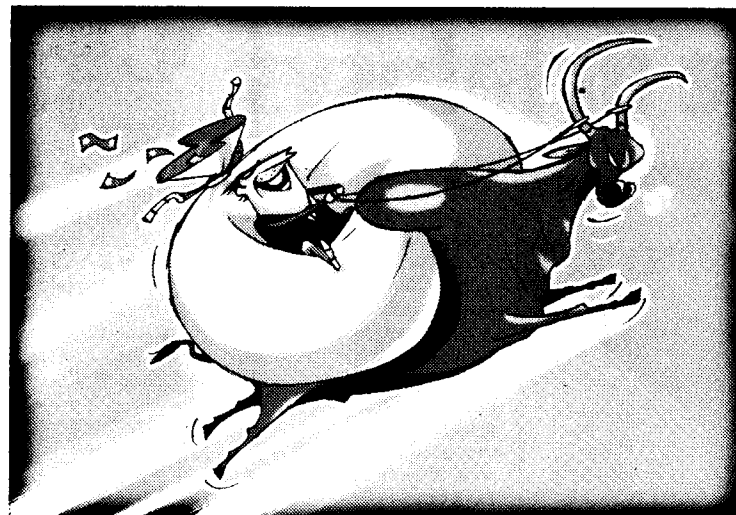
Time for a reality check

High earnings multiples can be sustained only with high returns on capital and high earnings growth, and not just accelerating investment and revenues, says U R Bhat

GENERAL Motors has no bad years, only good years and better years" — so said an exuberant Harlow Curtice who headed the company between the years 1953 and 1958. The state of the Indian stock market over the last two years is somewhat akin to the state of General Motors when the rather preposterous statement was made. Given the speed with which the sensx has been touching new highs, the buzz in the market is that the more aggressive brokers in Mumbai have already placed orders for caps bearing the legend "Sensx 15,000". Even after repeated upward revision of price targets, the analyst community is at a loss to rationalise the dream run of the sensx and most of the bulge bracket broking houses that have been calling a sell on the market for quite some time now are hard put to explain the turn of events.

The time-tested valuation theories point to fair values being the result of an interplay between two variables — the expected earnings growth rate and the expected rate of return. Given that the price of a security should theoretically be the present value of the future stream of payments it commands, higher prices should be the result of a larger expected stream of payments and/or lower discount rates. Market participants, whether knowingly or unknowingly, plug in a set of numbers for these two variables and trade securities with others who have different perceptions about what these numbers should be.

The recent trajectory of the sensx, if guided by the time-tested valuation theories, suggests that earnings growth is likely to be a lot higher than and/or the discount rates a lot lower than what analysts and strategists are expecting. Lower discount rates mean that the equity market is not impressed by the concerns of the central bank on oil prices and inflation and that equities are possibly less risky than what the assumed risk premia factor in. This is a rather stark contrast to the state of affairs immediately after the



SASIKUMAR

turn of the millennium when the equity market factored in a no-growth prospect as demonstrated by earnings yields (the inverse of earnings multiple or P/E) being in excess of the risk-free interest rate.

How can one reconcile the dramatic change in the attitude of investors towards corporate India over a relatively short period of time? This question is relevant because market participants who have been overly cautious about growth and discount rates over the last couple of years have missed one of the most spectacular bull rides in Indian stock market history.

Let's examine the differing perceptions about growth in corporate earnings between the market and the analyst community in some detail. The contributors to earnings growth could be better operating margins on account of increased pricing power or efficiency gains, lower interest costs and taxes, as also higher top line growth. Given the general buoyancy in the economy and high levels of capacity utilisation, manufacturers indeed have better pricing power in some sectors as evidenced, for example, by the repeated price increas-

es by the cement manufacturers. Corporate India has generated unprecedented efficiency gains over the last decade or so, by severely cutting costs, as also restructuring balance sheets and the business portfolio. However, the next quantum jump in efficiency is not immediately in sight.

INDIA'S dalliance with falling interest rates appears to be well behind us and if anything, interest costs can only increase for some time to come. Corporate taxation levels might have bottomed out and the government's thrust is towards rationalising the myriad tax exemptions and ensuring better tax compliance. With capacity constraints being apparent in several sectors and pricing power having been used to good effect, corporate top lines can show a quantum jump only with new investments.

The market appears to be quite enthused by the corporates currently implementing massive capacity additions and the consequential growth in earnings that these new capacities have the potential to generate. The crux, therefore, is in estimating how these new in-

vestments will contribute to increased shareholder value by generating an adequate return over the cost of capital. India's post-reform experience has shown that bouts of synchronised capacity creation on the back of easy access to capital are based on somewhat exaggerated notions of demand growth and, therefore, unrealistic expectations of returns on invested capital. It takes several years for demand to catch up with the speed of new capacity creation and the immediate casualty in the interregnum is the pricing power that is factored into the financial projections.

In the real world, there is nothing like a "normal" level for stock prices, given that in the market there is a multitude of opinions about the drivers of stock prices — earnings growth and discount rates. If actual returns are in excess of the previously expected returns, investors tend to revise their expectations of future real earnings growth and the future real discount rate, resulting in unanticipated capital gains on stocks.

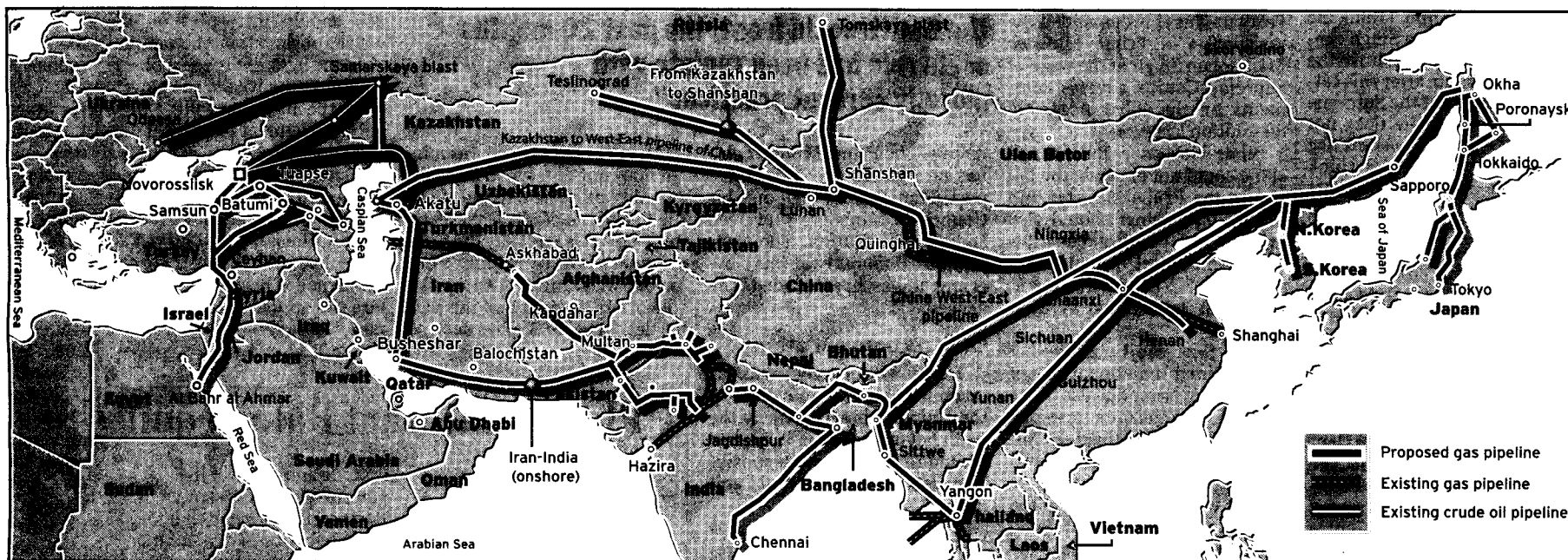
The rather robust earnings reported by corporate India for the March 2006 quarter might have warranted investors to revise their expectations of future earnings growth and discount rates. However, once investors attach a very high probability to the new parameters, actual returns trend towards the discount rate and the element of unanticipated capital gains reduces remarkably.

The market might have reached such a position at this juncture. With some uncertainty about the ability to generate excess returns on the outsized capacity creation by corporate India, thanks to the easy capital availability, this might be the best of times to conduct a reality check on the underlying growth and discount assumptions and take an objective view on the possible future course of the market. It is useful to remind ourselves that high earnings multiples can be sustained only with high returns on capital and high earnings growth, and not just accelerating investment and revenues.

08 MAY 2006

Energy key in the new Asian architecture

Pipelines bring mutual dependencies and hasten regional integration. India must not let the strings attached to the U.S. offer of nuclear cooperation — or its usual insecurities — choke off this process.



Map source: Ministry of Petroleum and Natural Gas

Graphic: Surajit

Siddharth Varadarajan

IN THE energy business, more than in any other aspect of international economic activity, fortune favours the brave. While the Indian establishment spent five years agonising over whether it should go ahead with the construction of a natural gas pipeline from Iran to India via Pakistan, China took just 10 months to propose, construct, and operationalise a 1,000 kilometre oil pipeline from Atasu in Kazakhstan to Alashankou in Xinjiang. No sooner was that project completed a few months ago than China indicated its eagerness to lay a gas pipeline along the same route as well. "We completed the 4,500 km-long pipeline from Xinjiang to Shanghai in just two and a half years," Chin Geng, president of the China National Petroleum Corporation (CNPC) told India's Petroleum Minister, Mani Shankar Aiyar, and a group of top Indian executives in Beijing earlier this month. The Indian side was suitably impressed.

Though a recent convert to the cause of pipelines, India is seeking to compensate for its earlier lack of interest with an ambitious proposal for an Asian gas grid that would take these two connections — Iran-India and Kazakhstan-China — and extend them in a way that links Asia's major energy producing and consuming regions to one another. "The energy-short countries of Asia are located cheek-by-jowl in the immediate vicinity of their energy-abundant Asian cousins," Mr. Aiyar said in a speech on India and China's joint quest for energy security. "Yet, if you compare a pipeline map of Europe with a pipeline map of Asia, Asia today looks almost naked."

At the meeting in New Delhi in November of principal North and Central Asian energy producing and consuming countries, India unveiled an ambitious \$22.4 billion pan-Asian gas grid and oil security pipeline system. The grid has four principal elements. The first would extend the existing Baku-Tbilisi-Ceyhan pipeline system — originally

conceived by the U.S. as a means of shipping Central Asian hydrocarbons westward — down to the Red Sea via Syria, Jordan, and Saudi Arabia, allowing Caspian crudes to be exported easily to the Indian Ocean littoral. Second is the famous Iran-Pakistan-India pipeline, with the possibility of two additional sourcing spurs, one from the Caspian-Turkmenistan region to Iran, the other from Turkmenistan via Afghanistan. The third element would be a pipeline system connecting eastern India to Myanmar and south-western China with one connection running from Sittwe on the Burmese Bay of Bengal coast to Mizoram, Manipur, and Assam into China, eventually connecting up to the West-East China gas pipeline near Shanxi, the other from Yangon to Kunming. The fourth element would involve the laying of pipelines that would connect the Sakhalin deposits in Russia to Japan, China, and South Korea. (See map)

Pipelines aim to deliver gas, crude or products between discrete points but this does not mean they have to be a zero sum game. The underlying economic logic of a grid is that the capital costs can be more easily absorbed and amortised and energy supplies calibrated to match demand variations in the consuming countries without too much effort. But there is a political logic as well. As Asian grid will create mutual dependencies, giving countries a stake in the political and economic stability of one another, and hasten the process of regional integration. If at all Asia is to make progress towards creating an Asian counterpart to the International Energy Agency (IEA) and develop a regional market for energy with its own price markers, the construction of physical infrastructure such as pipelines is essential.

Virtually all the Chinese energy officials and scholars this reporter interacted with on a recent visit to Beijing seemed convinced the route to greater Asian cohesiveness lies through cooperation in the energy sphere with India and other countries.

The Chinese strategic community is aware of the pressure being exerted on India by the United States to curtail its links with Iran and believes the U.S. policy towards Iran has the potential of upsetting the Asian applecart. "The U.S. is trying to coordinate with all countries around Iran in order to isolate it," says Liu Xuecheng, director of the Beijing Centre for American Studies and a senior fellow of the China Institute for International Studies. "India and China have good relations with the U.S. but must follow their own strategy on Iran. If India gives up on Iran in the hope of securing nuclear energy from the U.S., it may end up with nothing. You would lose your strategic pipeline and the U.S. might also abandon the nuclear deal at some point in the future. Pipelines from Iran and Central Asia are a strategic lifeline for Indian energy security."

"The nuclear deal offered by the U.S. makes sense from the Indian perspective," says Zhai Dequan, deputy secretary general of the China Arms Control and Disarmament Association, "but India should be on guard against American conditions." As an ancient civilisation, he adds, "India cannot be manipulated by anyone. It has its own way of doing things." Dr Liu agreed that if India could make a deal with the U.S. on nuclear energy, this would not be a bad outcome. "It could get something it needs. But this should not be at the cost of pipelines."

Chinese scholars see the emerging U.S. policy towards Asia as motivated, in part, by the emergence of the Shanghai Cooperation Organisation as a framework for all-round cooperation — from anti-terrorism, to economic interaction, including energy. "With India, Iran and Pakistan joining the SCO as observers, I think the U.S. already sees that happening and they don't want this grouping to emerge in a big way because it will pose a strategic challenge to the U.S. in this region," says Dr. Liu. The U.S., he says, appears to be basing its regional strategy for the moment on the creation of a four-country alliance linking itself, India, Japan, and

Australia "based on cold war logic."

According to Dr. Liu, Washington has four priority areas in Asia for making new political inroads — Mongolia, Afghanistan, Nepal, and Sri Lanka — and three "targets", i.e. Iran, Syria, and North Korea. "If I am right in my analysis, then it would seem to me that the U.S. needs India to work with it to accomplish its goals." India, on the other hand, is also crucial to any strengthening of the cooperative process in Asia, particularly at the "mid-level" where institutions like the SCO in "Northeast Asia" and the East Asian Summit in "Southeast Asia" have emerged. "China and India are in both so we bear great responsibilities to promote both processes."

Though they do not explicitly say so, the Chinese appear unsure of the degree of Indian commitment to the SCO. Given the Bush administration's apprehensions about the grouping and the new direction in Indo-U.S. strategic relations, they believe India would not want to send the wrong signals to Washington by embracing the organisation too enthusiastically. Partly due to this uncertainty, China is not contemplating a formal "upgrade" of status for any of the three SCO observers any time soon on the plea that the "rules" for expansion of membership have yet to be adopted.

As far as the larger regional oil and gas question is concerned, the question assumes importance because of Beijing's apparent preference for the SCO as the vehicle through which Asian energy cooperation should eventually be pursued. But even here, the emphasis is on the bilateral to begin with. "It is my opinion," says Dr. Zheng Ruixiang, a specialist on South Asia at the CIIS, "that first you have the bilateral, then trilateral and finally multilateral." In other words, whatever shape the Asian energy architecture takes in the long run, a strong partnership between India and China would have to lie at its foundation. A partnership based on each country acting on the basis of its own enlightened self-interest and not the *diktats* or blandishments of outside powers.

HISTORIC EVENT

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Moscow's Debut At East Asian Summit

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By DMITRY KOSYREV

The inaugural East Asian summit came on the heels of the first Russian-Asean summit in Kuala Lumpur on 13 December, which discussed the current issues of Moscow's political and business partnership with 10 South-east Asian nations. 14 December saw a historic event: the forum laid the groundwork for a new international institution.

Addressing both forums, President Vladimir Putin spoke about different aspects of Russia's relations with South-east Asia. At the East Asian Summit, he outlined the concepts of Russia's future cooperation with the community of states, which is gradually taking shape in this part of the world. The gist of his speech was as follows: as the only nation with huge and so far untapped hydrocarbon resources in Asia, Russia could guarantee power supplies to Asia and the Pacific.

Indian investment

Countries represented in Kuala Lumpur are obviously eager to have access to Russian energy carriers. Japan and China are engaged in an intricate struggle for the itineraries of Russia's "Eastern" oil and gas pipelines, and India has markedly increased its investment into Russian power engineering. These three countries are all parties of the East Asian forum.

At the forthcoming G8 summit in Moscow Russia will talk about supplying the West with energy carriers, having a well-developed network of gas and oil pipelines, at least, in Europe. But in the East, Russia will have to start this talk by outlining models of partnership on huge expanses of the East: This is what Putin suggested in Kuala Lumpur on a par with Russian technologies to prevent natural disasters and deal with their

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aftermath.

Moscow has a good claim for equitable participation in forming a unified region which, as the Malaysian *New Straits Times* wrote, will account for up to 40 per cent of the world GDP by the year 2040.

Cooperation), a forum which includes the United States and Latin American countries, but leaves out India?

India's growing ties with Asean emphasise that the East Asian summit is a strictly Asian forum, rather than Pacific. Rus-

nization last July. Almost all Asean countries voted for it. A reservation was made to the effect that Moscow did not meet one criterion of membership referred to as "substantive" cooperation with the region's countries.

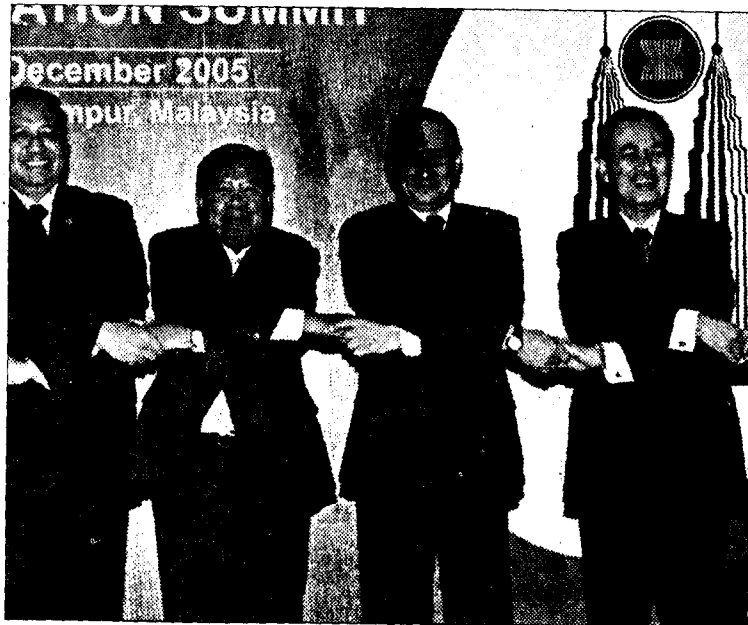
Russian diplomats argued that, at least in the sphere of counter-terrorism, its cooperation with Asean was much more "substantive" than that of other countries with more intensive trade with the Association. This is not to mention Moscow's potentialities in the energy sector.

Differences

The US was conspicuously absent at the summit and tried to make up for it by diplomatic effort. But questions of membership are decided at the East Asian summit by Asean's ten members, which was reaffirmed in Kuala Lumpur. The existence of many differences on most diverse problems within Asean is another matter. Objections of even a small country mean a great deal in the Association, which makes decisions by consensus. For this reason President Putin made a 20-minute speech at the forum not as a full-fledged member but a guest of Malaysia, the host country.

At the final news conference, Malaysian Prime Minister Abdullah Ahmad Badavi mentioned again that Russia wanted to become an EAS member and said that government officials of the region's countries would discuss the relevant technical issues. The next summit due to take place in the Philippines in a year would be attended by the same conferees, he said.

Hence, the fight for the Russian membership and for the essence of the summit as such will go on. But judging by the hints made in Kuala Lumpur, Moscow has recently taken several major steps towards the rapprochement with the world's most promising region.



Russian membership in the future summits is a diplomatic effort which is not very clear to the uninitiated. The East Asian summit, a brainchild of Malaysian former Prime Minister Mahathir Mohamad, had its trial session here, and the region's diplomats will discuss at length different aspects of the project launched in Kuala Lumpur and its future participants.

Economic integration

Apart from Asean, the current forum included from the very start China, India, Japan, South Korea, as well as Australia and New Zealand. The ideological affinity of the latter two to Asean was a source of disputes.

Should the new structure be involved in the economic integration of the Pacific if there is APEC (Asia-Pacific Economic

sia fits in well here, as is seen from its growing mutual understanding and cooperation with India, China, and Asean.

This emerging community is looking at Asean, a forum of 10 nations, which are involved in growing cooperation, and whose virtually free trade within the Association has already reached \$220 billion, generating zones of rapid integration along its perimeter. A project of free trade and development dubbed as 10+3 (Asean plus China, Japan and South Korea) is becoming a major zone. But there are many others as well.

This emerging family will concentrate on ways of forging closer partnerships, and enhancing its cultural and political community. Russia would like to be part of the process and has applied for membership in the new orga-

“Asia brimming with confidence”

P.S. Suryanarayana

SINGAPORE: Asia “brims with confidence and dynamism,” as it is “powered by the twin engines of China and India,” according to Singapore Prime Minister Lee Hsien Loong.

In a New Year message, Mr. Lee said the overall economic environment in Asia stayed favourable in the year gone by. In this milieu, the City-State’s ex-

ternal trade grew strongly by 14 per cent in 2005, “helped by our expanding network of free trade agreements,” he said, citing in particular the

Comprehensive Economic Cooperation Agreement (CECA), which Singapore signed with India last June.

While Singapore was moving forward by developing ties with new partners such as Russia and some West Asian countries, the

Association of South East Asian Nations (ASEAN) was now “building up links with major economic partners like China, India, and Japan.”

Emphasising that Singapore was being shaped into “a vibrant global city,” Mr. Lee said “terrorism is one major threat” to the multi-racial City-State’s security and stability, which were essential for economic growth and communal harmony.