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Crisis Management in Normal Times is a Necessity

Crisis management is not a measure taken merely for emergencies during the crisis period, but it also needs to be performed in non-crisis period as preventive tasks. If a crisis management system is enabled only once every crisis happens, then even an excellent malleable scheme could not avoid loss. Crisis normally happens suddenly and a swift response system is highly needed. Lack of preparation in normal times would cause none of the measures to function well in critical circumstances. A well functioning crisis management system has to be activated even during normal times to be capable of effectively minimizing the loss during crisis.

The main mission of the APEC SME Crisis Management Center is to not only assist SMEs in quickly responding to crisis, but more importantly in operating a crisis prevention task in normal conditions. In Principles and Checklist of Financial Crisis Management for APEC SMEs published by the center, the principles for SMEs in preventing the financial crisis are elaborated. On prevention, the document reveals how SMEs should build a financial alert system with daily management, and how a company’s financial status could be examined through quantification data of financial reports. The document also uncovers issues on: the potential risks of a company’s management strategy and building improved accounting and financial management system. Also, principles such as: undertaking regular examination of key financial ratios, monitoring key indicators of business performance on a long-term base, giving due emphasis on cash flow management and return on investment analysis and avoiding over-leverage, are also identified.

This October issue focuses on monitoring the appreciation of yen and renminbi. Although the two currencies’ rise has not yet created a harmful or significant damage, basically a considerable lookout even in the normal time is needed; hence, this month’s issue will observe this phenomenon. On the Crisis Alert section, this issue reveals the possible future development of yen and renminbi, its influence on SMEs, and the ways to prevent currency risks. Also, the results of regional reports indicate that the economic situation and potential factors of crisis around the globe is extremely complicated. Growth and decline exist side by side, with inflation and deflation emerging together in different parts of the world, thus, causing more possible risks and possibilities for crisis.

At the same time, experts of this center will present the ways to prevent financial crisis to readers, as well as the development and current condition of SMEs in the U.S.. Our experts discovered that despite each crisis has its own distinction, we could still learn from past experiences to minimize or prevent future crisis from happening. This issue has also invited the head of Malaysia’s SMI Association, Mr. Chua Tiam Wee, to share his association’s experience to readers, in assisting SMEs coping with crises.

The center is dedicated to providing SMEs with assistance in preventing crisis, and its full testimonials can be found in this issue. We hope that this issue could improve APEC SMEs’ capability of crisis prevention.

Robert Sun-Quae Lai, Ph.D.
Executive Director
APEC SME Crisis Management Center
One of the most significant developments in the global economy over the past month has been the substantial appreciation of Yen and Renminbi. Dramatic exchange rate volatility was one of the main factors causing financial crises, which is used to refer to “currency crisis”. Many small and medium enterprises (SMEs) may be worried that the pronounced appreciation of the two currencies could lead to a currency crisis in the near future. Given the enormous size of the Chinese and Japanese economies, a currency crisis involving the Yen or the Renminbi would inevitably have serious, far-reaching repercussions. In order to provide answers to this concern, it is necessary to analyze the recent surge of Yen and Renminbi.

Although it is said that currency crises are triggered by dramatic exchange rate fluctuations, the vast majority of past currency crises were ignited only by a sudden pronounced devaluation due to speculative attacks on a particular currency. A sudden currency slump of this kind can cause serious business losses, investment stagnation, and foreign debt defaults, whose impact on the real economy can thus be quite profound. Moreover, almost all past currency crises have occurred in economies that had fixed exchange rates, a regime usually unable to accurately reflect the development of the real economy. Once exchange rates and the real economy exists serious disequilibrium, speculators moved in to take advantage of the situation.

Given these two conditions for a currency crisis (devaluation and fixed exchange rates), it seems highly unlikely that either Japan or China will be threatened by such a crisis in the near future. Neither Japan nor China has fixed exchange rates, and both the Yen and the Renminbi have been facing the pressure of appreciation, instead of devaluation. So far, there is nothing to suggest that either currency will suffer a serious devaluation any time soon. Nevertheless, fixed exchange rates are just one of the chances that speculators can exploit; there are other ways in which they can attack a currency. In the same vein, although appreciation will not generate panic-induced capital flight as devaluation does, this should not be taken to imply that the economy is not being seriously affected.

Different factors lie behind appreciation of the Renminbi in China and of the Yen in Japan. However, as long as a currency’s value is a true reflection of the state of the real economy, and as long as the currency is being supported by the development of the real economy, then there should be no significant vulnerability to speculative attack or to sudden devaluation even after dramatic appreciation. A slow, steady appreciation of the Renminbi was beneficial to China’s economy because it has minimized disparities between exchange rates and the real economy, keeping the two in balance, and ensuring the stability of the Chinese financial sector as a whole.
By contrast, the dramatic surge of the Japanese Yen has led to the value of the Yen becoming increasingly divorced from the state of the real economy. Since the strong Yen has a definite negative impact on the real economy, the appreciation of Yen would make the disequilibrium between the two more pronounced, so that the weaker real economy will become less and less able to support the over-valued Yen. Currently, the strong Yen is being supported by the relatively weak economies of Europe and North America. The sluggish recovery of these economies, coupled with unattractively low interest rates, has encouraged investors to buy Yen-denominated assets. Nevertheless, if the situation changes, such as the interest rate starting to rise and economy becoming strong in Europe and North America, Yen’s value will collapse. In point of fact, the dramatic rise in value of the Yen could itself cause the situation to change, because the strong Yen will ensure that the Japanese economy grows more feebly than the European and North American economies.

SMEs should therefore keep a close eye on the value of the Yen, and on any intervention in the exchange rate by the Japanese government. The rise in value of the Yen and the Renminbi has shown once again that exchange rates are not determined by exporters and importers, but rather by speculative international arbitrage. SMEs have no ability to influence exchange rates whatsoever. The size of the profits that SMEs make in international markets, and even their very survival, is determined by the actions of arbitrageurs. This is a highly unfair situation, but it is reality. All that SMEs can do is to hedge against exchange risk as best they can.

In this final section, we suggest a few basic strategies that SMEs can employ to hedge against foreign exchange risk. Firstly, SMEs can use forward exchange transactions and forex options as hedging tools. SMEs should train their employees to make effective use of these tools. Secondly, SMEs should seek to incorporate hedging into their business transactions, for example by using cash transactions, or by using the same currency to calculate prices when importing raw materials and exporting finished products. Finally, SMEs should try to avoid becoming dependent on a handful of key export markets. Diversification of export markets makes it possible to offset exchange risk between currencies. Of course, the extent to which an SME is able to make effective use of these strategies will vary from firm to firm. Even so, keeping a close eye on international exchange rates is a vital task for all SMEs that are involved with international markets.
The United States

In August, the unemployment rate ticked up to 9.6 percent from 9.5 percent, not because of layoffs, but because more people entered the work force. Still, some 15 million people remain unemployed, and the unemployment rate marked the 16th straight month above 9 percent, the longest stretch above 9 percent in quarter of a century. Analysts, however, saw a silver lining in the latest unemployment rate, as modest hiring by the private sector eased concerns about the economy’s falling into a double-dip recession.

Reflecting the weak economy, the 10-year Treasury bond rate remained around 2.5 percent in August, down from 3.6 percent in April. The Federal Reserve, which engaged in additional purchases of long-term Treasuries, also kept long-term rates low, thereby further lowering yields. 30-year mortgage rates, which are benchmarked to long-term Treasury bonds, fell to 4.32 in August, the lowest mortgage rate observed in over 40 years.

Despite the historically low mortgage rates, the expiration of a lucrative tax credit in April for first time homebuyers has lowered the demand for housing, and hurt the housing market. An index of sales of existing homes has plummeted by 30 percent in recent months from the previous year. The weak housing market continues to put a strain on bank balance sheets.

To help the banking system, the Federal Reserve has kept interest rates low, and has extended further liquidity to banks. The Federal Reserve operations to increase liquidity in the U.S. banking system over the last two years have resulted in the U.S. banking system’s holding over $1 trillion in excess reserves (=reserves above what is required by law). Excess reserves are so high, because banks are generally not lending. While larger blue-chip corporations have no trouble borrowing from banks, credit is still quite tight for small- and medium-sized enterprises, which are riskier from the point of view of banks, lacking sufficient collateral and long credit histories.

Expanding bank lending to small- and medium-sized enterprises is critical for lowering U.S. unemployment, since these enterprises account for about 67 percent of all new job creation in the U.S. today. Some new government proposals to encourage lending to small- and medium-sized enterprises include injecting funds from the U.S. Treasury into smaller, regional banks to promote their lending to small- and medium-sized enterprises, their natural clientele.

More broadly, the U.S. banking system continues to be weak, with the ratio of problem loans (interest rate 90 days past due) to total loans...
staying above 5.5 percent in end-June 2010. As a comparison, between 2000 and 2005, the ratio of problem loans to total loans averaged 1.2 percent, and even during the peak of the Savings and Loan crisis of 1991, the ratio never went above 4.0 percent. Reflecting the weakness of the banking system, in 2009, 140 banks failed. So far, in 2010, 118 banks have failed. As a comparison, between 2003 and 2008, there were only 11 bank failures. It appears that lending to small- and medium-sized enterprises will be normalized only when the U.S. banking system returns to full health, which may take several years.

Canada

Canadian GDP growth slowed to an annualized 2.0 percent during the second quarter of 2010, brought down by slowing U.S. growth. The slowing growth raised the Canadian unemployment rate to 8.1 percent in August, up from 8.0 percent in July. The economy overall added private sector jobs, but more people entered the labor force, raising the unemployment rate.

Still, the Bank of Canada felt confident enough in the domestic economy to raise interest rates to 1 percent in early September, the third time interest rates have been raised this year. Further interest rate increases will depend on the strength of the U.S. economy. If U.S. growth dampens further, Canadian growth will be brought down, and further interest rate increases this year will be unlikely. (The author is Professor at University of Southern California.)

Northeast Asia

Inflationary versus Deflationary Pressures

Sayuri Shirai

China

Inflationary pressures remain, as evidenced by the CPI-based inflation in July (3.3%) and August (3.5%), exceeding the government target of 3%. However, this was caused mainly by the increase in food prices, and thus, it is not necessarily a reflection of excess demand. “Core inflation,” or CPI-based inflation excluding food and energy has remained below 2% throughout this year, notwithstanding that positive GDP gaps (defined as the difference between actual and potential GDPS) suggest an excess demand for goods and services.

A deceleration of real estate price hikes and sales transactions relieved the government’s concerns over real estate bubbles in major cities such as Beijing, Shanghai, and Shenzhen. To contain real estate speculation activities, the government has implemented a series of measures including a rise in down payments (greater increase for second home buyers) and an increase in mortgage rates since late 2009. Nonetheless, real estate prices still remain very high and are unaffordable for the general public.

The government appears to be reluctant to lower the real estate prices, fearing that this may lead to large non-performing loans held by “local government platforms.” The platforms refer to the firms established by local governments as a channel to circumvent budgetary restrictions (i.e., restrictions on local bond issuance and limited intergovernmental transfers) and to freely raise capital for infrastructure- and real estate-related projects. The number of these
platforms proliferated recently to over 8,000 as the government encouraged commercial banks and local governments to undertake two-third of the 4 trillion yuan equivalent fiscal stimulus package announced in late 2008. It is estimated that as of June 2010, these loans reached over 7.7 trillion yuan, of which, nearly 20% have been regarded as problematic with the possibility of being transformed into non-performing loans in the near future. As these loans are guaranteed by local governments, their credit risks are likely to be borne by them, and not by commercial banks. In response, the central government has directed commercial banks to limit loans to the platforms, which are now under close surveillance.

Moreover, potential risks related to real estate bubbles have not been completely eliminated for two reasons. First, the banks’ lending activities to the real estate sector (loans to developers and mortgages to households) continue to expand at a substantially rapid pace, achieving growth rates of over 40% in the first and second quarters of 2010. In particular, the growth rates of the loans to housing mortgages dropped merely from 53% in the first quarter of 2010 to 49% in the second quarter. Second, in the real estate sector, it appears that foreign investors have increasingly invested in real estate-related stocks and FDI since the second quarter of 2010. Their interests were magnified in anticipation of a medium-term increase in real estate prices (reflecting rising income and urbanization) as well as the yuan’s appreciation.

A mild slowdown of economic growth is expected in the second half of 2010, reflecting a tighter regulation on bank loans, as well as the anticipated sluggish growth in the United States, Europe, and Japan. In particular, SMEs in China may earn lower profits owing to the rise in minimum wages and the scrapping of export tax rebates. Meanwhile, a possible decline in domestic demand and import growths may decelerate global economic growth, including SMEs in the APEC region.

Japan

Japan has been suffering from prolonged deflation. Its economic recovery pace has currently lost momentum, as its real GDP growth rate dropped from 4% (annualized, quarter-to-quarter basis) in the first quarter of 2010 to a mere 1.5% in the following quarter. The end of favorable tax measures for buyers of new environment-friendly cars in early September 2010 may reduce sale volumes, further depressing domestic demand.

The recent sharp appreciation of the yen (reaching ¥83 against the US dollar, the highest in the past 15 years) has emerged as a major concern for the government as exports remain an important driving force for Japan’s economic recovery. The appreciation is largely driven by (1) a growing demand for safe-haven currencies (such as the yen and the Swiss franc) in the face of growing uncertainty over the economies of the United States and Europe, (2) persistent deflation (implying a limited possibility of the yen’s depreciation), and (3) increasing trade surpluses. Amid growing pressures, the Bank of Japan (BOJ) attempted to contain the yen’s appreciation in August 30th, 2010 by introducing a six-month financing operation of 10 trillion yen at the policy rate of 0.1%. The impact of this measure was limited since the market already anticipated this move ahead in time and the scale of the operation was smaller than expected. In September 9th, the Finance Minister, Yoshihiko Noda, hinted anxiety over China’s increased purchase of JGBs as a possible source of the yen’s appreciation.

The government and BOJ finally intervened in the foreign exchange markets of Tokyo, London, and New York unilaterally in September 15th, after the yen reached ¥82 and call for the intervention by the employers’ associations magnified. The last intervention took place in March 2004. The scale of the intervention for one day is estimated to have reached ¥2 trillion yen, the record level. The action was taken swiftly after Prime Minister Naoto Kan won a sweeping victory in an internal election for the head of the ruling Democratic Party of Japan (DPJ) in September 14th (so that he is able to remain as the Prime Minister). Immediately after the intervention, the yen shifted to around ¥85 yen against the US dollar, instead causing the appreciation of the euro and the pound against the US dollar. Given uncertainties in Europe and the United States, it is possible that the yen may begin to appreciate again in the near future.
While the persistence of the yen’s appreciation affects the Japanese manufacturing sector adversely, it triggers an exodus of Japanese firms to an emerging Asia with potentially large markets and low cost labor force. This, in turn, will accelerate regional economic integration further, contributing to the SMEs in the APEC region.

Korea and Chinese Taipei

Both Korea and Chinese Taipei achieved remarkably high economic growth owing to active investment and export activities. However, export growth is expected to slow down in the second half of 2010. Furthermore, in Korea, a deterioration of the real estate market (caused by an oversupply of housing) may affect consumption adversely, given that real estate accounts for 80% of household assets. In Chinese Taipei, major manufactures in the personal computers, liquid crystal panels, and portable phones sectors have faced declining profits. This reflects increasing competition and rising wages in their production sites in Mainland China and sluggish demand in the United States and Europe. (The author is Professor of Economics, Keio University.)

Southeast Asia

Currency Appreciation and Inflation Pressure impose threat on regional economy

Honghui Cao

It turns more and more obvious that the currencies are experiencing wide appreciation that attracts more capital inflow into most of the economies in this region and pushes forward the inflation pressure and the asset bubbles in real estate market. That the U.S. presses China to make RMB appreciate further more quickly might stimulate the conflicts of exchange rate regimes in this area and make the coordination of exchange rate more complex. The local currencies would be confronted with more pressure to be appreciated in the coming months.

Baht against US dollar reached the peak at 31.26:1 on August 30th since March 2008, and was appreciated by 6% in August compared with the same period of last year. The central bank raised the interest rate to 1.75% on August 25th, the second time to tighten the money supply in the last two months, meaning that it does not care too much about attraction of more capital inflow into the market. Actually, CPI in August rose by 3.3% year-on-year.

Another example of roaring real estate market occurs in Singapore. The price goes up by 11% in the first half of this year, and by 38% year-on-year, hitting the historic record in 1996. At least more than 17% buyers are from China in the second quarter, which would overpass Indonesian buyers afterwards. The booming market results in the intervention from Singapore government including the stamp tax for the transaction of houses within less than 3 years and more cash payment requirement for the new houses. This adjustment might make the housing market calm down in the coming months. But what would it go if the currency continues to be appreciated with more capital inflow?

Similarly, various capital flows into the real estate market in Malaysia with the ringgit appreciation which hits 3.1283 against US dollar on August 19th, reaching the peak in past 13 years.
The currency appreciation is influenced by the new decision of the central bank that ringgit can be utilized as the tool in cross border settlement. The housing prices go up to 10%-15% in the first half of this year.

In contrast, the State Bank of Vietnam announced another 2% depreciation of Vietnam Don against US dollar, the third time this year to make its currency depreciate. The central bank intends to improve Vietnamese textile products and rice export and to descend its trade deficit. The growth of CPI slows down to 8.2% in July from 9.2% in April, making the effort to depreciate the currency a little easier. But the inflation pressure would remain since the US dollar would be depreciated if the market players short US dollar. In fact, Fed would start its new round to purchase the assets which stimulates the quantitative ease policy expectation correspondingly.

More seriously, the Philippines continues suffering from the inflation pressure, tremendous fiscal deficit as well as the high unemployment. CPI hits 4% in August, higher than 3.9% in July and the average CPI in the past eight months reaches 4.2%. Government income/GDP descends continuously which is much lower the other economies of this region. Unemployment rate maintains above 7.6% and one third of 92 million people have been suffering from poverty in this economy. The economy as well as the society is still trapped in the tunnel. (The author is Director, Financial Markets Division, at Chinese Academy of Social Science.)

South Pacific (India, Australia, New Zealand)

Growth is robust but domestic demand lags behind

Kenneth Waller

Australia: Economic outlook sound despite uncertainties from the election

The final outcome of a prolonged election process has seen the Labor Government returned to power with the help of 3 independents and the Greens Party, creating the expectation of a government that to stay in power will be required to accommodate some Green Party policies and provide more funding to regional Australia. Changes in the Ministry left Wayne Swan as Treasurer, and Penny Wong (former Minister for Climate Change) replaced Lindsay Tanner, who retired from politics, as Finance Minister. The Prime Minister and the Treasurer have stated that they will continue to make jobs the focus of government economic policy. As well, there will be a strong focus on education, health and infrastructure and in particular on developing a fibre-based national broad band system.

The Australian economy is in a relatively very sound and robust sound condition. It retains an AAA credit rating, and based on the policy advocated by both major parties in the election, the budget would be brought back into surplus, after the stimulus package, within three years. GDP grew 3.3 percent from a year earlier in the June quarter, due to record commodity prices. The
unemployment rate declined slightly to 5.1 percent, and is expected to fall further. Business confidence rose in August to the highest level in four months. However, Australian business investment fell in the June quarter, reflecting cautious consumer spending patterns. Furthermore, the Australian Chamber of Commerce and Industry’s Small Business Survey for the June quarter pointed to the fact that while large businesses have been doing well, small businesses have been struggling due to insufficient demand.

The main short term concern for business owners arises from the government’s slender hold on power. There is the distinct prospect of inaction on major policies, and an expectation that the government will not meet its budget targets due to commitments made to the minor parties for regional development. The government has also committed to a tax summit by mid next year; however, it will not bring to the table the controversial mining resources tax or the goods and services tax. The period ahead will be a serious test of the Prime Minister’s skills in holding together a seriously weakened government dependent on its hold on power on the good will of a small rump of politicians that would not normally be in league with the Labor Party. Fortunately, the strong global demand for Australia’s resources and in particular demand from China, Korea, Japan and India and the completion of major infrastructure investments to support that demand will provide for a buoyant economic outlook.

**India: Maintaining domestic demand a concern but greater emphasis on foreign investment and trade policy**

During the April-June quarter, India’s gross domestic product (GDP) grew 8.8% compared with 6% in the year earlier, its fastest pace in 10 quarters. This has been attributed to the manufacturing sector, and trade and hospitality both recovering from a lower base. Furthermore, UNCTAD has reported that India has replaced the U.S. as the second most important foreign direct investment (FDI) destination for transnational corporations during 2010-2012. Domestic business growth, however, is still a concern. Market analysts note that foreign subsidiaries of Indian firms contributed 80% of their growth in net profit last quarter, but domestic activity is clearly the predominant driver of the economy. The June quarter, showed both weak private consumption and investment levels. A Nifty Survey has also attributed rising input costs to a decline in operating profit margins, hitting earnings growth in most sectors. The impact of corruption on the Indian economy is manifest in an estimated illicit out flow of $125 billion between 2000 and 2008, according to a survey by the Washington-based Global Financial Integrity.

There are continuing concerns about the effectiveness of the Indian authorities in dealing with inflation. There appears to be some level of policy uncertainty in bringing inflation down and in maintaining a strong growth strategy. Inflation measures have nonetheless undergone an overhaul with the inclusion of new items in the inflation index, such as refrigerators, computers and TV sets to better reflect changing consumption patterns.

While there has been concern about the pace of policy in the second term of the government, tax reforms are being implemented. Direct taxes code (DTC) legislation, will require some tightening of the taxation of profits earned internationally, the replacement of profit-linked incentives with investment-linked incentives and the introduction of tax provisions to provide the government with flexibility and taxpayers a sense of stability on rates. Provisions to increase the incidence of tax on will be made operational from 1st April 2012, and the implementation of a goods and services tax is under consideration.

Much greater emphasis is being placed on India’s external trade. The government has stated that foreign investment should be regarded as a priority in the pursuit of India’s foreign relations, and has instructed its foreign missions to vigorously pursue the economic component of relations with their host countries. A Japan-India trade deal is being finalized, with Japan planning to scrap tariffs on 94 percent of traded goods over 10 years. India-Laos trade links have also been cemented recently by business bodies.

**New Zealand: Legislation to fast track recovery from the Christchurch earthquake**
This month New Zealand saw the collapse of South Canterbury Finance (SCF), one of the largest non-bank institutions in New Zealand, and a major earthquake that destroyed much of the business district of Christchurch. The collapse of South Canterbury Finance did not shake confidence. Depositors were covered by the Government’s Retail Deposit Guarantee Scheme, which has accumulated funds to assist depositors in the event of financial institutional failure. As a consequence, the country’s credit rating, by Standard and Poor’s, was not affected by the failure; there was no contagion on the national economy. The impact of the collapse was felt mainly in the rural sector and specifically in the economy of the South Island economy.

The earthquake, however, does have consequences for New Zealand’s economic outlook. The rebuilding program will provide a boost to the weak residential building construction sector. Banks have arranged a range of financial packages to assist businesses recover. As well, the government increased its powers through legislation passed by parliament to help fast-track the rebuilding program in Christchurch. The legislation will also provide small and medium enterprises in the greater region free entry into a business mentoring program. No discernible change is forecast for the SME sector.

New Zealand’s economy, otherwise, appears to be healthy. Its five big banks have all posted profits for the first half of the year. Financial reforms have also been underway, with the Securities Commission approving the NZX to create futures markets, and the government has introduced a bill to create a new market regulator, consolidating the regulatory functions currently split across the Securities Commission, the Ministry of Economic Development, and the NZX, as well as granting it the power to enforce the duties of people involved in financial markets when it’s in the public interest. The regulator, known as the Financial Markets Authority (FMA) is expected to be operational by early next year. (The author is Director, Australian APEC Study Centre at RMIT University.)

Latin America

Positive Prospect for Debt Dynamics in Mexico
Cheng-Mount Cheng

Finance Minister Ernesto Cordero presented the government’s conservative 2011 budget plan to Congress on September 8th, in which the government plans to cut the fiscal deficit into half to 0.3% of GDP and pushes austerity in an effort to maintain Mexico’s hard-won reputation for fiscal responsibility.

The budget estimates 2011 GDP growth at 3.8% and inflation at 3.0%, and calculate revenues based on an average oil price at $63 per barrel. According to the budget plan proposed by the government, total revenues would increase 3.9% in 2011, with oil revenues up 4.5% and non-oil tax collection would reach the highest in 30 years at 10.3% of GDP. By contrast, government spending would increase by 2.1% only over the previous budget.
Cordero expressed in a press conference that “this package proposed to strengthen public finances through a public deficit reduction policy, certainty in the fiscal framework and improvement in spending quality and results.” Cordero called on Congress to keep taxes unchanged in order to maintain fiscal stability where opposition parties have been pushing to lower value-added taxes to 15% from 16%. He added that the government is proposing austerity cuts in administrative and operational costs of over 20 billion pesos.

The 0.3% budget deficit does not include investment in state oil company Pemex, which will increase by 12.4 billion pesos in 2011 or 2.0% of GDP, same as the ratio in 2010. The net total budget for Pemex would rise by 75 billion pesos to 335 billion pesos in 2011, less than the 400 billion pesos the company had pushed for. The government estimated 2011 oil production at 2.55 million barrels per day and exports at 1.14 million barrels per day.

With the proposed budget, the Finance Minister estimates that broad government debt will reach 36.6% of GDP in 2011, down from 37.1% in 2009 and 36.8% in 2010. In addition, Public Sector’s Borrowing Requirements (PSBR) are projected at 2.7% of GDP in 2011, down from an estimate of 3.2% in 2010. The government’s goal for debt policy in 2011 is to keep strengthening debt structure. The government intends to increase the share of the local debt market instead of borrowing externally, and to enhance liquidity of both fixed-rate and inflation-indexed securities. Another intention is to diversify its funding by reducing its reliance on traditional sources like the World Bank and the Inter-American Development Bank.

Against a backdrop of fiscal concerns worldwide and the shift among global investors in favor of Emerging Market local bond markets, Mexico has benefited from global conditions and received important capital inflows. With the inclusion of Mexico in the world indexes, foreign investors have shown a new appetite for holding comparatively bigger amount of longer tenure Mexico bonds, thus significantly lowered yields on the longer end of the yield curve. This would offer opportunities for Mexico’s debt management by lowering its costs of issuing longer-tenure bonds.

Still, Mexico government needs to demonstrate its determination to maintain fiscal discipline in order to improve its government debt to GDP ratio. Other reforms are also needed beyond the budget. As the Finance Minister constantly repeats what he has argued in the past, “the only way Mexico will achieve growth of over 5% a year will be if it passes structure reforms on labor, competition and tax laws, some of which are already being debated in Congress.” (The author is Vice President, Citi Taiwan.)

Mexico’s Debt to GDP ratio

Source: SHCP and Banamex.
Introduction

With the August holidays coming to an end, European governments have been returning to a troubling new reality: that the European economy may start diverging internally, with some economies in need of one set of policy measures, while others will need a contradictory set of measures (the stimulus versus austerity debate). The fear is that this would be impossible for the European system – and especially the European Central Bank (the ECB) – to manage effectively, and with pan-European political support. Debate about the renewed likelihood of a sovereign debt default by Greece, Spain, Ireland and Hungary and others has also revived.

An EU recovery will likely settle at a low level of economic growth for many years, with unemployment (currently about 23 million people) continuing to cause deep concern. Combined with an ageing population and stricter controls on immigration, this situation will compromise Europe’s competitiveness.

Low internal growth, combined with low U.S. growth and diminishing growth levels in Asia, also makes a trade-led recovery less likely.

The EU is continuing with its agenda to overhaul and reform its systems of financial and banking regulation and to improve its economic governance and policy coordination.

General situation

- There are growing concerns about emerging patterns with respect to growth, inflation, unemployment and competitiveness.

- A two-speed Europe seems to be emerging, which will pose complex policy challenges to Europe’s leadership. Key features include:
  - Some economies are recovering faster (Germany and France in particular), while some economies (for example, Greece, Hungary, Ireland and Italy) remain in recession;
  - Economies in recession need strong stimulus support even though they are committed to austerity measures because of government deficits;
  - Asset (housing) prices likely to fall further in some economies;
  - Economies that are growing prefer to concentrate on austerity measures alone.

- The UK: Current plans to reduce fiscal deficits by £30bn per year may lead to 600,000 government job losses. Inflation is now running at 4.7%. Recent figures also show deterioration in balance of payments, mainly in manufacturing.

- Although the Euro is weakening, EU exports are becoming more competitive in global markets. A number of EU economies could benefit from a weak Euro, re-enforcing the two-speed reality.

Implications for APEC SMEs: As with previous reports, it is difficult to establish the direct effect of current developments, however indirect effects likely to be as follows (some of which
remain unchanged):

**Micro/Firm Level**

- Strong and rising Asian currency values will make APEC SME products significantly more expensive in EU markets;

- Weak Euro and Sterling values should make European products more competitive in Asian (and particularly Japanese) markets;

- EU internal demand will remain weak except for food and energy necessities where prices are now expected to rise.

**Macro/National Levels**

- Fears about inflationary pressures within the EU gaining strength which may lead to higher interest rates and a further fall in demand for goods and services.

- Sovereign debt fears in several EU economies leading to severe cuts in government spending. This in turn is expected to reduce SME demand to an extent – already evident in Greece, Spain, Ireland and Italy.

- European SMEs increasingly protectionist, but it remains to be seen how this will play out.

**Important developments during the month under review (August 15th – September 15th, 2010)**

August and September are slow months in Europe, and it usually takes time for governments to get going. Nevertheless, the following important developments/initiatives took place:

- A new Single Market Act is planned for October, which will include provisions for European SMEs to access funding through a network of specialized stock exchanges. The objective is to improve SME access to funds, and to reduce the cost of these funds, making them more competitive.

- The EU Council’s economic governance task force convened urgently on September 6th to review developments. A double dip recession and rising bond market charges for borrowing dominated the agenda.

- Eurozone governments need to raise €80bn during September and some of the more heavily indebted economies may find this hard or expensive.

- The EU is planning to issue bonds to fund large infrastructure projects. More than €400bn would be needed to complete project commitments under the Trans European Networks (TEN) plan. This includes transport (mainly rail, river and road networks), telecommunications (the Galileo project) and energy market integration (yet to begin).

- Efforts will be made to clamp down on Europe’s derivatives and hedge fund markets. Details are awaited and to be agreed.

- Turkey’s referendum results should improve accession prospects for Turkey. If this occurs, it will have massive implications for the EU as an economic and political system. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)
An eventless month for regional economy but bumpy path ahead for Greece

Kuo-Yuan Liang

East Europe economies are generally sound in month of calm

August was a relatively calm period in contrast to the past 3 quarters since the Greek sovereign debt issue came afloat. In late August and early September, markets were not in a state of panic, nor were there too much reaction to newly developed or older issues that had resurfaced again. Amid the calmness, it allowed the regional economy to have a break from the disruptive market forces and regional governments to focus more on their own economic performance.

After GDP growth improvement in 2nd quarter, regional economies continue to recover

Looking at the readily available data, the overall economy was relatively good during August. The survey data of ESI (Essential Science Indicators) showed continued overall improvement within the region whether in terms of the continental Europe, Transylvania or the Baltics. Although the current situation in Greece is not particularly upbeat, where the trend has continued for some time, the good news is that the figures show the situation improving from worse to bad. The current assessment is not as dreadful now, based on the economic hole and challenges they need to overcome.

The exchange rates showed a slight depreciation in the Hungarian Forint against the Dollar, but this might simply reflect the preexistent issue it had with the International Monetary Fund (IMF) (and European Union, EU) over the scale of austerity measures. Meanwhile, the value of other regional currencies was relatively stable over the past month or so. In addition, another survey based source, the PMI (Purchase Management Index) conducted by HSBC and Markit, which is available for Poland and Czech, both showed robust advances toward a path of recovery in their manufacturing sector. The newly announced 2nd quarter economic growth figures also showed widespread improvement, with the exception of Greece with a negative 1.8% quarterly GDP growth, widening further from the -0.8% in the 1st quarter.

Minimal reaction to European sovereign debt issue, caution still advised

Once again since June the issue in funding governments with weaker financial positions, namely the PIIGS (Portugal, Ireland, Italy, Greece and Spain), or the peripheral economies as market sources refer to, might face refinancing difficulties in international markets once worries over European debt resurfaces and international funds may leave, have silently picked up during the past month. The CDS (Credit Default Swap), or the cost of protection from default or restructuring of debt, of PIIGS and most East Europe economies have risen over the past month, reminding people about the turbulence that previously shook everyone for some time. The better part of the news is, only the CDS of Ireland have reached new highs. Meanwhile, the bad news is, despite Greece already receiving support from the newly established EU-IMF bailout, where additional funds have just recently been approved by EU finance ministers, its CDS inched toward previous highs.

Whether the European debt issue will strike again is still in question. However, the prospect for
most regional economies is not that pessimistic. Aside from the skepticism surrounding Greece, the regional economies are recovering healthily. In the longer term, given their respective competencies to further drive up the economy, the issue of sovereign debt should eventually be only a matter of confidence and time, especially considering that these economies still have control over their own domestic currencies, a luxury Greece does not have.

**Bumpy path ahead for Greece: Austerity measures are just kicking in**

What is the current status regarding Greece? The reality is, they are not firmly out of the bottom yet. The austerity measures are just in the initial phase of implementation and its impact is still yet to be fully experienced. The process is painful even if it succeeds in cutting deficit – the economy is shrinking, making outstanding debt appear increasingly daunting in terms of the ratios of GDP, not to mention servicing a debt larger than the economy at borrowing costs well over the annual nominal GDP growth rate. The tougher part is, Greece does not have the option of inflation, as Germany is certainly against, nor can Greece depreciate the common currency unilaterally to boost tourism and exports.

**Not all fingers point to Greece: the creditor who lends to a gambler can blame no one**

When will all of this be over? The Greek economy, where the public sector is being shirked, is in a major restructuring process, and is searching for the appropriate size and business model for the future economy. But before that they will need to first hit bottom, and then build up from there. The quicker it hits the bottom, the faster it can start thinking on how to climb up. Yet, unless they can immediately achieve a sizable shrink to their budget deficit this year, and work on maintaining a sustainable deficit in the many years to come, there is no way Greece can find bottom before being bankrupt if they are to service the debt their parents irresponsibly owed and creditors irresponsibly allowed them to owe. Creditors speculate that Greece will not dare to go bankruptcy, and Eurozone members are being dragged down in the process as extra insurance.

In conclusion, if we are to see improvement in Greece, budget deficits must shrink swiftly, and the initial austerity effect needs to get through soon to allow GDP growth to turn positive, and see creditors as a whole agree to at least a debt service window. These are all tough to meet and it is up to the regional leaders to make it happen. (The author is President, Polaris Research Institute & Honorary Professor, College of Technology Management, National Tsing Hua University.)

Russia's economy has performed well over the past six months with GDP increasing by 4.2%, industrial production increasing by 10.2%, exports accelerating 25.8%, and cargo shipments expanded by 12.2%. The Russian government is expecting to announce adjustments for this year's economic growth to somewhere over 4%. However, a significant number of Russian economists and New York University Professor Roubini are generally concerned with the excessively concentrated
dependence of the Russian economy on basic commodities and raw materials exports, as well as inadequate domestic investment. Additionally, Russian think tanks have recently announced their September and October commercial forecasts. According to the report, most enterprises expected that sales performance over the latter half of the year will appreciably abate, indicating the slow recovery of domestic consumption and overseas exports, and the difficulty to maintain the strong pace of their performance over the first six months of the year. It appears that the current favorable trends for recovery in the Russian economy may be lacking in stability.

Exports of basic commodities exercise an extremely important role in the overall stability of the Russian economy, and over the past two months, grain production exports have been subjected to significant influences natural fire disasters, with the Russian government feeling required to implement a series of stages for export control measures in response to domestic grain demand; while at the same time another export dependent industry, namely the Russian energy export sector, has enjoyed a number of recent measures implemented to accelerate energy exports and enhance trans-border industry cooperation.

In terms of the overall foreign trade strategy perspective, in April of this year Russia returned to international bond markets with issuance of a government bond in the amount of only some US$5.5 billion. Since a considerable percentage of the Russian banking system's capital still comes from abroad, Russia must continue to rely on trade surpluses to accumulate foreign reserves, to avoid risks such as deterioration of sovereign debt, inadequate bank liquidity, or ruble exchange rate volatility. Thus, acceleration of energy exports and international cooperation should provide practical support for accumulation of US dollar foreign reserve holdings, thereby averting many of the aforementioned risks.

In terms of the specific measures applied by Russia, initially they have reduced their crude oil export tariffs, effective from October 1st, with reductions between US$6.5 to 8.5 per ton, representing overall reductions of 2.4%. Additionally, Russia has begun energy cooperation with Canada, Korea and China, focusing mainly on the areas of nuclear energy, electricity generating plants, and oil and natural gas exploration, while Canada and Korea hope to increase their Russian natural gas imports; while China, contingent on a loan of US$6 billion, secured agreement for a 25-year increase in the provision of Russian coal supplies, and as Russia's natural gas prices are lower than North America’s and Russian coal exports to China are roughly only 80% as costly as those from Australia, it is expected that these energy cooperation efforts will result in enhanced exports volume for these sectors, ensuring continued important contributions to her exports, though perhaps of questionable impact in terms of reducing Russian unemployment, with oil prices and hot money it is possible there will be an increasing Ruble exchange rate, which may counteract some of the benefits.

In the Middle East, Iran remains on tense terms with the West, with economies applying varying degrees of economic sanctions in response to the adoption of UN resolutions, though the effects are practically speaking, rather de minimus. A highly interesting development involves the September 2nd meetings between China’s Commerce Ministry and Iran, with discussions about establishing a bilateral Joint Investment Council, as China expressed its intentions of expanding imports of Iranian oil, and expeditious deployment of a mechanism conducive to enhancing bilateral investment relations. These efforts coincide with China’s more cautious deployment of economic sanctions, so as China avoids overly aggressive sanctions efforts, it can be expected that the Iranian situation will not likely continue to deteriorate.

Turkey, however, happens to just be conducting a referendum calling for constitutional amendments, which aim to enhance worker and union rights, while further limiting the domestic political influence of the military, in furtherance of Turkey’s attempts to comply with EU accession requirements. But the ruling party’s constitutional amendment proposals are being subjected to vociferous dissent from the opposition, focusing on complaints that the constitutional amendments would permit the administration to interfere in the judiciary, causing a new source of public corruption, but international commentators are not certain that these amendments won’t result in a new round of political turmoil or a military coup d'état. (The author is Vice President, Taiwan Institute of Economic Research.)
During the last one month (mid-August to mid-September), there have been gradually increasing signs of a crisis in the global commodities market. There were slight gains in commodity prices due to continued US dollar depreciation, but in terms of demand, investors are unsure that prices will continue to rise amid an increasing possibility of a slowdown in the global economy.

The commodity that received the most attention was precious metals, especially gold. Gold prices set a new historical high on the back of an increase in safe asset preference. On 15th September, gold prices gained 1.9% to settle at a record high of 1274.75/oz, while silver prices gained 2% to close at 20.43/oz, the strongest close in two and half years. Palladium also showed a strong gain to close at $550/oz, its strongest close since late April. However, the increase in safe asset preference does not indicate that prices of other industrial commodities such as crude oil and copper will go up.

Under the current situation of spreading macroeconomic pessimism such as the G2 (U.S. and China) risk, safe asset preference can translate into an avoidance of risky assets including most industrial commodities. Therefore, the possibility of commodity prices going up within the next month has weakened amid growing concerns of a slowdown of the G2 economies. However, this means there is an increasing possibility that SMEs will face difficulties in selling their products rather than confronting cost problems.

The two top commodity indices, the Reuters CRB (Commodity Research Bureau) index and LME (London Metal Exchange) non-ferrous index, have shown slight increases from mid-August to mid-September. The Reuters CRB index (year 1967=100) moved up from 487 points to 526 and the LME index (April 1999=1,000) increased from 3,218 to 3,519. The average for the Reuters CRB index from mid-August to mid-September increased 2.5% while the average for the LME index rose 3.7%. Such changes are evidence that upward trends or steep slopes still remained in the commodity indices compared to the previous month. In terms of price variations, the daily price changes of the Reuters CRB index were higher than in the mid-July to mid-August period, but those of the LME index were not, indicating a smaller increase in investment risk for non-ferrous resources.

As for energy prices, the WTI (West Texas Intermediate) near month futures price moved within the range of 71.63 and 77.19 USD/barrel and Dubai crude prices moved between 70.58 and 75.91 USD/barrel during the same period. Both the minimum and maximum values were smaller than those in the mid-July to mid-August period. Among non-ferrous metals, or more commonly known as base metals, tin and zinc prices rose the most. The average prices for tin and zinc rose 9.2% and 5.9% respectively, compared to the previous month. The hottest base metals in the first half of this year, nickel and copper, also showed rising price patterns. The highest price for copper and nickel for the last one month period were 7,661 and 23,180 USD/ton, respectively. The recent prices of these two base metals are still lower than the yearly highs of 7,950 and 27,600 USD/ton recorded in
April. Other base metals, including aluminum and lead, also revealed increasing variations.

The one important variable we must keep a closer eye on in the coming month (mid-August to mid-September) is new evidence of a slowdown in U.S. consumption and employment. If fresh evidence of a slowdown in the economy emerges or an unexpected fall occurs, commodity prices will be affected, in the way of a downward trajectory. SMEs will benefit in terms of cost saving, but it also means that their business environment will deteriorate. Korea’s SMEs have already become more pessimistic in their economic outlook, weighed down by a probable U.S. economic slowdown and other external negatives. The Bank of Korea (BOK) reported in September that the manufacturers’ business survey index stood at 103 for July, down from 105 in June, the first decline since last December, indicating companies including SMEs have become more pessimistic about the business outlook.

Consumers may also start tightening their belts on gloomier economic prospects and rising consumer prices. If external economic conditions further deteriorate, it could seriously dampen SMEs’ economic activities. SMEs dependent on exports will suffer more from the possible global economic slowdown. Therefore, SMEs should have a conservative business plan for their sales and profit for the remaining months this year and the following year. (The author is Research Fellow at Samsung Economic Research Institute.)

<Table> Changes in Raw Material Prices - August 16th to September 15th, 2010.

<table>
<thead>
<tr>
<th>Index</th>
<th>Crude Oil (USD/barrel)</th>
<th>Non-ferrous Metals (USD/ton)</th>
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<tbody>
<tr>
<td></td>
<td>Reuters CRB</td>
<td>LME</td>
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<tr>
<td>Min</td>
<td>487</td>
<td>3218</td>
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<tr>
<td>Max</td>
<td>526</td>
<td>3519</td>
</tr>
<tr>
<td>Average</td>
<td>503</td>
<td>3401</td>
</tr>
<tr>
<td>Mid-July to Mid-August Average</td>
<td>491</td>
<td>3279</td>
</tr>
</tbody>
</table>

Note:
1. The Reuters CRB index recorded 100 in 1967 and LME non-ferrous index recorded 1,000 in April 1999.
2. The WTI price is based on the near month futures price traded in NYMEX and non-ferrous metal prices are based on the spot prices traded in LME.
The biggest economic problem in the U.S. right now is the lack of aggregate demand, which has raised the unemployment rate, and has kept that rate high. This problem arose, of course, from the recent economic crisis. Unless aggregate demand is increased, the U.S. cannot grow, and a “double dip” recession cannot be ruled out. To sustain aggregate demand, the U.S. needs to increase its exports. U.S. consumption, investment, and government spending cannot increase numerously in the future. Consumers are tapped out with high debt and lower home equity. Businesses are more pessimistic about the future, and are not investing very much. Public debt is too high for the U.S. government to increase spending. That leaves increased exports as the main hope for larger U.S. aggregate demand.

U.S. policymakers are especially targeting U.S. small- and medium-sized enterprises (SMEs) to contribute to the expansion in U.S. exports. Typically, in the U.S., enterprises with fewer than 500 employees are considered small- and medium-sized enterprises. Of the $1.1 trillion in U.S. exports of goods in 2009, small- and medium-sized enterprises (SMEs) account for about 30 percent. Recently, much of the growth in SME exports was attributable to the increase in the number of new market entrants—SMEs that were new to exporting.

Policy-makers are especially interested in SME exports, because collectively SMEs account for a large proportion of U.S. employment. Today, SMEs employ slightly over half of the private sector workers in the U.S. SMEs under 100 employees account for about 36 percent of all U.S. private sector workers. By expanding the opportunities for SMEs to export, the total employment of U.S. workers can be increased. To do this, policies should be adopted to make it easier for SMEs to export, since as we will see below, only a very small proportion of the largest U.S. SMEs actually engage in any exporting at all.

Characteristics of U.S. SMEs in the Export Sector

While SMEs account for a sizable fraction (30 percent) of total U.S. exports, only a very small fraction of SMEs actually export. Only about 2 percent of U.S. SMEs engage in any exporting activity. Exports contributed to only 4 percent of SME GDP, lower than the 11 percent contributing to large firm GDP. That is, the vast majority of SMEs do not export. The relatively small percentages of SMEs that do export, export a lot, and collectively account for a sizable fraction of total U.S. exports.

There are two reasons for the under-representation of U.S. SMEs in U.S. exports. The first reason is that most U.S. SMEs are in the services sector, particularly in wholesale and retail trade. Services accounted for 80 percent of
SME employment, while manufacturing accounted for 10.1 percent, with construction and mining accounting for the remainder. Wholesale and retail trade accounted for 72 percent of the service sector of SMEs; thus accounting for 60 (0.72*0.80) percent of overall SME employment. Output of the service sector such as wholesale and retail trade generally cannot be exported.

The second reason is that exporting entails heavy barriers, both explicit and implicit. Firms that seek export markets must find and act on opportunities abroad. Factors such as limited personnel, the inability to meet quality standards, lack of financial backing, and insufficient knowledge of foreign markets limit the ability of SMEs to export, compared to larger firms.

Specifically, SMEs seem to be particularly concerned about the following barriers to exporting. First, they are especially concerned with their lack of access to funds, both trade finance and working capital. This often prevents them from financing purchases by foreign buyers, which encourages foreign buyers to choose suppliers that are able to extend credit. Second, SMEs report that the costs of transporting goods put them at a disadvantage compared to larger firms, who can spread out these costs over larger volumes. Third, costs of understanding and complying with foreign government regulations can be significant barriers to exporting. These costs include the lack of standardized regulations across economies and the administrative costs of compliance (testing, certification, and sanitary requirements.) Finally, the limited knowledge by SMEs of foreign markets is a significant export barrier, because SMEs do not have the resources to hire staff with the specialized skills to identify export opportunities, understand the foreign language and culture, and establish relationships with foreign buyers.

Thus, exporting firms that are able to overcome these substantial barriers tend to be larger and more productive. Studies show that while only about 2 to 3 percent of all U.S. firms export at all, the top 1 percent of these exporting firms accounted for 11 percent of U.S. workers, and 90 percent of the value of U.S. exports. Importantly, exporters have been shown to be more skill- and capital-intensive, to display higher productivity, and to pay higher wages than non-exporting firms. The picture that emerges is that U.S. exports are dominated by larger firms, and the few SMEs that export are relatively large, skill- and capital-intensive, and are highly productive.

The principal markets for SME exporters are in Canada and Mexico, and their products are in computers and electronic products and machinery. This is probably because U.S. SMEs are more familiar with these nearby markets, which would lower trade costs. Yet, recently, SMEs have increased their share of exports—mostly computers and electrical products—to further away small-but rich economies such as Hong Kong, Israel, and Switzerland. Many of the owners of these SMEs tend to be immigrants from these economies. For example, SMEs exporting to Hong Kong tend to be owned by people emigrating to the U.S. from Hong Kong.

What can be done to expand U.S. SME exports?

Compared to larger firms, the typical SME is “resource constrained,” which lessens their ability to export. SMEs simply do not have the money to acquire expertise to export, to learn about foreign markets and distribution channels, to navigate the foreign bureaucracy. Exporting is often viewed by SMEs as risky, and their small scale limits their ability to withstand losses. As companies become larger, the unit cost of many goods and services decline, as the bargaining power of the companies become stronger. However, the internet and new technologies that benefit smaller-scale production of commoditized products have helped expand SME export sales.

Recognizing the importance of SMEs in generating employment in a recessionary environment such as nowadays, the U.S. government has tried to implement policies to expand SME exports. To alleviate the lack of funds of U.S. SME exporters, the U.S. Export-Import bank provides export financing assistance. The U.S. Commerce Department holds trade fairs to facilitate the contact of U.S. SMEs with foreign customers. However, these measures appear to be insufficient, from the point of view of U.S. SMEs. Clearly, more needs to be done to promote the exports of U.S. SMEs. These additional measures may include establishing industry consortia to...
allow SME manufacturers to share information and risks related to foreign regulations and markets. The government can also help SMEs establish links with larger companies, so that the larger companies can facilitate the SMEs to establish business relationships with foreign buyers and global logistics and shipping firms. (The author is Professor at University of Southern California.)

Preventative measures are urgently needed

Kenneth Walker

Financial crises occur with alarming frequency; they are a common phenomenon, and each has its own particular causes; they differ, if only in varying degrees, one from the other. They will continue to happen and while there is something we might learn from each crisis, the causes do vary and they are unlikely to be repeated in precisely the same way. In short, each crisis has its own unique characteristics. For this reason, there is no manual to guide individuals or institutions through a financial crisis. But that does not mean we should not learn from each crisis and build on measures to prevent or minimise the prospect of future crisis.

Some critical lessons learnt from the global financial crisis

Indeed, the IMF (International Monetary Fund) and other major financial institutions have researched the causes of financial crisis that have occurred over recent decades. It would be a cause for deep concern, and some despondency, if societies did not learn lessons from past events. In the main, lessons are learned but the fact is that causes differ and crises do have unique features. Arguably, the emerging focus on stress testing of banks and on macro prudential supervision as responses to the recent global financial crisis reflect some critical lessons learned from that crisis. Some critical lessons are that if prudential regulation is fragmented and key financial functions are outside the reach of regulatory authorities, pressures will build in a global financial environment which can overwhelm the capacity of even the most rigorous prudential regime. The emergence of shadow financing revealed major weaknesses in regulation and it has led to the development of macro prudential supervision in an effort to provide a holistic approach to financial regulation.

The emphasis now placed on the stress testing of major financial institutions is a response to the weaknesses in risk management in those institutions in rapidly changing financial systems where capital provisioning and governance systems do not fully reflect the inherent risk on the books of those institutions.

An analysis of the global financial crisis points to fundamental weaknesses in regulatory coordination in a world in which financial markets have integrated at a pace beyond economy’s and international cooperative regulatory capacities. Indeed, this is one of the central matters being addressed by the G20, the Financial Stability Board and the various global financial system standard setting bodies. Greater attention is being paid to enhancing the global regulatory coordinating framework. This is a response to a framework which was ineffective; a lesson learned from the crisis.
Perhaps, however, the major fundamental weakness revealed by the crisis was that of the failure of governments and regulatory agencies to take early action to combat an expansion of money and credit growth and excessive leveraging over a sustained period of time. This is not a new phenomenon and in recognising this as a fundamental cause of the crisis, there is a basis for genuine concern that societies do not learn all the lessons they could from past crisis. If, for whatever reasons, societies choose not to pursue policies that would minimise economic and financial instability, they will almost certainly be confronted with unpredictable and often serious consequences.

The lesson learned from this point is that poor policy choices made by responsible agencies can be as fundamental to the occurrence of crisis as are external or other factors. That is, crisis often results from wrong policies. Ensuring that government actions do not conflict with sound macro-economic policy objectives is a critical factor in minimising the prospect of financial and economic crisis. This objective should be at the forefront of economic management decision making. It is an essential prerequisite in any approach to preventative crisis management.

External factors may and do inflict destabilising forces on an economy. But here again a sound macroeconomic framework – for example, flexible exchange rate mechanisms which allow adjustment to volatile capital flows or to sharp changes in commodity prices – would help facilitate a smoothing of the adjustment process and minimise the prospect of a crisis occurring. This may also be regarded as preventive crisis management but it is a different point to the one made earlier.

**Measures preventing the occurrence of crisis**

The global financial crisis occurred in part as a consequence of integrated capital markets and the underlying transmission mechanisms that follow as an inevitable fact of integration. Integration has brought massive benefits in terms of facilitating global growth and the exchange of goods and services. But contagion and the prospect of destabilising forces occurring in and between markets is perhaps an increasing fact of life. It is an aspect of capital market integration.

Two important measures are seen as minimising the prospect of crisis occurring. One relates to an emphasis on constant monitoring of economic phenomena, particularly in respect of data that is reflective of forces that give rise to problems occurring as a consequence of transmission across financial markets. This is the essence of macro prudential management. The collection, monitoring and dissemination of data are not new; it provides the basic material on which good economic policies are designed. But global financial integration has sharpened the focus on a holistic approach to how policy makers and regulators need to view influences on economic, financial and regulatory policies arising from the massive increase in cross border capital flows and the rise of new financial instruments.

As important to a better understanding of data is the coordination of responses between economy’s jurisdictions. Crisis management at an economy’s level is one matter; to be effective in an integrated market system there is an obligation on government agencies to exchange information on a regular basis and to agree to take coordinated action in regard to the activities of institutions whose actions seem likely to cause major market disruption.

It is not easy to achieve the coordination at the suggested level. Some economies may well resist passing data to others because it may impinge on market confidentiality. As well, government agencies may lack the legal authority to engage in serious coordination. But as financial institutions choose to deepen cross-border activities, coordinated regulatory approaches will become an inevitable political and policy requirement. Success in that would help minimise future crisis occurring as a consequence of integration.

More direct lessons learned in the management of the global financial crisis include the importance of quick and decisive action in determining the essential issue that economies faced when confronted with a liquidity crisis. Of particular interest was the tendency of government authorities to take independent action in efforts to minimise the impact of a global liquidity crisis.
The actions taken varied between economies but perhaps the striking lesson learned was that confidence returned to markets primarily as a consequence of the G20 and major economies agreeing to some level of global coordination. The crisis came under control because of determined and coordinated action by the major economies. As noted earlier, there is still much more to be achieved in shaping global coordination but it will be an essential ingredient in the management of major financial turbulence in the future.

The crisis also highlighted many shortcomings in the way in which economic and financial authority is exercised in central governments. Legal powers and regulatory authority and the power to take urgent and critical action were clearly not always in alignment in most if not all economies. Weaknesses or shortcomings in institutional structures compounded the problem of crisis management, suggesting that much more work is needed if economies are to effectively manage future crises. And this point illustrates the importance of stress testing financial institutions on ways in which they would handle phenomenon – like the absence of short-term liquidity, over varying periods of time or if they were faced with major reputational damage.

Issues of survival or exiting markets have always been a factor facing institutions. However, those kinds of challenges may occur with greater frequency for both financial and non-financial firms as a consequence of financial market integration. Equally important is the need for national financial and regulatory agencies to be subject to stress testing to assess their effectiveness and their powers to handle crisis situations. (The author is Director, Australian APEC Study Centre at RMIT University.)
How did the SMI Association of Malaysia help SMEs overcome crises?

Chua Tiam Wee

Since its inception in 1995, the SMI Association (Small and Medium Industries Association) of Malaysia has helped its members and other SMEs in Malaysia to overcome various crises that affected the SMEs with timely proactive actions. These crises include:

The Asian Financial Crisis of 1997-98
The SARS Epidemic Crisis of 2003
The Petroleum Price Hike Crisis of 2008
The Global Financial Crisis of 2008-09

SMEs are known to be agile, having greater flexibility, able to make decision fast, having ability to adapt to market changes quickly due to the owner operated nature of its business. However they also have limited resources, often with resources that can only sustain their business for several months when affected by crisis. Hence they need fast proactive assistance especially from the government to overcome the crises. On the other hand, the Association can play an important role in getting the feedback on the problems SMEs faced and help government come up with the right, appropriate and timely policy measures that can help turn around the SMEs and the economy fast. For example, it is a common reaction of the financial institutions to deleverage, turn cautious when faced with economic crisis and become risk adverse and shy away from the SME financing when this financial support is most needed to tie over the difficult period. Hence government intervention is necessary to prompt the financial institutions to continue to support SME financing in times of crisis.

During the Asian Financial Crisis in 1997-98, the SMEs in Malaysia were facing problems of severe economic contraction, severe credit squeeze in the banking system, rising interest rates, severe currency volatility, depreciation of the ringgit, and a drastic drop in market demand in the economy.

The problems SMEs faced were promptly feedback to the Malaysian government and the Association had a top level dialog with the then Deputy Prime Minister cum Finance Minister, resulting in setting up of an initial 1.5 billion ringgit (1 USD =3.15 ringgit) Fund for Small and Medium Industries carrying a low interest of 4%. Thus banks are able to lend out to SMEs using this government fund to overcome the credit squeeze and this has helped many SMEs to survive. The Association then helped to disseminate information and helped SMEs to secure this special funding through a economy-wide roadshow of several cities. Meanwhile, our then Prime Minister Tun Dr Mahathir Mohamed took the courageous and unorthodox measure of pegging the ringgit at 3.80 to US dollar and introducing selective capital
control measures including making the ringgit non tradable outside the economy to overcome the Crisis.

In addition, during this Crisis the Association also launched the Export Promotion Campaign and its economy-wide roadshows to encourage SMEs to export their products overseas especially to economies with purchasing powers that were not affected by the crisis. As a result of these campaigns whereby we impart knowledge and skills on export marketing, organize trade exhibitions and overseas trade missions SMEs were able to take advantage of the weak ringgit to export their products, offsetting the collapse in demand in the domestic market. Later the E-Commerce and ICT (Information and Communication Technology) Adoption Campaign roadshows were initiated to encourage SMEs to use e-commerce to market their products across borders enabling them to compete at low cost with the big corporations and to adopt ICT to enhance their competitiveness.

During the petroleum price hike crisis of 2008, the Association also took proactive actions to urge the government to set up a special SME Assistance Fund to help SMEs who were affected by the hike in petroleum prices as well as world commodity prices such as steel, plastics, food, etc. SMEs at that time need additional financing due to the increase in the cost of raw materials, logistics cost and various other cost.

During the recent Global Financial Crisis, the Association again provided feedback to the government on the problems SMEs faced by the credit squeeze and drop in export demand especially to USA, Europe, Japan and other economies affected by the financial crisis and come up with various proposals in the form of a SME Position Paper which the National President of SMI Association of Malaysia presented to the Prime Minister of Malaysia including setting up a special SME Fund, cuts in statutory contributions by the SMEs, interest rate reduction and import duties cuts to ease cash flows and increased government spending to offset drop in consumer demand. These proposals were used in formulating the Economic Stimulus Packages by the government.

As a result, Special Guarantee Funds for SMEs totally 12 billion ringgit out were set up out of the 67.5 billion ringgit Economic Stimulus Packages to ensure SMEs have adequate financing. The Working Capital Guarantee Scheme (WCGS) was most helpful and popular since what was needed by SMEs then was working capital and not funding for capital expenditure. This is because during this time SMEs have excess capacity having suffered drastic drop in demand with stocks piling up and facing cash flow problems with customers stretching their payments. Thus the government guarantee of 80% for the WCGS loan was important in prompting the banks to be more willing to lend to the SMEs again. During this crisis period, the Association also organized SME Fairs for SMEs to sell off their slow moving stocks at discounted prices to consumers and hold numerous talks on what SMEs should do and should not do to weather through the economic storm.

As a result of these crises, the Association also took proactive actions to organize activities and programs for its members and other SMEs to help them to be more prepared to face future crises as well as to have more permanent solutions. One of these activities is the SME 1-Stop Solution Exhibition (SMIOSS) which the Association has been organizing for the last 11 years. SMEs faced various challenges and problems in their daily operations as well as in expanding their business. However they may not know where to find these solutions as well as the time to source for the various solutions. With this in mind the Association has conceived the SMIOSS Exhibition which is unique in the sense that it is not the SMEs who are exhibiting but the solution providers to the SMEs, be it the product, service or business opportunities partners who are gathered under 1 roof to showcase their latest solutions to the SMEs such as financial solutions, access to the market, ICT solutions, human resource solutions, environmental solutions, etc. to the busy SMEs. With this SMIOSS Exhibition we hope the SMEs will be able to find more permanent solutions to their problems faced and will not have to do “fire fighting” which can lead to an internal crisis one day.

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Another of the Association’s proactive activity to help the SMEs is the SME Recognition Award
which is a prestigious Award the Association has been organizing for the 9th consecutive years. The applicants for this Award will need to fill up an elaborate questionnaire form including details of the 5 core competency areas of management philosophies, product, services & promotion, operation & technologies, human resource and financial performance. The applicants are then evaluated, moderated and paid site visits by the team of evaluators made of independent auditors, bankers, venture capitalists and successful entrepreneurs. During the process, the applicants are interviewed and given feedback using the SWOT analysis by the evaluators. In this way, the SMEs are able to find out their strengths and weaknesses and to benchmark against their competitors. On the other hand the Winners will become role models for other SMEs to emulate. In this way we hope to encourage our SMEs to have risk management in their organisation and we provide talks and collaborative programs with insurance companies to help SMEs reduce their risks.

Apart from this, the Association also carried out numerous other relevant activities for the SMEs to cope with globalisation, to cope with the challenges and opportunities with the implementation of the various Free Trade Agreements such as AFTA (ASEAN Free Trade Area) and CAFTA (Central America Free Trade Agreement), to cope with the challenges of ICT, technology and competition from cheaper cost producing countries. Last but not least we encourage our SMEs to have risk management in their organisation and we provide talks and collaborative programs with insurance companies to help SMEs reduce their risks.

Currently, our latest initiative is to help our SMEs to transform, to innovate, and to move up the value chain in line with our Prime Minister’s Vision to make Malaysia a high income economy and an industrialised economy by 2010. This is the latest challenge our SMEs faced as they are now being targeted as the growth drivers of this New Economic Model. (The author is National President, SMI Association of Malaysia.)
Japanese Government Intervenes after Sharp Rise in Yen

The range of Yen’s recent surge has left the Japanese government no choice but to advance its first ever currency intervention since 2004. In the 1980s, because of the booming of Japan economy, the Plaza Accord was signed by G5 in 1985. It caused a historical record of 79.75 Yen per US dollar, and yet, the end of Japan’s economic bubble.

During the recent months, the Japanese Yen has surged up to 83 Yen per US dollar, very close to making a breakthrough in history. The cause of this rise, however, was not because of Japan’s economic performance, but mainly because of the central banks of many economies substantially expanding possession of Japan government bonds. Take China for example. From January to July 2010, China had been purchasing Japan government bonds worth 2.3 trillion Yen, a number almost 9 times the amount of China’s total acquisition in 2005. Among the purchases made, China in July had bought Japan’s short-term bonds worth 640.8 billion Yen. After the financial crisis, many economies re-arranged the structure of their foreign exchange reserves from mainly using US dollar to expanding Japanese Yen to avoid any risk. To boost each of their economies’ competitiveness in exports, Europe and America had also been considering on maintaining a comparative devaluation for their currency.

But to avoid the Japanese Yen from further rise that would devastate Japan’s economy, the Bank of Japan (BOJ) finally intervened in the currency market on September 15th. The Japanese government’s intervention in the currency market created a chain reaction of slight depreciation on a few Asian currencies, such as Singapore (whose currency recently had been swelling high), Malaysia, Thailand, Indonesia, Australia, New Zealand, and the Philippines; whereas each of the economies’ central bank is also paying close attention to the main competition of its rivals’ currency rate. This battle of foreign exchange is also a battle of export competition—and it is feared that there will not be any effective result in the short run.

Basel III: Draft Finally Confirmed

The Group of Central Bank Governors and Heads of Supervision (GHOS) on September 12th, 2010, have officially passed “Basel III” (or Capital Accord) proposed by the Basel Committee on Banking Supervision. It is expected to be implemented after the G20 summit in November 2010.

Basel III mainly aims to regulate global banking. After the financial crisis outbreak in 2008, economies have decided to revise the previous Basel II to improve risk management, and strengthen supervision in the banking sector by raising the Capital Adequacy Ratio (CAR) and liquidity ratio, as well as setting the leverage ratio limit of banks. Since banks may have to cope with the possibly deteriorating economy, a newly added regulation demand banks to hold a counter-cyclical capital buffer up to 2.5% of common equity. Banks are given time for adjustments; the deadline to meet the requirements is extended until 2019.

One of the main contents of Basel III is raising banks’ capital reserve ratio. The requirement for Tier 1 capital will be as high as 6%. Banks must raise their Tier 1 core capital within 5 years from the current 2% to 4.5%, and will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%.
Although according to the new regulations of the agreement there are 8 years of buffer period, many banks urgently require an increase in its capital. In Europe, for instance, banks with seriously insufficient assets, such as Deutsche Bank, Allied Irish Banks, Bank of Ireland, and the Erste Bank need a faster pace in financing to fulfill CAR requirements. Compared to Europe, the impact on banks in the US, Canada, and UK is much smaller since banks in those areas have long practiced large-scale capital accumulation.

However, still there are many banks in the world which need to accelerate in accumulating funds in order to be qualified by the regulations’ scale. Besides raising funds from the market, in the short run, reducing dividend payout or lending to achieve CAR is not conducive to economic recovery. But in the long run, implementing Basel III would lead the structure of banking and finance to a robust development.

Cross-Strait ECFA Officially Takes Effect

The Economic Cooperation Framework Agreement (ECFA) has officially taken effect on September 12th, 2010. It focuses on the tariff sector, where measures are taken to progressively reduce or eliminate tariff and non-tariff barriers on the majority of trade commodities between the two sides. On the service sector, it aims to gradually reduce or eliminate the domains with restrictive measures on both sides. Both sides have to also provide investment protection and facilitate trade investments and industrial exchanges. The agreement opens up opportunities for Chinese Taipei and Mainland to enter each side’s market, and to obtain stronger partnerships. While the restricted measures are progressively being eliminated, the agreement has given a length of time for impacted industries to make certain adjustments and transformation, so as to reduce the harmful side effects of competition.
In the previous two issues of this Monitor, we introduced the literature focused on economic crises. However, in this issue we will concentrate not only on economic crises but also on other crises faced by corporations and their appropriate crisis management responses. Otto Lerbinger’s magnus opus, “The Crisis Manager: Facing Risk and Responsibility”, proceeds in four sections discussing in turn communicating in an era of crises, managing seven types of crises, improving management performance, and his conclusions.

The work begins with a rather simple definition of crisis, arguing that a crisis should occur suddenly, unpredictably, and urgently, and then proceeds to provide an overview of the crises induced by natural and technological disasters, crises derived from the process of human evolution, and mismanagement-induced crises. This is followed by the authors’ recommendations for pre-crisis preparation, crisis responses, and post-crisis management and communication.

The author cogently advances his thesis that prior to the occurrence of a crisis, corporations should undertake exhaustive assessment of their inchoate unpredictable risks, to help better ensure their capacity for appropriate response during a crisis. When a crisis erupts, corporations should focus their entire energies on maximally mitigating potential harms to the very minimum. Post-crisis resolution efforts should also not be overlooked, and companies should adjust their organizational structure, business culture, risk control mechanisms, and management policies.

At the onset of a crisis, the unfolding events are often not in a clear shape. However, a crisis does not instantly appear out of the blue, and one can often ascertain an indelible trail leading to the critical crisis events. Even when the micro-fine details of such risks remain elusive, it is yet possible that such micro events can rapidly accumulate into a snowball, thus it behooves any corporation to maintain constant vigilance, and to confront and directly engage in crisis response.

It is essential that corporations should develop crisis response and preparedness plans before a crisis strikes. The author recommends that such preparedness plans’ contingencies should include: identification of inchoate crises and risk factors, establishing crisis thresholds, appointing persons responsible for crisis warning efforts, installing and training crisis management teams and preparing a crisis communication center.

The book discusses seven types of crises requiring crisis management resolution besides economic crises and commercial crises, namely,
crises arising from natural or technological causes, confrontation, malevolence, skewed business values, deception, and management misconduct. The author provides a number of detailed case studies for each kind of crisis, advancing a variety of alternate responses, ensuring that readers can not only clearly understand the type of crisis, but also obtain knowledge about an appropriate crisis management response. For example, technological crises referred to industrial accidents resulting from human errors involving technological applications (such as the Chernobyl nuclear incident). This category of crisis can often be avoided through prophylactic changes in consumption patterns or technology choices taken in advance, while it is also possible to engage in effective damage mitigation after onset of an incident through early warning, rapid evacuation, and appropriate use of safety equipment.

To improve corporate crisis management performance, the author recommends crisis management, crisis communication, and an emphasis on corporate ethics as the three essential elements for an effective remedy given that prevention is the best cure. Best efforts in crisis management can help reduce the deleterious effects of crises on a corporation, while excellent crisis communication can ensure the company enjoys the benefits of accurate crisis information, and corporate ethics can help reduce the risks which evolve from various forms of corporate malfeasance.

As the social and economic structure becomes ever more complicated, with dramatic changes in the natural ecology, and given the accelerating pace of technological advance today, crises are no longer an unfamiliar part of our lives, but have rather come to be expected, and may result in very serious consequences—the risks of which we simply cannot afford to overlook. We can expect that small and medium enterprises must be prepared to face even greater crises on an even more urgent basis in the future. This book provides an excellent reference for companies planning to deploy crisis preparedness efforts.