Contents

Foreword 01
Column 1 Crisis Alert 02
Column 2 Regional Reports 04
Column 3 CM Knowledge 19
Column 4 CM Best Practice 24
Column 5 CM News Digest 27
Column 6 CM Publication 30
International Organizations should Play a More Important Role in Handling Currency Issues

The G20 Summit has ended. Despite consensus has been reached to avoid competition of currency devaluation, and for emerging economies to use prudent capital control measures, it still lacks of the possibility for concrete cooperation to reduce currency competition. Such cooperation includes developing a set of specific guidelines to regulate fluctuations and a mechanism to coordinate each economy’s monetary policy. In fact, not only the last global financial crisis, currency issue of this time and even the European debt crises, all show that one economy’s monetary policy can influence another’s development and the global financial stability.

Besides coordinating policies, international organizations can also boost cooperation on pursuing balanced growth and strengthening small and medium enterprises (SMEs) crisis management. It is known that the most fundamental cause of the currency chaos of this time is the post-crisis imbalance growth between economies. This issue has been addressed in the G20 Summit and the G20 economies believed that at a time where the discrepancy of economic growth gradually expands, currency devaluation rivalry and trade protectionism should be avoided. This year, APEC has also included balanced growth in its Growth Strategy, and suggests that economies with trade deficit should think of a way to increase the private savings and strengthen their finances, while economies with trade profit should make efforts in stimulating their domestic demand.

The focus for this issue nonetheless is on keeping track with the development of chaotic currency instability. On the Crisis Alert section, this issue evaluates the tightening monetary policy and capital control emerging market economies are currently adopting; and the possible new risks rising from the abuse of the two strategies will also be discussed. On the Regional Reports section, our experts give us updates on the fluctuations of exchange rates, property and commodity prices for each region, as well as on economies’ responding policies and their effects.

At the same time, this issue has also invited two experts to discuss the problem of global food supply and ways for SMEs to cope with exchange rate fluctuations. On the issue of food supply, the expert considers that due to the climate factor, there is increasing concern about the global food supply. Main grain producing economies are cutting down their export, and thus, raising food nationalism. Soaring grain prices will eventually threaten the global economy. From mid to long term perspective, it is necessary to formulate a mechanism to ensure the stable supply of grains.

In this issue, we have specially invited Senior Research Fellow Jung Dae Suh from Korea’s Small Business Institute to share with us the two key institutions helping Korea’s businesses to cope with the financial crisis—Korea Credit Guarantee Foundation and Korea Technology Finance Corporation. The two institutions use the credit guarantee mechanisms to assist SMEs in getting through the difficult situations of credit crunch.

On the section of News Digest, our journal has selected three important news articles from the past few months for further analysis: Ireland’s debt crisis, G20 Seoul Summit’s important conclusions, and the second round US quantitative easing. Finally, our journal also introduces readers a book regarding economic crises—George Cooper’s *The Origin of Financial Crises: Central Bank, Credit Bubbles, and the Efficient Market Fallacy*, published on September 2008.

Currently, the crisis situation is easing to some degree but has not been lifted by any means. SMEs nonetheless should remain cautious on the development of every risk item and alert with the warning signs pinpointed by our journal to ensure a secure survival in this dangerous period.

Robert Sun-Quae Lai, Ph.D.
Executive Director
APEC SME Crisis Management Center
Over the past month, there have been major new developments concerning the current monetary disorder in the global economy. The G20 summit formally recognized the appropriateness of using capital controls. Individual economies no longer become the subjects of criticism when making use of capital controls to regulate the inflow and outflow of “hot money.” At the same time, emerging economies have been joining the camp led by European Union (EU) to adopt austerity policies in response to steadily increasing inflationary pressure.

The combination of capital controls and tight policy on real estate has made emerging markets look less attractive; as a result, over the course of the last month there have been indications that hot money is starting to flow out of the emerging economies. In particular, the successive increases in the required reserve ratio that China have announced have taken the wind out of the sails of the commodity markets, which had previously been forecast to see high growth.

The fall in exchange rates and the weakening in the commodity markets, both of which go against previous trends, have led to a temporary easing in the pressures put by currency surge and price rise of commodity. Even so, a number of the major emerging economies are still working hard to combat inflation; it can be anticipated that these economies will continue to maintain a tight monetary policy until the threat posed by inflation has been effectively eliminated.

Most of the emerging economies seem to be relying on a combination of tight monetary policy and capital controls to combat the recent monetary instability. So far at least, this strategy seems to have succeeded in mitigating most of the problems that had been caused by the overflows of hot money. However, there are two key questions that need to be asked. First, is this improvement only a temporary phenomenon? Second, could the policies that emerging economies have been adopting cause new problems of their own?

With regard to the first question, although there are signs that hot money is flowing out of emerging markets, the overall quantity of hot money that is sloshing around within the global financial system has not been reduced. This money flood will still need to find an outlet somewhere. There are several possible destinations for this flood. First, although capital controls have made it more expensive for hot money to enter particular emerging markets, this disadvantage can be offset by the rising interest rates which has increased the potential profits that can be made by investing in emerging economies. To succeed in blocking the inflow of hot money, economies need to strike the right balance between interest rate hikes and capital controls. Even if all emerging economies were to adopt capital controls, hot money would still continue to flow towards the economies with the lowest costs and highest potential earnings. Economies that have implemented substantial interest rate hikes in an effort to combat inflation will be particularly attractive targets.
Second, hot money may also flow into some of the advanced economies, particularly the US bond market (reflecting investors’ anticipation that the Federal Reserve will continue its bond purchases). Third, hot money will still be on the lookout for opportunities to move into commodity markets. Although the commodity markets currently lack an excuse for speculation, as soon as any such opportunities appear, the commodity markets will once again become a major target for hot money flows.

As for the second question, while the combination of tight monetary policy and capital controls has been effective in easing pressure put by hot money, it may lead to the emergence of new problems. Firstly, a real estate bubble has been developing in some emerging economies. A rigorous contractionary monetary policy, and interest rate hikes in particular, could cause these bubbles to burst, creating a situation similar to the sub-prime mortgage crisis in the US (albeit less severe). Secondly, the combination of tight monetary policy and strict capital controls could cause economies to experience a hard landing. With a new European debt crisis looming, this raises the specter of a double-dip recession in the global economy.

Based on the above analysis, we can see that, although the dangers have eased somewhat, as long as the quantity of hot money flowing around the global financial system remains undiminished, the latent threat of a new crisis will not go away. Emerging economies will continue to face challenges in their fight against inflation and hot money. They will need to be very careful in their choice of policy tools, otherwise they may find that either they are unable to control the flow of hot money and inflationary pressure, or else their economy may sink into recession. Even worse, a burst of a real estate bubble may come to visit.

To be successful, the use of monetary policy and capital controls to deal with the current chaotic situation will require a high level of policy acumen. There is no getting away from the fact that, for emerging economies, the available policy tools and capability are unlikely to make them eliminate risk altogether. The situation can be compared to walking along a tightrope; one false step and you are in serious trouble. The danger is exacerbated by the fact that the emerging economies also have to face another source of risk that is beyond their control: the possibility that the price of raw materials may start to shoot up again.

Under these circumstances, APEC SMEs should not relax their guard just because the threat of a major crisis has temporarily receded. On the contrary, they should take advantage of the fall in the price of raw materials and of the currency devaluations to engage in hedging activity, while keeping an eye out for a possible falling off in market demand due to governments’ adoption of tight monetary policy.
While the unemployment rate remained at 9.6%, the US economy added 151,000 jobs in October, the highest total since May. Growth in private sector employment was especially rapid (159,000 jobs), which offset the decline in public sector jobs, as state and local governments cut payroll, given their budget difficulties. The rise in number of new jobs, however, was much lower than in previous economic recoveries (typically 300,000 jobs a month), which underscored the weakness of the current recovery. To seriously lower the current unemployment rate, employment must expand at about 350,000 jobs a month, and the US economy is still far from that rate of job generation. The weak economic recovery is underscored by the low 2% growth in GDP in the third quarter of 2010. In previous recoveries, GDP has grown at nearly 6%.

In early November, the Federal Reserve embarked on the much-anticipated quantitative easing program, in which the Fed purchased $600 billion in US Treasury bonds over the next 6 months. Economists are divided whether the Fed purchases of Treasury bonds would have much effect on the real economy, pointing out that yields on benchmark 10-year Treasury bonds cannot go much lower than they are currently, at 2.5%. Rather, the bond purchasing may be harmful, by weakening the dollar, stimulating capital flows to and destabilizing emerging markets, and possibly reigniting US inflation when the recovery finally takes hold.

The Federal Reserve quantitative easing program, however, has definitely raised US stock prices, by lowering the return on riskless assets and raising the attractiveness of risky assets such as stocks. Since late August, when Chairman Bernanke announced the Federal Reserve’s plans for quantitative easing, the US stock market has increased by more than 16%. The Federal Reserve is hoping that the rise in stock prices will increase consumption through the wealth effect, thereby stimulating the economy and lowering unemployment. However, the empirical evidence supporting the wealth effect is weak, especially wealth that is generated by stock price appreciations, which tends to be transitory.

In the US midterm elections in November, the Republican Party regained control of one branch of Congress, the House of Representation, by a surprisingly large margin. Given that the Senate and the Presidency are still controlled by the Democratic Party, the US policy-making branch is again divided, implying that major legislation are unlikely to be passed. Given the penchant of Republican Party lawmakers to be against tax increases, the US budget deficits will continue to increase—perhaps as much as an additional $4 trillion over 7 years—lending further instability to financial markets, as the Federal Reserve tries to monetize and inflate away these additional budget

North America

QE2 is raising the attractiveness of risky assets

Robert Dekle
Small business employment creation has continued to be sluggish. A record 41% of small businesses cannot get adequate financing today, and government policies are targeting increased small business lending. Some analysts have suggested that rather than have policies target small businesses, policies should target startups and entrepreneurs. This is because new research has shown that most net jobs are created by startups, not small businesses. In 2005, startups created 3.4 million jobs while small businesses—those larger than startups but smaller than 100 employees—destroyed 1 million jobs. Most startups are small, and once they pass their first birthday, small businesses lose more jobs than they create. This is because most startups fail and go bankrupt between 1 and 5 years. Perhaps the key to lowering the US unemployment rate is to encourage entrepreneurship.

Canadian unemployment rate stable

In October, the Canadian unemployment rate edged down to 7.9%, from 8% in September. Employment growth in recent months appears to have stalled, owing to the slow growth in the US and the strong Canadian dollar. Losses in small business employment, in wholesale and retail, were offset by gains in information technology and in construction. Owing to the sluggish domestic economy, the Bank of Canada is expected to keep its policy interest rate unchanged at 1%. (The author is Professor at University of Southern California.)

Northeast Asia

Dilemma between maintaining the managed float system and controlling inflation in China

Sayuri Shirai

China

Inflationary concerns have deepened in October 2010. The CPI-based inflation (4.4% on a year-on-year base) not only remained well above the government target of 3%, but also exceeded 4% for the first time since October 2008. The cause was attributable to food price hikes. They reflected bad weather conditions, an increase in international farm product prices, as well as speculative investment in certain agricultural products (for example, garlic) driven by liquidity injected into the market. Liquidity has risen owing to active bank lending activities (e.g., the year-on-year growth rate increasing from 18.5% in September to 19.3% in October), which have been supported by a continued accumulation of deposits and a repeated intervention by the People’s Bank of China [PBOC] (central bank) in the foreign exchange market.

As a result of active intervention in the foreign exchange market aimed at stabilizing the renminbi mainly against the dollar, foreign reserves have expanded by $249 billion between end-December 2009 and end-September 2010, to $2.65 trillion. About a half of the increase came from a trade surplus, and the rest arose from a valuation impact (i.e. a strengthening of the euro and Japanese yen against the dollar contributing to an increase in foreign reserves measured in the dollar terms), net foreign direct investment (FDI) inflows, and speculative capital inflows. The massive scale of foreign reserve build-up has increased the supply of the renminbi by the PBOC into the market.

The government reacted to the accelerating...
inflation with two monetary measures: (1) an increase in the base interest rates and (2) a hike in the required reserve ratios. Lending and deposit base rates were raised in October 19th; for example, an increase of 25 basis points took place in the case of one-year lending and deposit base rates to 5.56% and 2.5%, respectively. The increase was the first move taken since December 2007, thus being caught with surprise by investors. As for the required reserve ratios, another hike occurred in November 16th by 50 basis points, to 17% for large banks and 15.5% for small and medium banks. This is the forth action since January 2010.

Despite these efforts, the inflationary pressures are likely to strengthen because China’s output gap (the difference between actual and potential GDP) remains positive and the interest rates still remain too low in the real terms. Furthermore, speculative capital inflows are anticipated to grow further owing to an expected appreciation of the renminbi, as well as the decision by the US Federal Reserve System on November 3rd to resume the second round of quantitative monetary easing (i.e. a purchase of longer treasury securities of $600 billion until mid-2011).

Therefore, the government may be forced to raise interest rates further in the near future. As this invites new capital inflows and additional appreciation pressures against the renminbi, the dilemma faced by the government between maintaining the ongoing heavily-managed exchange rate system and controlling inflation will be intensified. In the end, such a dilemma may encourage the government to accelerate the pace of appreciating the renminbi. Uncertainty surrounding the exchange rate policy and inflationary developments may have adverse impact on not only SMEs in China, but also on SMEs in other Asian economies (as the exchange rate policies of other Asian economies are often influenced by China’s exchange rate movement).

### Japan

The government is concerned about the sluggish economic performance, even though real GDP economic growth accelerated from 0.4% (on a quarter-to-quarter basis) in the second quarter to 0.9% in the third quarter. This is because the improvement reflects largely a temporary increase in sales before the end of the subsidies provided for the purchase of new low-emission cars in early September. The growth rate is likely to turn into negative in the fourth quarter, reflecting the fading effect of the stimulus measures, yen’s appreciation, and global economic slowdown.

Therefore, the government submitted to the Diet the supplementary budget plan for the fiscal year 2010 (ending March 2011) with the scale of ¥4.8 trillion ($59 billion). This budget plan was prepared to cope mainly with deflation and yen’s appreciation. The budget will be allocated largely on SME financial support, transfers to local governments aimed at re-energizing local areas, a cut in health care cost for the elderly, and growth-promoting investment projects, etc. The plan is expected to pass the Diet within November.

### Korea

Inflationary concerns have intensified in Korea. The CPI-based inflation reached 4.1% in October, exceeding the official target of 2~4%. The accelerated inflation was attributed to farm product price hikes, which had been affected by bad summer weather conditions, strong domestic demand driven by high investment and consumption growth. The policy interest rate, thus, was raised by 25 basis points, to 2.25% in July 2010. As this measure was insufficient to contain inflationary pressures—as result of capital inflows (recently, from China) and high domestic demand— the central bank raised the policy rate further in November 16th by 25 basis point, to 2.5%.

To avoid excessive appreciation and large interest rate hikes, the government is expected to introduce a new capital control measure aimed at containing speculative capital inflows. This follows an imposition in June 2010 of tighter limits on foreign current forward positions by domestic and foreign banks.

Despite inflationary pressures, the real GDP growth dropped from 1.4% (on a quarter-to-quarter basis) in the second quarter to 0.7% in the third quarter. This reflects a decline in exports in July and August caused by won’s appreciation and sluggish demand from the United States and EU.
Chinese Taipei

The export sector has shown resilient performance, after showing a slowdown in trade and production activities in September 2010. Exports grew by 22% especially in the sectors of electronic inputs and information communication appliances. The real GDP growth continued to remain high in the third quarter, as evidenced by a 9.8% growth rate (on a year-on-year basis)—a high level notwithstanding a drop from 11.4% in the second quarter.

Chinese Taipei started the Economic Cooperation Framework Agreement (ECFA) with China from September 2010. This will reduce the tariffs of 539 items of its exports to China (worth $14 billion) and 267 items of Chinese exports to it (worth $2.9 billion) into zero within the next 2 years. This is likely to benefit the Chinese Taipei’s manufacturing sector including SMEs, as it can mitigate possible erosion of Chinese Taipei’s competitiveness caused by the implementation of the Free Trade Agreement (FTA) between China and the Association of Southeast Asian Nations (ASEAN) from January 2010. While the number of items covered under the ECFA is limited, the next round of negotiations is likely to take place soon. More importantly, the ECFA will give an opportunity for Chinese Taipei to engage in the FTAs with other economies and regions including the ASEAN. (The author is Professor of Economics, Keio University.)

Southeast Asia

Thai Baht again

Honghui Cao

It is about the story of Thai baht again now for it has been appreciated more than 11% against US dollar this year and is the 2nd strongest currency in Asia. But the past story of the external shock of industrial structural conflicts and mismatched currencies in 1997 cannot explain the status of the rapidly growing trade surplus and then the current account surplus at present. The current GDP growth is on the peak of the past 15 years. The spreads between its interest rates and those in the developed economies have also expanded, resulting in the tremendous capital inflows. Consequently, the authorities take their measures to restrict the rushing capital inflows even though they are considered fundamentally necessary but probably futile. Those measures including the choice of Tobin Tax may lead to very complicated side-effects to the stability of the financial system and real economy in the long run.

Over the past 5 years, Thailand has run a sizeable current account surplus on the order of 4% to 5% of GDP, which usually supports by a positive balance of private capital flows. Both the government and the central bank have stressed the necessity for Baht exchange rate appreciation to help offset the external pressure. This also helps not only to move away from continuous dependence on Foreign Exchange (FX) intervention in favor of domestic inflation as a long term target, but also to provide a stronger anchor for price stability.

Thai baht on shore interest rate locates at around 1.7% per annum for a 3-month T-bill and 2.5% for a 5-year treasury bond. But year-to-date baht appreciation against US dollar more than 10% and expectations of continued upside is higher than those in Brazil, Indonesia and South Africa. The overall portfolio capital inflows have soared in the
past few quarters, reaching more than 11% of GDP in the 3rd quarter and converting to great sum of base money which results in extreme pressures. A combination of capital controls and aggressive sterilization policies by the authority can hardly be effective for very long. The problem is that the severe exposure to capital inflows may overwhelm monetary policy which is too aggressive.

The over-supply of liquidity has pushed up the asset prices and consumer price index (CPI) that is expected to reach 4.0% this year. The stock index has gone up by 40% this year but has affected little to the real economy. The problem is how to maintain the money in the financial markets or transfer into long term investment because not all the inbound capital is “hot”. Foreign direct investment approvals from Europe, for example, have been risen fivefold up to this August.

The authority has taken measures to add 15% capital gain tax and interest tax from October 13th to the state owned corporation bonds. It wants to take loose capital inflows policies and strict capital outflows policies so as to avoid the shock to the market as it did from 1997 to 1998. We are not aware of the development and reactions of the global markets in the coming months if US Federal Reserve continues its quantitative ease policies to expand the liquidity. But, what we are aware of is that the potential risks are accumulating in Thailand as in other emerging economies. (The author is Director, Financial Markets Division, at Chinese Academy of Social Science.)

South Pacific (India, Australia, New Zealand)

Increasing Concern about China’s Tightening Policy

Kenneth Waller

China’s restraint - may impact adversely on the economies of the Pacific region

The $A (Australian Dollar) continues to maintain near or above parity with the $US. Continuing strong external commodity demand, a second round of quantitative easing by the US Fed Reserve and a further rise in the official cash rate of 25 basis points by the Reserve Bank of Australia (taking the rate to 4.75%) contribute to the strength of the local currency. The International Monetary Fund (IMF) has estimated that the $A is overvalued by 5-15%. Rather surprisingly, 70% of domestic SMEs are of the view that the strength of the $A will not affect their business negatively.

The IMF projects the growth rate of Australia to 3-3.5% in 2010-11 due to commodity exports and investment in mining, which is expected to outpace growth in public investment. Budget forecasts rely on maintaining income from commodity exports but actual outcomes for income may be dampened as China attempts to contain its growth to ease inflation and speculative pressures.

Short-term fundamentals remain favourable, supported by positive views on the outlook by the IMF, the Organisation for Economic Co-operation and Development (OECD) and official forecasts. Some caution is needed however. Recent surveys by the National Australia Bank, the Australian Chamber of Commerce and Industry and MYOB point to an easing in general and small business conditions.

The economy is showing something of a dual nature; commodity exports showing strong growth while there is only modest growth in the domestic sector. There are mixed signals on the domestic
The average time for settling business-to-business payments is trending downwards, 53.1 days for the period ending September. Credit growth is showing signs of recovery. Commercial finance commitments increased by 2.7% in September, the second rise in 5 months. The Performance of Services Index has expanded 5.1 points to 50.7. Against these positive signs, there was a rise in unemployment in the September quarter, seasonally adjusted, to 5.4% from 5.1% and consumer confidence declined in October by 5.3% to 110.7.

The early November rise in the official cash rate has been followed by increases in lending rates by major banks; in some cases by nearly double the 25 basis point rise in the official rate rise. The banks have justified their actions by the need to offset rising wholesale funding costs. But since banks are also reporting buoyant profit growth, their actions are coming under political scrutiny. The government plans to introduce measures to strengthen competition in the financial sector.

**India imposes measures to offset a liquidity crunch**

The Reserve Bank of India (RBI) is conducting buybacks of government securities until December 16th to infuse money into the economy, to offset liquidity shortages. The RBI’s Second Quarter Review noted that while a restriction on liquidity may help combat inflation, an excessive shortage could disrupt the financial system and credit growth. In conjunction with the buy-back policy, the RBI also raised interest rates by 25 basis points, to 6.25% to moderate inflation growth. Despite concerns over tight liquidity, there has been not to easing in the reserve ratio requirements for banks.

Microlending regulation has been fast-tracked nationally after what was seen as an industry-threatening reaction by the state of Andhra Pradesh against a sector that appeared to be using questionable means to secure its loan repayments. While the Finance Ministry did not intend to regulate interest rates in the sector, the industry has agreed to cap interest rates at 24% in the state.

The RBI has also raised concerns with general lending in its Report on Trend and Progress of Banking India, with the non-performing asset ratio remaining unchanged at 2.25% since 2007-08, at the peak of the global financial crisis. Despite this, the report notes that the banking sector has remained largely resilient in 2009-10 due to robust capital adequacy.

Following the conclusion of the India-Japan Closer Economic Partnership Arrangement (CEPA) negotiations, India has also concluded negotiations on a trade pact with Malaysia, to be implemented in July 2011. US President Obama’s recent visit to India included business deals of $15bn between the two economies, as well as a commitment to allow exports of dual-use technology to India. Concerns were raised by US Commerce Secretary Locke about the opaqueness of India’s foreign investment rules. India plans to supervise foreign investment inflows by making it mandatory for companies bringing in foreign equity to periodically disclose the end-use of such funds.

With the rise in India’s global economic position, India has secured a stronger voting position in the IMF, moving from 11th to 8th rank in the organization. India’s ranking on the World Bank/International Finance Corporation (IFC) Doing Business Report, has risen modest one place to 134, based on changes to the tax system and some reduction in the burden of starting a business. ING notes a rise in investor attitudes in the third quarter 172 to 175, the highest among Asian economies. Rating agencies are making upgrades of some firms in India. Exports rose 23.2% to $18.02bn in September, a 2 year high. India’s service sector expanded in October from 55.6 to 56.2, perhaps signaling an end to the slowing expansion levels of the last three months. India’s equity and bond markets attracted a record $33.8bn in foreign funds since January, but foreign direct investment (FDI) during the same period has dropped 35%. The inflation rate declined marginally to 8.58% from a year earlier in October from 8.62% in September. Improving economic indicators are not matched by other indicators. India’s Human Development Index ranking dropped one place this year to 119, attributed mostly to the fields of education and health.

**New Zealand – recovering but slowly**

The Reserve Banks’ Financial Stability report
was released last month. Recovery over the recent period was at a ‘tepid’ pace; a focus on debt has led to the paradox of thrift among households and businesses. This is perhaps also reflected in the BusinessNZ’s October Performance of Services and Manufacturing Indexes which show slight declines in October. There is some improvement in the funding base of New Zealand’s banks; non-performing loans may be approaching a plateau, increasing 0.1% to 2.0% in the 2nd quarter.

There are other positive signs. The Reserve Bank removed the last remaining temporary liquidity facility put in place during the financial crisis. Labour costs rose 1.3 percent in the year to the June quarter and the unemployment rate fell to 6.4% in the September quarter. A third consecutive quarterly seasonally adjusted trade surplus was recorded in the 3rd quarter, of NZ$ 378 million, equivalent to 3.5 percent of exports. The New Zealand dollar increased to be above 79USc for the first time in 29 months, after the Federal Reserve announced QE2.

The general business environment has maintained a positive global reputation by retaining its top rank on the Corruption Perceptions Index this year and its 3rd position in this year’s Doing Business Report.

The second 2025 Taskforce Report was released this month. Maintaining its stance from the last report, it pushed for fiscal austerity measures and for greater efforts to improve the environment for foreign investment. New Zealand’s public finances remain pressured as the global crisis and the slow recovery continue to pinch revenue, forcing hefty government borrowing to finance the shortfall. The improved economic environment removes any imminent risk of a downgrade, but the economy’s debt level and the constraints it places on policy remain a key theme. (The author is Director, Australian APEC Study Centre at RMIT University.)

Intervention and Extra Liquidity

Cheng-Mount Cheng

Local authorities seem to be eager to counteract the strength in Latam currencies. However, expectations associated with the second round of quantitative easing (QE2) in the US are leading to further appreciation in local currencies against the US dollar. Note that original QE translated into an increase in global liquidity at a time of high risk aversion. But under QE2, liquidity would mix with low measure of risk aversion and thereby translate into a faster appreciation of Latam asset prices. Brazil, Colombia and Peru are among Latam economies to take more aggressive measures to limit their currencies’ strengthening against the USD, while Chile is using verbal intervention and possible intervention in the foreign exchange (FX) markets. On the other hand, Mexico is not likely to enact any policy specifically to curb appreciation.

In Brazil, the Minister of Finance increased once again the financial transaction tax (investment of foreigners, IOF) for fixed income inflow to 6% from 4% on October 18th. The previous hike was on October 4th, when the IOF was increased to 4% from 2%. In addition, the government also raised the IOF tax on foreign investors’ margin deposits at the BM&FBovespa for future markets to 6% from 0.38%. As in the previous IOF hike episode, the tax on equities-related inflows remained at 2%, whereas foreign direct investment (FDI)-related inflows remain exempt. On October 21st, the Brazilian government announced additional
regulations to close loopholes in the recent IOF increase. First, the National Monetary Council (CMN) prohibited foreign investors to rent bonds from domestic ones. Second, inflows that were previously used as margin deposits will be taxed with IOF at 6%. Third, the Central Bank prohibited the BM&FBovespa from accepting bank guarantees as collateral on derivatives.

In Colombia, the Central Bank released a communiqué on September 15th stating that it would purchase at least US$20 million through daily auctions, and that the measure would last at least four months until January 15th, 2011. With respect to further intervention, Finance Minister Juan Carlos Echeverry has mentioned that capital controls were discussed but stated that no plans have been made for implementation.

In Peru, the Central Bank further tightened reserve requirements for both domestic and dollar denominated obligations, while the financial regulator is discussing a proposal tying banks’ forward positions to their equity. Although the impact on the FX is still unknown, the measure might prompt small banks to close short USD positions in the forward market and lead to upward pressure on USD against Peruvian New Sol. In Chile there have not been direct intervention, but this stance might change soon. So far the government has been using verbal intervention, even though statements over possible FX intervention from the Ministry of Finance have substantially increased as of late. If the exchange rate of Chilean Peso per USD approaches 450-460 level (currently 480) that could affect export dynamics, the risk of central bank intervention would increase significantly. In Mexico, the government appeared to remain patient and not likely to take any measure to curb Mexican Peso appreciation.

Those defensive government measures should have a limited impact in the near-term. With more liquidity from QE2 that coupled with a positive environment in terms of risk aversion, it’s likely that assets in Latam economies could continue to rise in the short run. However, the risks of a correction should increase over longer time horizon once this extra liquidity begins to be drained out of the system. In particular, if there are more signs of rising inflation pressure or recovering activities in the developed economies. In general, the end of extreme liquidity environment and the worsening in domestic fundamentals, especially a deep deterioration of the current account, should be the main factor constraining Latam currency appreciation in the future.

Things to watch before the year-end include congressional approvals for 2011 budgets in major Latam economies, including Chile, Mexico, and Peru. In the political calendar, Ms. Dilma Rousseff’s winning the Brazil presidential race should indicate overall desire to continue with current policies, meaning strong economic growth and social programs. In Venezuela, we will watch for a legislative agenda that could give President Chavez the possibility of writing laws without the need of National Assembly approval. In Argentina, the political development after the former President Nestor Kirchner’s death would require particular attention. (The author is Vice President, Citi Taiwan.)
Within the EU, the period under review has been dominated by essentially two questions. Firstly, whether the G20 meeting scheduled for Korea would produce an agreement that would help resolve the problems of the global economy. And secondly, whether the three most indebted EU economies – those of Ireland, Portugal and Greece – would request financial assistance from the EU, and if so, what conditions would be applied.

Both these issues reflect an underlying uncertainty about economic revival and whether governments and banks can promote growth. Governments around the EU are committed to austerity programmes, and are hoping that economic growth and revival will come from private sector activity, which in turn depends on banks to provide liquidity and credit.

The EU and the G20

The EU is a privileged player in the G20 having 5 member states represented (Germany, France, the UK and Italy, with Spain as a permanent invitee), together with the EU itself.

The EU was in favour of currency revaluations, but they were broadly opposed to the US decision to apply Quantitative Easing (QE) of $600bn on the eve of the session, because this was seen as potentially counterproductive. They were also broadly opposed to US ideas about applying limits to surpluses and deficits as a means of forcing rebalancing measures on economies.

US action on QE together with its proposals for rebalancing the global trading system was thought to be broadly ill advised. The EU’s approach would be to work with China and other surplus economies to find solutions that would address the two critical issues facing the global economy, namely resolving sovereign debt issues, and reviving economic growth around the world. Currency management issues could then fit into that general framework, with economies moving gradually towards more market-determined exchange rates.

Unlike the US, the EU did not expect any significant decision from the G20 on the broader issues facing the global economy. To their way of thinking, the dialogue was itself important for building mutual understanding amongst a very diverse group of economies. They see the G20 process as something that addresses more long-term issues through a global consensus on an agreed approach, rather than as a forum to solve specific problems.

The EU and the sovereign debt problem

EU governments are somewhat divided about dealing with the indebtedness of economies and the fact that these economies owe banks a lot of money – estimated at between €2-3 trillion for Greece, Portugal and Ireland alone.

The German government in particular wants banks to accept that there will be no full repayment of these debts – just as in typical private sector lending. Other governments take the view that
full repayment must be guaranteed, otherwise these economies together with many other EU states that also have high debts (the UK, Italy, and Spain in particular) will find it difficult and expensive to access new credit. At the very least, these governments need to roll over their existing debts through further borrowing, because tax receipts have been falling in the current economic conditions. There is a fear that the German line of argument will actually precipitate another crisis and may cause the collapse of the Euro system more generally.

At the same time, both Germany and France have a particular interest in solving this problem. Estimates suggest that it is their banks that are significantly exposed, perhaps to the extent of €2 trillion. If their banks lose even a significant part of this money, then this will make banks even less willing to lend, and could derail any hope of a private sector led recovery.

A further level of debate is taking place within these highly indebted economies, with Ireland resisting (at least at the time of writing on 18th November) solutions that would oblige them to borrow from the new EU funding facility because of the conditions that would apply. Ireland perhaps prefers to pay a higher loan premium to roll over its existing debts (estimated at about €70 bn) than compromise its ability to use its tax regime to stimulate recovery and growth. Or perhaps they are contemplating a default and then negotiating a fresh repayment schedule.

**Broader implications of these developments**

Within the EU, the sovereign debt crisis is now reaching a critical stage. If economies start to default (which many expect) then the consequences will be unpredictable for the Euro. In the meantime, speculators are enjoying the uncertainty, and probably making the job of policy-makers even more difficult.

Interestingly, this crisis within the Eurozone has kept the value of the Euro itself fairly low and competitive. So the problem of international currency values is less of a concern here than in the US.

But the bigger problem is the effect of this crisis on the banking system. It is still to recover from the crisis of 2008-2009 and is now faced with further major losses. Credit to businesses and to SMEs in particular will be badly affected if this uncertainty continues. An EU recovery will be delayed and Asian and developing economy markets will become the long-term focus for many business strategies. The possible impact for APEC SMEs (indirect) will be increased competition from the EU, and increased pressure to open markets where EU businesses think that they can increase their market share. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)
East European SMEs should be cautious about QE2 and rising debt concerns

Kuo-Yuan Liang

Last month, a lot of discussions were brought up regarding the US QE2 and the rising debt concerns due to the October EU summit. As the repercussions from this development and associated issues will certainly affect the economies of the East Europe region, this month’s article will address how things might play out in the regional economy, and who should be wary and what kinds of precautions should be made.

Recent appreciation did not hurt export competitiveness as much, but it is time to adjust to a world where US consuming power is weaker

Over the previous months, East Europe regional currencies and the Euro have fluctuated with the general weakness of the dollar due to the then pending QE2. Concerns centered on whether this might affect their export competitiveness. According to recent business climate surveys, exporters from Germany reported positive export competitiveness. This is quite understandable, as most currencies have also appreciated against US dollar too. The East Europe region as a whole, with a significant portion of trade activities concentrated on the Eurozone in which Germany is the growth engine, is not expected to lose markets directly from the appreciation against the dollar, as their currencies did not share a particular trend against the Euro.

As for the US markets, whether the QE2 will raise inflation expectation and urge the American consumers to consume more in the near term, or if the weakened dollar hampers their purchasing power creating a notable effect, will require further monitoring. Current predictions point to the latter effect dominating, since after years of consuming in advance, there may not be a lot of cash held in the hands of the US consumers to spend, especially in a time of deleveraging. In other words, the world and the East Europe regional economy need to adjust to a change where the US market is of lesser importance than the past half century.

East Europe markets are especially vulnerable in the new financial landscape

A lot of concerns have addressed the financial stability aspect of the QE2. The planned additional issuance of greenbacks not only urges the consumers to spend, but also sends the message to those who use Dollars as a store of value, to scramble for alternatives for storing their wealth. Central banks, especially those who have abundant dollar reserves, will seriously reconsider their foreign reserve portfolio, and even call for change to the current Dollar based system. Amid the global trend to retain less dollars will likely last for several years, turbulence in the financial markets is expected to increase. While there is plenty of dollar funding, free capital now feel the increased need to search for investment and speculative opportunities to counter loss of value in the Dollar. However, at times of stress nothing is comparable to the Dollar in terms of security, as the Dollar turned out to be the safe haven even in the US centered financial crisis. Therefore, in the next decade, global markets will sway back and forth between rising waters of speculative trends, and subsequently retreat as bubbles burst and money search for safety once again.

Situated in the new financial landscape, East Europe economies are particularly fragile: As part of the EU, regional economies have full
capital mobility and free foreign exchange markets compared to peers elsewhere with similar economic development level, while their economies rely heavily on foreign investment and international funding, leaving them exposed to external forces. Unlike some Asian economies that have tight capital and currency control and huge foreign reserves to resist speculation, unfortunately, East Europe economies here would occasionally require current account aid in times of international fund withdrawal. For SMEs of the region, this proves a challenge as currency hedging is costly and occasional speculation on raw materials can affect their profit margins significantly.

Demand is falling throughout Europe amid impending austerity measures and slowing global economy – winter preparations called for

Besides the longer term and indirect effects of the QE2, the region still faces near term challenges. The Procurement Managers Index (PMI) report of the Eurozone indicated a declining service sector for 2 straight months for overall Eurozone when excluding Germany and France, suggesting that austerity measures might have started to cause falling demand. Though it is the situation in the peripheral Eurozone, there might be similar cases in East Europe as well, as austerity measures are being felt by the people. The Oct. Economic Sentiment Indicator (ESI), though improving, was mostly in the industrial confidence and not the other sectors, which may have confirmed the PMI’s suggestions of service sector decline. As the global economy is slowing down, SMEs in the region have to tune down their expectations and prepare for a period of humble growth.

Ireland issue should be contained; markets are more rational after Greek experience

When this article was written, the issue of Ireland debt was escalating. This should put a temporary end to the current wave of Dollar weakness as it gives speculators a reason to realize gains. Although Ireland did not introduce any special measure recently, the EU summit on Oct. 29th discussed the prospect of replacing the European Financial Stability Facility (EFSF) with a permanent mechanism for solving sovereign debts via amending the Lisbon Treaty. The mechanism, as proposed by Germany and France, would demand bond holders to share the costs of fiscal reconstruction, or take the so called “haircuts.” This raised a few eyebrows on Ireland, which was on the verge. The conclusions to the proposal may be finalized during the December EU summit. The proposal, if realized, would have the debt market participants become more accountable for their loans, and more careful when buying bonds of fiscally weak economies. In East Europe, except for Greece, more attention would be raised on Hungary and Romania, as indicated in last month’s article. They both have somewhat higher inflation, and Hungary has a debt that is slightly higher than normal levels. However, their conditions are not even close to the examples of Portugal, Ireland, Italy, Greece and Spain (PIIGS). Just keep an eye on those two and hope that the prospect of such a proposal would keep governments upfront on their budget plans. (The author is President, Polaris Research Institute & Honorary Professor, and Professor, College of Technology Management, National Tsing Hua University.)
Russia and Middle East

QE2 policy should have limited influence on the export sectors

Ming-Hsin Kung

The predominant focal point for Russia and the Middle East and other emerging economies continues to be what effects may be anticipated from America's QE2 policies on export prices for energy commodities, and impacts on domestic consumer prices resulting therefrom. In regard to international petroleum prices, North Sea Brent crude prices have gone from 81.99 dollar per barrel at the end of October to the current levels 88.59 dollar per barrel, representing an increase of 8%. Thus for the Russian and Middle East economies heavily dependent on oil exports, increasing oil prices have been able to compensate for foreign exchange losses resulted from the weaker dollar, so the QE2 policy should have limited influence on the export sectors, particularly for Russia. As November 1st marks the opening for initial operations of the China Russia crude oil pipeline, it represents an extremely favorable development for Russia's energy export sector, and at least for the time being it's expected that exports will remain stable.

In terms of inflation, recent Russian CPI evinces a steady rising trend, with annualized CPI increasing from 7% at the start of the year to 8.2% currently. Especially, since the middle of October, CPI has exhibited continuous growth for 3 weeks consecutively. As the Russian central bank has noted, food and basic consumer goods prices do not appear subject to inflationary concerns in the mid-to long-term, so it's expected to maintain the current rate of 7.75%, and the Russian government expects to maintain and utilize CPI within the 7% to 8% range, so for the APEC members' small and medium-sized enterprises active in Russian regions, the risks of increased costs of overhead are not appreciable, though vigilance in this regard is still required.

As for the Middle East, economic trends also continue to be stable. The International Monetary Fund (IMF) recently announced that unabated increases in global petroleum prices and economic stimulus measures adopted by Middle Eastern governments should ensure the Middle East economies continue to enjoy stable growth as they has over the past 2 years. It's anticipated that in 2010 economic growth will reach 4.2%, while 2012 estimates expect for growth to reach 4.8%. Regarding to commodity prices, non-oil-producing Israel and Turkey should enjoy annualized CPI well within their comfort range, and Israel's statistical departments announced their September annualized CPI remains around 2.3%, while the central bank in Turkey expects annualized CPI to stay within the range of recent years at within 7.5%, so the Turkish central bank expects to maintain their rates unchanged throughout the fourth quarter of 2011. As long as prices are not completely unchecked, Israel and Turkey and the other non-oil exporters’ monetary policies will also likely continue to maintain their stable trends.

Besides their macro-economic stability, industrial developments in Russia and the Middle East have seen remarkable results recently. In terms of their energy sector industries, in addition to the impressive start of the Russo-Chinese crude oil pipeline transmission, in early November Russia and Vietnam signed an energy cooperation agreement, providing that they shall begin work on two nuclear reactors for Vietnam within two years. In the Middle East meanwhile, Iran has pledged to give China an additional 4 years of
their 40% duty-free preferential treatment, enticing Chinese enterprises to expand their investments in Iranian minerals and mining and other industries, while Turkey and Egypt also continue to work assiduously with China to promote their respective bilateral industrial cooperation, focusing on minerals and mining, basic infrastructure, and development of special economic zones, all of which should yield substantial investment opportunities for APEC member’s small and medium-sized enterprises, which should remain of interest for our attention. (The author is Vice President, Taiwan Institute of Economic Research.)

Global Commodity Market

Attention in the commodity market is on China’s tightening and European sovereign debt risk rather than QE2

Hwa-Nyeon Kim

In the last month period (mid-October to mid-November), there have been subtle warning signs of a crisis in the global commodity market. There was a steady gain in commodity prices due to massive amounts of money liquidity being diffused by a second round of quantitative easing (QE2). Still, in terms of demand, it is uncertain whether commodity prices will continue rising amid the increasing possibility of a slowdown in the global economy, China’s tightening worries and revisited sovereign debt risks in European economies.

The US Federal Reserve has opted for a quantitative easing policy by buying 600 billion USD of US government bonds. QE2 has exacerbated the problem of excess liquidity in global markets including commodities. Commodity prices went up before and after the commencement of QE2. However, global economic woes started to spread from mid-November. Chinese Premier Wen Jiabao said that China’s government was preparing steps to lower inflation. Consequently, financial markets expect that China will be likely to start tightening monetary policy and raise the key interest rate in the near future. Another macroeconomic concern is the reviving European (especially Irish) sovereign debt risk. These two problems hit the commodity market in mid-November and affected most commodity prices which dropped steeply for a few days.

The top two commodity indices, the Reuters CRB index and LME non-ferrous index, have shown somewhat gradual increases from mid-October to mid-November. The Reuters CRB index (year 1967=100) moved up from 547 points to 602 and the LME index (April 1999=1,000) increased from 3,641 to 4,040. The average for the Reuters CRB index from mid-October to mid-November increased 5.8% while the average for the LME index rose 4.6%. Such changes are positive signs that there are still upward trends and steep slopes within the commodity indices compared to the previous month. However in mid-November, the two indices fell sharply for a couple of days due to spreading concerns of China’s tightening and Europe’s sovereign debt risk. In terms of price variations, the daily price changes of the Reuters CRB index was higher than those in the mid-September to mid-October period, indicating an increase in investment risk in commodities.

As for energy prices, the West Texas Intermediate (WTI) near month futures price moved within the range of 79.49 and 87.81 USD/barrel and Dubai crude prices moved between...
78.65 and 86.57 USD/barrel during the same period. Both the minimum and maximum values were larger than those in the mid-September to mid-October period.

Among non-ferrous metals, or more commonly known as base metals, lead and zinc prices rose the most following the previous period, with the average prices of lead and zinc rising 10% and 9.6% respectively. The hottest base metals in the first half of this year, as nickel and copper, showed different price patterns. The price of copper increased while the price of nickel went down slightly. More recently, the price of copper rose to a new high of 8,985 USD/ton since the global financial crisis began. Other base metals including aluminum and tin also revealed increasing variations.

The most important variable we must keep a closer eye on during the coming month (mid-November to mid-December) is the commencement of China’s tightening monetary policy and how much and how long the European sovereign debt risk will spread. Indeed, these two factors will shrink global commodity demand. Therefore, as has happened a couple of times this year, China’s tightening and Europe’s sovereign debt risk will be likely to make commodity prices go down even if the US dollar depreciation persists. However, this means there is an increasing possibility that SMEs, especially firms mainly trading to China and Europe, will face difficulties in terms of exports because the domestic markets in China and Europe will be likely to shrink. (The author is Research Fellow, Samsung Economic Research Institute.)

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.

<table>
<thead>
<tr>
<th>Index</th>
<th>Crude Oil (USD/barrel)</th>
<th>Non-ferrous Metals (USD/ton)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reuters CRB</td>
<td>LME</td>
</tr>
<tr>
<td>Min</td>
<td>547</td>
<td>3641</td>
</tr>
<tr>
<td>Max</td>
<td>602</td>
<td>4040</td>
</tr>
<tr>
<td>Average</td>
<td>569</td>
<td>3873</td>
</tr>
<tr>
<td>Mid-September to Mid-October Average</td>
<td>538</td>
<td>3697</td>
</tr>
</tbody>
</table>

Note:
Shrinking global grain supply threatens world economy

Hwa Nyeon Kim

Growing worries over the global food supply

Amid continued climate anomalies across the world, frequent, climate-related disasters, especially in major grain producing economies such as China, Russia and Ukraine, are taking a heavy toll. For instance, Russia experienced the hottest summer to date which was accompanied by the worst drought in about 100 years. In China, torrential rains displaced roughly 230,000 people in Liaoning. Russia, the world’s 3rd-largest wheat exporter, lost 26% of its wheat harvest due to extreme drought, prompting a ban on exports until the end of year, and Ukraine, the 5th-largest wheat exporter and biggest barley exporter, limited export quotas. These two economies announced that their grain export ban would be extended to the first half of 2011. Moreover, commodity markets are worried that the 2011 winter wheat crop harvest in Russia and Ukraine will be weak. Wheat planting was delayed in August in both economies because of a lack of moisture in the ground. Winter wheat accounts for nearly all of Ukraine’s wheat production and about 40% of Russia’s.

*Figure 1*  Grain Prices (June 1st to November 8th, 2010)

*Source: Thomson Reuters Datastream.*
Against this backdrop, worries over the global food supply are growing, and major grain producers are cutting down on their food exports, provoking food nationalism. Soaring grain prices are also coming to a head. As of November 8th, the price of wheat has soared 44.4%, soybean 46.8% and corn 54.4% compared to June 1st. The problem is that extreme weather events, partly due to intensified El Nino and La Nina weather phenomena, are becoming more frequent and more damaging. This will aggravate grain supply and price instability in the mid- to long-term. The range of grain price changes has already become wider and the cycle of price increases is becoming shorter.

**Grain price will show an upward trend until the first half of 2011**

Concerns about tight grain supplies will likely persist as climate abnormalities hit the southern hemisphere this winter after this summer’s weather disasters in the northern hemisphere. There is a growing possibility that grain producers in the southern hemisphere such as Brazil will be affected by La Nina this winter. According to Samsung Economic Research Institute’s (SERI) base scenario projection, the wheat production volume for 2010/2011 will drop 5.1% year-on-year while the volume of soybean will fall 2.4%. However, there is a possibility that global harvest could decline more than 10% compared to a year ago if extreme weather events occur.

Demand will likely continue to rise particularly in emerging economies. For example, in 2010/2011 India’s rice consumption and China’s soybean consumption are expected to increase 14.7% and 12.8%, respectively. Speculative demand from investors will rise and they will keep turning their eyes to the grain market amid dollar depreciation. With the dollar showing signs of weakening from July, the net long (purchasing) position in the non-commercial transaction of wheat shifted to positive territory, indicating that more money was being invested into the grain market. Therefore, given the rising possibility of grain supply shortages and growing demand, grain prices are expected to increase until the first half of 2011.

Soaring grain prices will end up threatening world economy

Soaring grain prices are stoking fears of agflation especially in emerging economies. The term “agflation” is derived from the combination of the words “agriculture” and “inflation” and it refers to inflation led by rises in the price of agricultural products such as grain. Price fluctuations of grain will cause concerns of inflation and food insecurities in emerging economies. Moreover, the inflationary pressure from China, that is, price hikes of Chinese agricultural products and increases in Chinese workers’ wages could cause export prices to rise, resulting in global inflation.

Growing agflation risk: Korea’s case

Food prices have a significant influence on consumer prices in Korea, so any increases will affect household budgets and increase expectations of inflation. Korea has a low grain self-sufficiency rate of 26% and is highly dependent on grain imports therefore soaring grain prices will directly affect Korea’s consumer prices. The effect of a price hike of imported grain on Korea’s domestic consumer prices was analyzed and the results showed that a rise in grain import prices is estimated to raise Korea’s consumer prices by 0.27%. And if the price for the three major grains (e.g., wheat, soybean and corn) rises, producer prices will increase 0.12%. A jump in grain prices does not affect domestic consumer prices

<table>
<thead>
<tr>
<th>Item</th>
<th>2008/09</th>
<th>2009/10 (Est.)</th>
<th>2010/11 (Projections)</th>
<th>% Changes (Year-on-Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output</td>
<td>2,241.09</td>
<td>2,229.41</td>
<td>2,182.76</td>
<td>-2.1</td>
</tr>
<tr>
<td>Supply</td>
<td>2,609.84</td>
<td>2,680.22</td>
<td>2,672.51</td>
<td>-0.3</td>
</tr>
<tr>
<td>Use</td>
<td>2,159.03</td>
<td>2,190.47</td>
<td>2,240.20</td>
<td>2.3</td>
</tr>
<tr>
<td>Trade</td>
<td>285.69</td>
<td>283.64</td>
<td>275.54</td>
<td>-2.9</td>
</tr>
<tr>
<td>Ending Stocks</td>
<td>450.81</td>
<td>489.75</td>
<td>432.31</td>
<td>-11.7</td>
</tr>
<tr>
<td>Ending Stocks to Use Ratio</td>
<td>20.9</td>
<td>22.4</td>
<td>19.3</td>
<td></td>
</tr>
</tbody>
</table>

immediately; there is a lag of 4 to 6 months, although it may vary according to the item. If wheat prices rise, flour prices will increase by 26.8. Also, if there is an increase in the price of soybean, the price of fat and cooking oil are expected to rise by 5.5%.

Therefore, emerging economies should pay more attention to risks of agflation. To deal with inflation caused by grain supply shortages, several policy measures should be implemented. Since the recent consumer inflation was caused by grain supply instability, micro-economic measures (e.g., stabilizing supply shortages) would be more effective rather than macro-economic measures (e.g., interest rate hikes). In the mid- to long-term, it is important to devise a measure to secure a stable grain supply as grain prices will become more volatile with higher demand stemming from income growth in emerging economies and market shortages due to adverse weather. (The author is Research Fellow, Samsung Economic Research Institute.)

---

The Means SMEs Employ to Hedge against Exchange Rate Risk

Mario Kan

Businesses engaged in international trade or those with investments abroad, may find that in times of exchange rate volatility, direct influences on their operational overhead or profitability may become inescapable. When faced with such circumstances, small and medium-sized enterprises (SMEs) are subjected to relatively greater magnitude impacts, and thus, appropriate response to the risks resulted from foreign exchange rate volatility are matters which SMEs cannot afford to casually disregard.

When will the foreign exchange rates fluctuate? What is the expected magnitude for any fluctuation? These are all matters completely within the control of market mechanisms, and these market mechanisms are dependent on results from the coalescence of multiple variables. Until the latest updated results are announced, no one can be said to have the upper hand in ascertaining which among the numerous factors might prove to be most influential at any time, or which among those might be least consequential. In other words, no one has the capacity to precisely forecast exchange-rate values for any given moment in time. While it’s true that some academic experts or analysts may be able to provide some useful guidance for trend analysis, it remains a certain truism that no one can accurately predict the when or how much of forex market price changes.

Before employing any responsive strategy to currency fluctuation, business should realistically assess two primary factors. The first is the companies’ intrinsic foreign exchange position. Importers have to pay for their goods through foreign exchange, naturally then these importers’ foreign-exchange status will tend to be a short position; whereas exporters have anticipated earnings denominated in foreign exchange, so the status of exporters’ foreign-exchange will tend to be a long position.

Besides realistically appraising the firms’ existing foreign-exchange position, factors of timing, and shortfalls or foreign exchange reserves available to sell, the next most important thing is to consider the banks’ published spot rate and forward rate prices. If the forward rate is more expensive than the spot rate, this indicates the bank expects foreign exchange rates to appreciate over the near-term, or in other words that bank anticipates...
the foreign currency to remain strong. On the other hand, if the banks’ forward rate is cheaper than the spot rate, this indicates that the bank anticipates a drop in foreign exchange prices, and views the currency as inherently a weaker one.

A bank’s posted forward rate prices did not mean that at the specified future date that rate should be the spot rate in effect, so SMEs should not risk all of their position on forward rate contracts. If all of one's positions are fixed in terms of a forward rate, once one discovers that they've bought too high or sold too low, the consternation may be unavoidable.

Forward foreign exchange contracts are not a panacea. They often tend to produce continuous anxiety for contractors until they become due. If an enterprise maintains perhaps one quarter of its overall foreign-exchange position in forward contracts, and if at maturity they should realize that their buying or selling was indeed prescient, naturally they may feel some regrets for the other three-quarters of their position. But if at maturity they discover that they've bought high and sold low, at least they'll be able to comfort themselves with the thought that the remaining three quarters of their position were not adversely affected or burnt up in flames by the market.

As the proverbial wisdom goes, it's not wise to put all one's eggs in one basket, and foreign-exchange positions are not immune to this proposition. Banks’ published forward exchange rates are not the only means of hedging foreign currency exposure, but they are certainly one of the means available to deal with such risks.

For SMEs considering deploying measures to respond to foreign exchange rate volatility, there are an additional four basket options available:

1. Go it alone, buy and sell on the spot market in real-time as actually needed, it may be that you won’t lose;
2. Adjust payment schedules with upstream providers and downstream clients, to spread foreign exchange rate risks;
3. Modify the enterprises cash flow and finance structure, borrowing on weaker currencies and then immediately transferring to stronger currency for deposit;
4. Use bank forward foreign exchange contracts and related derivatives.

After an enterprise evaluates its own foreign-exchange position and considers the banks’ forward forex rates, they should initially assess the firm’s risk-bearing capacity, ensuring retention of a sufficient percentage of their positions as needed for exchange in the spot market. It often happens that psychological comfort and distress resulted from exchanges in the spot market and exchanges under forward contracts tend to mutually ameliorate the other. The fundamental purpose of hedging is not related to create unexpected profitability, but rather to deploy a myriad of techniques to reduce the foreseeable potential risk exposure to minimally bearable levels.

In terms of financial management theory, one of the most commonly accepted principles is to “maintain assets in strong currencies, and liabilities in weaker ones.” Maintaining one's assets in stronger currencies ensures asset preservation along with the possibility of benefiting from rising foreign exchange rate values, while keeping one's liabilities in weaker currencies, ensures that when the currency is sufficiently low one can easily satisfy the debts and expunge the liability.

**Chinese Taipei example**

Through close cooperation with upstream and downstream stakeholders, it is often possible to adjust payment terms or timing as the most practical means of effective risk management. For example, should some company in Chinese Taipei import Japanese spare parts, and after value-added processing re-export them to the United States. The import payments are in Japanese yen, while their foreign exchange receipts are in US dollars, and the trend is for the Japanese Yen to be stronger as against the New Taiwan dollar, while the US dollar is running weaker against the New Taiwan dollar. In such circumstances it is best to try to eliminate the stronger Japanese yen payment demands, while also reducing the accounts receivable denominated in US dollars.

In order to satisfy the Japanese yen payment
demands, it may be necessary to renegotiate payment terms with the Japanese providers, so that provisions originally calling for later payment can be converted to immediate or advanced payment terms. If the enterprise still has some available credit line at the bank, you might borrow in New Taiwan dollars to immediately pay the Japanese providers at the more acceptable current foreign exchange rate levels for the Japanese yen, while also exchanges this immediateness for reasonable price cuts from Japanese suppliers. It often happens that the annualized percentage value of such price cuts can be much more rewarding than the cost of loans. If however there is no remaining flexibility in the available bank line of credit, an enterprise could nevertheless apply for a temporary increase in their new Taiwan dollar lending limits from the bank, and then exchange the loans of new Taiwan dollar to Yen. But this time, it needs to save the money in certificates of deposit, instead of paying them to Japanese suppliers. While such may result in some cost of funds losses, at least this would allow one to avoid unbearable foreign exchange rate losses.

To minimize US dollar accounts receivable, it should be possible to negotiate with American buyers to make accelerated payment or advance payments, with Chinese Taipei’s enterprises providing standby L/C from banks and offer American buyers satisfactory discount. Typically an American buyer will find that the advantage of a price discount is much more appealing than their local US cost of funds anyway. If however it should not be possible to adjust the dates of payment, at the very least a firm can apply for US dollar denominated export loans, and then use the spot rate to exchange for new Taiwan dollar while the New Taiwan dollar is strong, and save the money in certificates of deposit with the bank, thereby avoiding future adverse exposure to declining US dollar exchange rate valuation. (The Author is Senior Industrial Advisor, European Bank for Reconstruction & Development.)
Two institutions displayed their full power as supporters of SMEs in the period of the global financial crisis

Jung Dae Suh

Major stumbles in economic stable growth have had something to do with banking system problems. This was true of the Great Depression, true with the Asian financial crisis, and now again with the recent global financial crisis. Problems in financial sector have significant impacts on business activities, and especially affect the SMEs more.

The crisis has caught SMEs in a vicious circle of poor credit availability, impaired liquidity, rapidly changing trade conditions and discouraging business confidence. It hits SMEs in the following ways: drastic drop in demand for goods and services; tightening in credit terms, which is severely affecting their cash flows; increased payment delays on receivables which - added to an increase in inventories - result in an endemic shortage of working capital and a decrease in liquidity; increase in reported defaults, insolvencies and bankruptcies.

For the period from the second to third quarter of 2009, Korean economy, amid the shock wave caused by the global economic crisis, grew at an annual rate of more than 10%, a 0.2% hike from the previous year and a remarkable recovery compared to major economies. It could be attained as the government took aggressive economic stimulus policies and its exports were on the rise due to favorable exchange rate. However, the growth momentum seemed to enter an adjustment phase, as the cyclical components of coincident composite index were downed for the first time in 10 months and hikes in the sentiment index of both households and firms showed a downward trend.

The year 2009 were remembered as a period when some of institutions displayed their full power as trusted supporters of SMEs. The global financial crisis started at the end of 2008 led to the economic downturn in many developed economies, which in turn damaged the developing world that depended considerably on the global economy. The rapid fall in exports was one of the factors that seemed to threaten the second Great Depression. Fortunately, with the preemptive countermeasures of the government and the innovative efforts of enterprises, Korea was able to achieve positive growth rate, even if it was not huge.

In the process, Credit Guarantee Systems in Korea performed relieving roles in the economic crisis, adhering to the principle of putting the public before private profit.

Korea Credit Guarantee Fund (KODIT)

Established in 1976, the objective of Korea Credit Guarantee Fund is to lead the balanced development of the economy by extending credit guarantees for the promising SMEs which lack
tangible collateral. KODIT has played a key role in supporting SMEs for the past 34 years, and its credit guarantee system has been evaluated to be very effective for supporting SMEs, especially in overcoming the foreign currency crisis in the late 1990’s and also recent global financial crisis.

In 2009, in order to help SMEs overcome economic difficulties following the global financial crisis, KODIT put its full force into dealing with the rapid changes in management environment with preemptive countermeasures such as the largest guarantee support since its establishment.

Responding to the deterioration of the financial environment for SMEs, KODIT radically executed an “Intensive Rescue Plan” in 2009, such as an extension of the maturity date for the full amount of existing guarantees, expansion of the maximum guarantee limit, and upward adjustment of coverage ratio. This realized general credit guarantees worth USD 33.6 billion (KRW 39.2 trillion), increased from USD 7.7 billion (KRW 8.9 trillion) in 2008, easing the financial pressure on SMEs.

KODIT supported businesses with new guarantees worth a record USD 15.2 billion (KRW 17.7 trillion), and by concentrating 72% of its yearly guarantee target on the first half of the year 2009, it put its full force into achieving an early conquest of the economic crisis. As a result, in the first half, 42% of net increase for bank loans to SMEs was covered by credit guarantees; KODIT taking the role of a driving force in liquidity support to SMEs.

Furthermore, KODIT provided “Primary Collateralized Bond Obligation (P-CBO) guarantees” worth USD 1.6 billion (KRW 1.9 trillion) to vitalize financing to SMEs through the direct financial market. Besides, in January and March last year, through the “Guarantee for Bond Market Stabilization Fund” of the size of USD 1.4 billion (KRW 1.7 trillion) and the “Guarantee for Bank Recapitalization” of the size of USD 2.3 billion (KRW 2.6 trillion), KODIT contributed in securing the supply of financing for SMEs.

In 2010, the global economic crisis has been somewhat relaxed and the recovery of the economy is forecasted, but comprehensive support for SMEs is still in high demand. KODIT is planning to actively support credit guarantees for SMEs with growth potential, and through step-by-step normalization of “Intensive Rescue Plan” set up in 2009. It will enhance the efficiency of guarantee policies with measures such as restructuring of insolvent SMEs and other unsustainable SMEs.

**Korea Technology Finance Corporation (KOTEC)**

Since its establishment in 1989, KOTEC has played a leading role in strengthening the competitiveness of SMEs and facilitating technology finance by providing credit guarantees based on technology appraisal worth 166 trillion won. KOTEC has also discovered and supported ventures and Inno-Biz enterprises (technology-based SMEs) with great potential as well as provided a variety of technology appraisal services, thereby establishing a comprehensive technology financing support system.

It established the guarantee support system based on technology appraisal which values intangible assets such as the intellectual property owned by companies. The system enabled KOTEC to extend intensive support to SMEs that have technological prowess but weak financial health. Meanwhile, the guarantee resources of KOTEC were intensively extended to SMEs with growth potential such as technology start-ups in order to create future growth engine and quality jobs.

In particular, KOTEC expanded R&D financing support to all stages of R&D process to facilitate R&D investments and catalyzed transformation of industry structure into technologically innovative one by aggressive identification of technology firms. These are expected to enhance technological competitiveness of SMEs and contributing to creation of new growth engine in the economy.

Meanwhile, in an effort to cope with economic recession spilled over from the global financial crisis, KOTEC prepared and put into action some preemptive, swift emergency measures as well as liquidity provision measures. Such measures are including the expansion of guarantee
ceiling and guarantee ratio to loan amount and the full-amount rollover.

Through the efforts, KOTEC helped SMEs to alleviate credit crunches and played an important role in overcoming economic crisis. From now on, KOTEC plans to expand its service to the knowledge-based industries such as cultural contents industry, as well as technologically innovative firms and technology start-ups. An all-out effort will be put to the areas with high potential of job creation, in order to help instill vitality into the economy. (The author is Senior Research Fellow, Korea Small Business Institute.)
The Irish sovereign debt crisis

As a result of the impacts from the burst of the real estate bubble in Ireland in 2009, the Irish government had to spend $45 billion in bank relief, but this led to excessively high uncollectible debts for the government. It's expected that in 2010 the deficit will roughly reach 32% of GDP, exceeding the ceiling of EU guidelines by more than 10 times. The massive amount of bad debt losses accumulated by the Irish banking system may exceed 70 billion euros, as nearly as half of GDP in Ireland.

At the same time, deposits in Allied Irish Bank have rapidly evaporated since June, with the cumulative declines of US$13 billion, representing about 17% of total deposits. In between August and September, Bank of Ireland experienced dramatic deposit declines totaling US$10 billion. Besides these declining deposits, the Irish banking industry also faces unprecedented difficulties in capital formation, and at present it heavily relies on low-interest loans from the European Central Bank (ECB) and emergency trust funding from the Irish Central Bank to support and maintain their operations. As of September the accumulated debt of the Irish banks owing to European Central Bank was in excess of 121 billion, nearly 78% of their GDP, more than Greece’s 40% and Portugal’s 29%. Should the ECB cease its continued lending, the Irish banking industry will suffer incomprehensible impacts. The Irish government as their guarantor would need to be responsible for the accumulated banking debts in the end, and would have to restructure the public debts.

Costs for short-term capital in Eurozone increased as a result of the concerns over the Irish credit problem and any possible domino effects to Portugal, Spain or other economies in Europe with relatively weaker financial systems. In order to avoid negative impact on economic stability in the euro region, the EU has aggressively intervened to provide Ireland with EU and IMF’s 750 billion euros (US$1 trillion) in emergency relief, and however, one of the conditions is that Ireland will likely have to increase its lowest corporate tax rate in Europe, currently at 12.5%. Moreover, British banks, which are outside the euro region, are also at risk in consequence of their massive exposure to Irish lending in excess of US$220 billion, so they also intend to provide relief for Ireland.

Following immediately on the heels of Greece, Ireland has accepted the relief package from the EU and IMF, while Portugal also remain subject to long-term impacts of low growth rates and high deficits, and may very well be the next economy to require intervention. To stave off any sudden deleterious collapse of the entire Euro region, Portugal may temporarily withdraw from the euro region. Even more disheartening is that the fourth largest economy in Europe, Spain, with an economy 3 times that of Ireland and Portugal combined, is also experiencing an credit crisis, and the 750 billion EU (US$1 trillion) in emergency trust funds may not be adequate for the magnitude of intervention in need.

Important decisions reached at the G20 Seoul Summit

The G20 Summit was held November 11th and 12th in the Korean capital city of Seoul, and the focus of the agenda was overcoming crises by working hand-in-hand to accelerate growth. Recent global deficits and the imbalances of capital flow are the topics of central focus during the meeting. In addition, the continued decline in value of the US dollar, resulting in unprecedented worldwide currency wars, inflation, and asset bubble risks, all of which were discussed at the G20 meeting. In the end of the meeting, the Seoul declaration was
issued as the meeting conclusion and output.

In terms of foreign exchange rates, the G20 pledged to avoid currency wars and rely on the free market to determine exchange rates; that is, exchange rates should reflect basic economic conditions. They also agreed that the emerging economies could deploy necessary control measures to curb the continuous rise of the value of their currency. The G20 express their unanimous opposition to any protectionist trade measures, ensuring that prior to 2013 there would be no additional new trade or investment barriers. They also pledged to accomplish the negotiation of the Doha Development Agenda (DDA) by 2011. With regard to the finance industry, the G20 approved the Basel III Accord, as well as the governing principles for international capital flows and systemically important financial institutions (SIFI).

Financial supervision efforts, including establishment of a global financial safety network, were also made in the meeting. Under the network, when international capital flows experience massive fundamental changes, the affected economies could apply to the IMF for loans. The IMF loan system will integrate regional financial safety networks to prevent an incipient of debt default crisis resulted from short-term capital flow impediments.

In respect of government finance, the developed economies expect to produce comprehensive budget plan with special attention to the possible economic risks resulted from the sovereign debt. The G20 also welcomed IMF’s shareholding reforms, improving lending mechanisms, and streamlining administrative changes. To further enhance economic development, the G20 proposed the Seoul development compact, with an emphasis on eliminating poverty in developing economies and narrowing the development gap between rich and poor economies. Finally, under the unprecedented variability in economic circumstances worldwide, the G20 decided to avoid currency wars and resuscitation of trade protectionism to advance balanced global development. By doing this, IMF will work on formulating indicative guidelines, providing a set of indicators for trade imbalance determinations. The negotiation on these mechanisms is set to begin in the first half of 2011.

While the G20 Seoul Summit obtained many important agreements, many of the specific measures will have to await further negotiation after the meeting, such as comprehensive financial planning needed by some of the credit crises-affected EU economies, the IMF lending mechanism and intervention timeliness issues, the opposition of the European banks to Basel regulations, as well as possible asymmetric protectionist trade measures.

The US again deploys quantitative easing measures

The US Federal Reserve Board in their early November meeting decided to start another round of purchasing US Treasury bonds by 600 billion in over the next 8 months. Fed chairman Ben Bernanke remains convinced that quantitative easing can ensure strong economic fundamentals for the US, helping strengthen the US dollar, providing the optimal means for global economic recovery. He thinks that providing practical means for maintaining stable prices is a prerequisite for ensuring economic recovery in the US. As Bernanke put it, QE2 should conjoin with the measures of enhancing economic growth and reducing budget deficits to help ameliorate any Fed policy misjudgments.

Fed believes that since capital markets remain adequately liquid, a loosening monetary environment, which maintains a low cost of capital, can stimulate borrowing from business for investment, while also stimulating the real estate market. As more and more house owners are able to borrow money from mortgage-based lending for consumption, the unemployment rates will be improved; it is hoped that in the next 2 years, 700,000 new jobs will be created in the economy because of the quantitative easing policy.

Additionally, economists have concerns that the US’s quantitative easing policy may exacerbate pressures on the weakening dollar, further sending hot money into the emerging economies, exacerbating inflation and asset bubbles. If the QE2 measures cannot control deflationary risks and stimulate economic growth, it might be necessary
to undertake a QE3, with purchase of even more treasury bonds.

World Bank President Zoellick notes that acceleration of the inflow of hot money in the emerging economies in the near term could simply be seen as the natural market tendency to favor areas of higher economic growth rates for investment. So, while it is expected that current global foreign exchange competition trends will remain tense, there can be no doubt that the market will surely develop appropriate new currency mechanisms in the future.
The Origin of Financial Crises: Central Bank, Credit Bubbles, and the Efficient Market Fallacy

authored by George Cooper, published by Harriman House in 2008

Ching-Chia Lee

In 2008, a once-in-a-century financial crisis was triggered by the explosion of the sub-prime crisis in the US. Everywhere around the world has all been under the impact, and many books have been published to widely investigate the primary causes of the latest financial crisis. In his book published in September 2008, *The Origin of Financial Crises: Central Bank, Credit Bubbles, and the Efficient Market Fallacy*, Dr. George Cooper probes into the core problems of the latest financial tsunami, investigates how the fallacy of the efficient market theory influences the operation of the financial markets, elucidates the entire process of how the problems take place, and suggests some solutions to these problems.

First of all, the author reviews the Efficient Market Hypothesis, which argues that the fluctuations of the market naturally balance towards the only equilibrium and tend to settle in stability, a status that can be maintained in a long term unless some new, unpredictable external events appear and exert influence. Dr. Cooper, however, discusses another theory to explain the operation of the financial markets—the Financial Instability Hypothesis proposed by the US economist Hyman P. Minsky. According to this hypothesis, there are some internal forces in the financial markets, which cause the credit expansion and asset inflation in the market, followed by the contractions of both credits and assets.

By introducing the history of currencies and analyzing the differences between the natures of actors in commodity markets and those in asset markets, the author notes the disorder and turmoil around the macro-economic policies and central banks, and points out that with the global financial crisis, the miscalculations in the central banks’ monetary policies cannot be neglected, and that it is necessary to have a more comprehensive and consistent framework of macro-economic management strategies.

Regardless of the many uncertainties in the financial markets, Dr. Cooper investigates the relationship between financial data to suggest some macro-economic variables to observe if the bubbles are going to burst, and if the financial systems are becoming vulnerable. The core question of this observation is—is the credit creation much faster than the economic growth? If the answer is yes, it means that the momentum of the economic growth is generated by credit creation, which is a signal of danger. Once the credit ceases to expand, the economic growth loses its support. By the same token, the ratio between the total loan of the bank system and GDP, and the proportion of interest burden in the disposable income can be deployed to measure economies’ vulnerability to a financial crisis.
crisis. On this basis, monitoring loan condition in the private sector and analyzing the returns the investors obtain from asset investments are also able to provide us with clues on the very likelihood of a crisis.

Finally, Dr. Cooper concludes with what role a good central bank should play by citing the theory of James C. Maxwell, an engineering scientist, from his paper “On Governors.” About such an inherently unstable system as the financial markets, what we should do is not to strive for complete stability, but to take strategies for dynamic stability, and to allow, and sometimes even encourage, some short-term cyclical variations. Besides, we should also eliminate the over-fluctuations in the system by means of softer and more frequent downward modifications. This strategy can prevent another wide-ranged financial tsunami like the latest one, which is so violent, tumultuous, and with a global impact.

The author also suggests that the primary task of the central bank is to prevent the economy from accumulating too much debt to manage. It should swift from the control over the consumer price index to the control over asset prices, meaning that it should pay attention to the inherently unstable asset markets rather than the inherently stable commodity markets. Through financial monitoring, the central bank can regulate both the public and private sectors at the same time, so as to prevent behaviors of waste and squandering that would bring about unnecessary credit creations.

In sum, according to Dr. Cooper, it is improper to explain the unstable financial markets by the Efficient Market Hypothesis. Instead, the central bank should function as a feedback control system to help clarify which items need to be controlled. For the controlled items, the central bank should set up some correct regulation and warning signals for the purpose of monitor and observation, and when the alarms are sounded, the most suitable correcting measures should be triggered. The author continuously emphasizes the problems of credit creation, maintaining that the crisis warning signals and control mechanism should address the tendency of the money supply growth. All of these provide us with some new and worthwhile aspects to think over as we are engaged in the management of crisis.