Economic Crisis Caused by Natural Disasters

Australia, an important member of Asia-Pacific Economic Cooperation (APEC), is now suffering from floods. The entire Queensland has been drowned; great losses have been caused in casualties, properties and economy. We hereby wish wholeheartedly that Australia can be recovered from this disaster and can accomplish the work of reconstruction as soon as possible.

It is not only Australia’s own economic development that has been impacted by the floods. Since Australia is one of the world’s primary producers of agricultural, livestock, and mineral products, the global supply of such products has also been seriously impacted, which in turn has led to a rise in the prices of relevant products. In addition to floods, other natural disasters that are frequently seen in the APEC region include typhoons, earthquakes, tsunamis, etc., which may all probably cause sudden, great economic losses, and hence economic crises. For example, the production halts and soaring prices caused by natural disasters will lead to economic instability.

In the present international economy, the rise in food price is the most prominent phenomenon under the influence of natural elements. The food price has already reached the historical highest point, triggering a global inflation. As to the soaring food price, one of its most important causes is the frequent natural disasters and climate anomalies over the past year. Accordingly, the various kinds of such natural elements must be included into consideration as we monitor the global economic crisis, which makes the task even more complicated.

It is the inflation resulted from the rise in commodity prices that plays a central role in our discussion in the present issue. In the section of Crisis Alert, we consider inflation as the most serious problem among the current risk factors. Also, we categorize the crisis risks each economy faces, so as to help the SMEs deal with crisis that may occur in different economies. Moreover, in this issue, our expert introduces the new supervisory structure over financial services and markets in Europe. According to the analysis, the prevention and early warning of crisis becomes the primary concern in Europe’s future establishment of a permanent stabilization mechanism.

We also interviewed with the General Manager of Proud Sun Heat Treatment Co. Ltd., Ms. Joan C.Y. Huang, who talks about how her company succeeded in response to the global financial crisis. The main reason for their success, in short, is the building of a long-term mutual trust relation among banks, suppliers, and clients. In the section of News Digest, some of the most relevant and concerned events are selected, including the temporary relief of the European credit crisis, the soaring commodity prices such as food and raw materials, and new capital controls launched in emerging economies. Meanwhile, we also introduce the book *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, published in February 2010, by Raghuram G. Rajan, Professor of Finance at the University of Chicago and former chief economist of the International Monetary Fund (IMF).

As noted, the main risk embedded in the current global economy is the threats of inflation, while the exchange rate risks remain in some regions, making the situation still complicated. We will continue clarifying for the SMEs the ongoing economic circumstances and the context of crisis in this publication.

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During last month, there has been a dramatic rise in commodity prices, with the prices of grains (wheat, maize, and soybeans), crude oil, and various metals all rising to recent highest levels. Among them, the increase in food prices has been most pronounced. In December 2010, the food price index of Food and Agriculture Organization (FAO) shot up to 214.7 points, the first time that it has exceeded the high point reached during the 2008 food crisis, the highest level since 1990. The price of crude oil has also risen to nearly USD 100 per barrel, sparking fears that the inflationary crisis of 2008 may be about to repeat itself.

A combination of factors – including poor weather conditions, strong demand, and manipulation by speculators – has kept commodity prices high for some time now. Given that abnormal weather is continuing, that the global financial markets are flooding with excess liquidity, and that global demand remains robust, it can be anticipated that, in the short term at least, commodity prices will continue to rise. This will drive worldwide consumer prices upwards, and will also worsen inflation expectation, thus accelerating the growth of inflation threat.

Of the various risk factors that currently threaten global economic stability, inflation poses the most serious danger. Besides the impact of rising commodity prices, the loose monetary policy that economies adopted in response to the global economic crisis creates the other important factor leading to current inflation predicament. In an attempt to combat inflation, many emerging market economies have begun to raise interest rates; however, so far this appears to have had little effect. Imported inflation resulted from the recent rise in commodity prices is offsetting the impact that interest rate hikes would otherwise have had on inflation.

Another important recent development is the strengthening economic recovery in the US. If this trend continues, it could change the risk outlook for the global economy as a whole, for several reasons. Firstly, meaningful economic recovery would reduce the likelihood of the US government being forced to implement a third round of quantitative easing (QE3), and therefore slow the increase of the quantity of “hot money” sloshing around the global economy. Secondly, a convincing economic recovery in the US might lead the Federal Reserve to terminate its long-standing policy of low interest rates. The value of the US Dollar would be also strengthened accordingly. All of these developments would tend to reduce excess liquidity in the global economy.

In the commodity markets, though an upward revaluation of the US Dollar would tend to curb further increases in the price of those commodities that are traded in US Dollars, an upturn in the US economy, which will stimulate economic growth of emerging markets, would also lead to increased demand for commodities. It can therefore be anticipated that commodity prices will continue to rise.
After a period in which the exchange rate issue had faded from view, the recent appreciation of the Renminbi has made exchange rates a focus of attention once again. Since late December, the Renminbi has continued to rise to record levels, stimulating large upward revaluations by other East Asian currencies, including the New Taiwan Dollar, the South Korean Won, the Malaysian Ringgit, and the Singapore Dollar. As a result, unlike other regions whose main task is to fight inflation, the economies of East Asia are experiencing both inflationary pressure and currency appreciation.

If we now go on to examine the level of inflationary and exchange rate risks faced by the world’s major economies, we can find that those economies struggling with both a high level of inflationary risk (defined as an inflation rate of 3% or higher) and a rising currency value include China (with an inflation rate of 4.6% as of December 2010), Singapore (4.4%) and South Korea (3.5%) in East Asia, as well as Brazil (5.91%), Russia (8.8%), and Mexico (4.4%). These economies are all exposed to a high degree of complex risks that require sophisticated measures to curb the possibility of a potential currency crisis.

The second group of economies includes those who are facing a serious threat of inflation, but the exchange rate has not risen significantly. These economies include Vietnam (with an inflation rate of 11.75% in December 2010), Indonesia (6.96%), and India (8.43%). The level of risk to which these economies are exposed is not necessarily smaller than that faced by the economies in the first group. Although their currencies have not risen in value, the combination of a substantial devaluation of the currency with high inflation could also indicate that the economy in question is teetering on the brink of a crisis. In Vietnam, the Dong has been devalued significantly, indicating that investors lack confidence in the future of Vietnamese economy. The currency devaluation together with a high inflation rate of 11.75% makes Vietnam expose to a risk that large amounts of foreign investment will flee away, and therefore increase the potential of a currency crisis.

The third category includes those economies that have experienced a substantial currency appreciation, but where the rate of inflation has remained relatively low. This group includes Chinese Taipei and Malaysia. Though these economies are relatively safe from the attack of a crisis, a number of sources of risk still exist. Firstly, if foreign investment continues to pour into the economy, it will become increasingly difficult to hold inflation in check. Secondly, these economies will need to maintain both stability in their financial markets and steady economic growth, to avoid creating the conditions that could encourage a sudden outflow of foreign investment. Third, if imported inflation becomes a serious problem, it could lead to an outflow of foreign investment as well.

SMEs should be aware of the crisis potential of both the economies in which they themselves operate, and the economies with which they do business when seeking to gauge the level of risk to which they are exposed and to anticipate future developments. The classification presented above can also provide a useful reference when formulating strategies for responding to a future crisis.
The US: Some bright spots despite high unemployment

The US unemployment rate fell to 9.4% in December, from 9.8% in November. The decline in the unemployment rate owed much, however, to the decline in the workforce, as workers became discouraged, and left the labor force. In December, the workforce shrank by 260,000 workers and the proportion of the population in the labor force shrank to 64.3%, the lowest in 26 years. Retailers added jobs, because of the Christmas shopping season, but sectors such as construction and manufacturing lost jobs.

The US inflation rate in December was 1.5% from the previous December. The “core” inflation rate, which excludes energy and food price increases was only 0.1% in December, implying that underlying inflation in the US is mostly driven by the increase in energy prices.

Since the Fed announced its USD 600 billion purchases of Treasury securities in early November, financing terms of companies have improved, the stock market increased by 6%, and the spread between high yield debt and treasuries fell from 5.92% to 5.27%, implying a decline in the overall risk level in the economy. However, despite the improving economy, given the still weak employment picture, Fed policymakers are unlikely to slow their purchases of treasury securities. In fact, they are likely to announce another spurt of Treasury security purchases, Quantitative Easing III, as long as actual inflation remains below 2% and employment growth remains slow.

The risk, however, is that the Fed may ease too much. While actual inflation during 2010 was around 1.5%, inflationary expectations have risen. Investors now expect prices to rise by an average of 2.3% per year over the next 10 years, compared to 1.6% before the announcement of QE2. In fact, owing to this rise in inflationary expectations, the announcement of QE2 has—contrary to expectations—raised the yields on 10-year treasuries, from 2.57% to 3.33%, thereby partly undoing the original intent of the monetary loosening.

Non-performing loans (over 90 days past due) over total loans in the US commercial banking system were dipped from 5.35% in end-June to 5.23% in end-September. Still, the non-performing loan ratio is the highest on recent record (from 1980), comparable only to the 4.0% non-performing loan ratio during the savings and loan crisis in 1991. The US banking system is thus overall still quite weak, and the Fed policy of low interest rates and essentially free liquidity to the banks is clearly intended to raise bank profitability. The banks can then use these profits to write-off these non-performing loans. Reflecting this rise in bank profitability, bank stocks soared in December.
In December 2010, according to the Fed’s Senior Loan Officer Survey, most firms, including large, medium, and small firms reported loosening lending standards compared to a year ago. The improvement in lending conditions, however, has been more dramatic for large- and medium-sized firms. Small firms report that although the situation has improved from a year ago, lending conditions are still tight. Thus, it appears that banks have used their favorable interest rate spreads to increase their profits, rather than expand lending to small enterprises.

Canada

The Canadian unemployment rate was 7.6% in December, unchanged from November. While the modest 22,000 jobs were created, most were temporary and part-time, mainly seasonal, for Christmas. Manufacturing sector jobs rose, while public sector jobs such as in health and education sharply decreased.

Still, forecasts for the Canadian economy for 2011 are rather upbeat, owing to hopes for increased exports to the recovering US economy. It is thus widely expected that the Bank of Canada will increase policy interest rates from the current 1% to 1.25% by mid-Spring, to slow the economy and to control inflation. (The author is Professor at University of Southern California.)

Northeast Asia

A Revival of Tensions between China and the United States over exchange rate issues

Sayuri Shirai

China

Reflecting a change in its monetary policy stance from “moderately loose” to “prudent” for 2011, the People’s Bank of China (PBC) raised the reserve requirement imposed on banks by 0.5% (to 19% in the case of large banks and 15.5% in the case of small and medium banks) on January 20th, 2011. This is the eighth increase since the beginning of 2010 and the first tight monetary measure adopted this year.

The measure reflects the government growing concerns over a general inflation hike and real estate bubbles. The inflation led to higher prices in the mainland than in Hong Kong, thereby prompting an exodus of shoppers from the former to the latter. The steady deceleration of the year-on-year growth rate of the property price index for the 70 cities from 12.8% in April 2010 to 6.4% in December 2010 is a welcome sign. However, the real estate price growth rates remain high in a number of cities, including Beijing, Chongquin, Lanzhou, Yueyang, Hefei, etc. The government permitted the cities of Chongquin and Shanghai to impose a real estate tax against luxurious houses and residential buildings this year.

The active real estate investment—recording a 33% growth rate in 2010—has been supported by banks’ equally active lending behavior. New bank loans for the same year grew by RMB 7.95 trillion, thereby exceeding the government annual target of RMB 7.5 trillion. Notwithstanding a 0.25% increase in base lending (and deposit) interest rates by PBC last December, lending (and deposit) rates remain significantly low in real terms—about 0.7% in the case of one year rate. Therefore, further
monetary tightening measures are expected this year.

Another government’s concern is the sheer size of foreign reserve increase registered for 2010. Foreign reserves expanded RMB 448 billion—the third largest growth in recent years (after record increases of RMB 461 billion in 2007 and RMB 479 billion in 2008). The increase was concentrated in the third and fourth quarters, accounting for about 43% of the annual increase respectively.

Trade surpluses contributed to about 40% of the annual foreign reserve increase with the rest being explained by foreign direct investment (FDI) inflows, valuation changes (caused by exchange rate changes), and hot money inflows (which appears to have surged in the fourth quarter). The total amount of trade surpluses for 2010 declined by 6.4%, but the quarterly figures indicate an increase in the second, third, and fourth quarters.

Despite a decline in the total trade surplus for 2010, the annual trade surplus against the United States grew by 26%, suggesting an expected intensification of political tensions between these two economies. As expected, US Treasury Secretary Timothy Geithner stated that China’s heavily managed exchange rate policy with capital controls had effectively led to the undervalued level of the renminbi against the dollar in January 12th before a January 19th meeting between Chinese President Hu Jintao and President Barack Obama at the White House. He also repeated that the renminbi should be appreciated more quickly in order to contain inflation and real estate bubbles. In January 16th, President Hu rejected this view in his written answers to the Wall Street and Washington Post newspapers and stressed that inflation couldn’t be a main determinant of the exchange rate policy. The renminbi accelerated the pace of appreciation against the dollar from January 13th and recorded the highest reference rate of RMB 6.588 in January 20th—a move regarded widely as “political” just before and after the top level meeting between the two economies. The pace of appreciation of the renminbi for a whole year is likely to continue to be moderate.

One worrisome issue is that the automobile industry may face an oversupply and thus a price decline this year as a result of the expiration of tax incentives applied to small cars at the end of last year. Small cars accounted for about 70% of total passenger car sales. The expected end of this measure promoted substantial car sales over the last two months of last year. Moreover, an introduction of a new car purchase regulation in Beijing from January 2011, aimed at containing traffic congestion, is expected to reduce a sales volume this year as well.

Japan

Premier Naoto Kan reshuffled his cabinet in January 14th and surprised the public by appointing Mr. Kaoru Yosano as Economic Minister. Mr. Yosano is a 72 year old politician, who had been formerly a member of the then ruling Liberal Democratic Party (LDP) and served as Minister of Finance in 2009. Last April, he subsequently quit the LDP to jointly form a new opposition party called “Sunrise Party” and openly criticized various fiscal and social policies performed by the ruling Democratic Party of Japan (DPJ).

He is a strong advocate of a fiscal reform and an increase in the sales tax rate from the current low level of 5% to possibly 10%. Therefore, Premier Kan’s choice of Mr. Yosano signals his strong will to initiate discussions involving all opposition parties to launch at a fiscal reform in the face of mounting public debt and growing aging-related expenditure. Nonetheless, there is little public support for the fiscal reform because the pace of economic recovery appears to have slowed down in the fourth quarter of 2010 owing to (1) a phasing out of stimulus measures applied for environment-friendly cars and home electronics last year, (2) a continued appreciated level of the yen, and (3) a decelerated pace of economic growth in other economies. (The author is Professor of Economics, Keio University.)
The risks of external payment, inflation, and exchange rate become more severe in Vietnam

Honghui Cao

Viet Nam

Again, Viet Nam still holds the headline of the crisis monitoring. It just announces the new growth target in its Communist Party session. But the worries about the risks of its external payment, inflation, and exchange rate become more severe. High reliance on investment ratio weakens the stability of its fiscal system and the loose monetary policy push the inflation and asset bubble to the peak. The liberalization of capital account to match the current account deficit and the gap between the saving and the investment deteriorates the stability of exchange rate and asset markets. The trade deficit in the first eleven months reaches USD 10.66 billion. Its foreign reserves are just USD 14.1 billion in September, which equals to the import of 1.8 months. And the pressure of external payment expands, resulting from the downturn of FDI which descends by 40% in the first ten months and the crisis of external debt of Viet Nam Marine Industry Group.

More and more obviously, the depreciation of VND is the only exception in South East Asia in 2011 with the capital outflows. What is worse is the further weakening pressure of VND. The market rate against US dollar is still 10% weaker than the official ceiling. Thus it might result in more purchase of US dollar and precious metals, and then the currency crisis soon.

Thailand

For the sake of inventory-driven import and export gains, foreign trade in Thailand decelerates in December and is close to on a sober note though the year-on-year export and import growth still reach 27.8% and 38.5% respectively. Because of the season adjustment, the import declines by about 3% month-on-month, which hit the record by 20% in November. The exports are mainly manufactured products by electronic groups. The sharp slower export growth in December may imply the beginning of the export correction as the base effect reverses in non-Asian markets.

As the main counterparty of Thailand, Euro area would suffer from the debt crisis. As the economy is too weak, manufacturers in Euro Union members have not improved their inventory, predicting the weakening of the export to Euro economies. Also, the continuous appreciation of Thai Baht weakens the competition of the exporting sector in Thailand and therefore reduces the current account surplus. In 2010, the export to Euro Union would grow by 12% to 15%, while it is expected to slow down by 6% to 10% in 2011. Various exporting products including raw materials, semi-products and consuming products from Thailand to Europe would experience pressure in the coming months. Any SMEs associated with the exporting sector in Thailand should keep their eyes on the Euro economic status and the tendency of Thai Baht.

On the other hand, rising commodity and oil prices would also pad up import payments and partially offset the volume of import growth slowdown. Thus, the trade surplus would slightly decrease from the preceding months.

Malaysia

Also, the export in Malaysia would be underperforming in 2011 though GDP growth
with structural impediments will likely moderate to a still respectable pace. While the pace of consumption would be mixed with the boost to rural incomes from rising prices cushioning the pull from high household debt burdens and decreasing job creations.

Moreover, the upward inflation pressures resulted from the rising oil prices and the food prices are posing obvious risks. Risks would be greater if the recent upside surprises in global growth rate is sustained, which lead to a swifter hike in commodity prices and closing the output gap. And the high levels of the household loan growth would also raise risks. (The author is Director, Financial Markets Division at Chinese Academy of Social Science.)

South Pacific (India, Australia, New Zealand)

Crisis Management Tested by Natural Disasters

Kenneth Waller

Australia

The breaking of a ten year drought in many parts of Australia by heavy rains late last year caused serious flooding in Queensland and New South Wales. It has been followed in the last two weeks with extreme weather conditions further leading to massive floods in Queensland, NSW, Victoria and Tasmania.

These natural disasters point to the vulnerabilities that all economies are subjected to and which can overwhelm normal disaster precautions. The crisis has required responses by civilian and military personnel and in the context of a “200 year flood” has shown major weaknesses in flood mitigation measures. Longer term responses will involve the economy in massive expenditures in flood and drought proofing.

The consequences of the floods now affecting Australia will be felt for a long period ahead as many communities come to terms with the human tragedies arising from the loss of lives, homes, jobs, infrastructure, small businesses and crop as well as stock losses on a massive scale. Major coal mines have been closed; rail, road and bridges were destroyed; and major damage occurred to crops. Short-term food prices are rising as are some basic mineral commodities with impacts on global food and commodity prices. It is too early to estimate the rebuilding costs but an inevitable consequence will be some rise in deficits at both Commonwealth and State levels of government as recovery programs come into play.

There are calls by the business community that the Commonwealth government should push out further in time its policy to get the budget back into surplus by 2013. There is little doubt that the community generally will expect Governments to give highest priority to recovery expenditures, and to supporting the rebuilding of homes, infrastructure and businesses. The fiscal position of governments and the credit ratings that the Commonwealth and some States command are such that some extension of the current fiscal deficit beyond 2013 would be unlikely to be of concern to financial markets.
The insurance and banking sectors have been asked to respond sympathetically to the disaster and both will come under scrutiny in the period ahead as they balance commercial realities and the small print of contracts with community and political demands for “fairness”.

The Australian dollar, has fallen marginally from its 28-year high of USD 1.02 to around USD 0.99, probably reflecting some improving sentiment on the US economy and uncertainties about Australia’s short term export potential as a consequence of the floods. Equity prices are stable, perhaps reflecting the underlying resilience of the economy to the natural disaster and the broad geographic diversity of the economy.

Official growth expectations for the year ahead are likely to be revised downwards—perhaps by 0.5%—as a consequence of the floods but there are likely to be offsets between business investment and public investment on infrastructure. GDP growth in the September quarter was softer than expected at a seasonally adjusted 0.2% for the quarter and an annualized rate of 2.7%, due to reduced household spending. Business confidence in November was improved marginally by 2 points. Australia’s trade surplus in November narrowed by USD 636 million to USD 1.9 billion, or 24.8% from October, due to increased merchandise imports during the period. The unemployment rate fell from 5.2% to 5% in December.

The government released its second response to the Cooper Review on Australia’s Superannuation industry. It has supported 139 of the review’s 177 recommendations. These include creating a simpler, low cost superannuation product (MySuper) and phasing in the majority of backend (SuperStream) reforms by July 2015, with the implementation of tax file numbers as primary identifiers for member accounts phased in from July 2011. The government rejected the Review’s controversial recommendations relating to changes to trustee board equal representation rules.

India

The Reserve Bank of India left interest rates on hold in December, with the perception that inflation had moderated. However, rising oil prices and a recent spike in food inflation to an annual rate of 18.3% has brought inflation fears back into focus, making another rate rise likely. India’s nine-year bonds fell, driving yields to an eight-month high. FDI inflows to India have also dipped for the second consecutive month by 7% to USD 1.6 billion in November. India’s manufacturing sector index expanded at a slower pace during December than the previous month, at 56.7 down from 58.4, and the service sector index fell to 57.7 in December from 60.1 in November. The IMF has nonetheless projected a robust growth outlook of 8.75% for 2010/11, due to a rebound in agriculture, private consumption and rising infrastructure investment.

Corruption continues as a prominent feature of the economy. In response to telco corruption scandals the Government has penalized three telco companies for failing to launch mobile phone services on time and notices have been issued to 14 companies, asking why their licenses should not be cancelled due to their involvement in the corruption scandal and subsequent failure to meet eligibility rules.

India’s banks are concerned about the liquidity shortage affecting the economy, which is impacting on their reserves. At the end of December, they tapped the short-term debt market to raise RUP 44.60 billion (USD 989.7 million) to combat the shortage and they have requested the central bank to reduce mandatory bond and cash holding ratios. Since the central bank rejected this request, banks have been increasing deposit rates and there is greater competition amongst banks in attracting depositors. Due to heavy lending by banks in the past year, loan-to-deposit ratios for several banks are now close to or above a historical high of 75%.

Banks have also made a commitment to ensure that microlenders remain fully funded in the short term to help them overcome recent constrains on their activities. Russia has just struck deals to supply India with energy and military equipment.

New Zealand

The economy contracted 0.2% during the September quarter 2010, down from a revised 0.1% during the June quarter, and much weaker than expectations. This is attributed to the impact
of a resurgent NZ dollar on exports, the scheduled increase in the Goods and Services Tax and the earthquake which impacted on the business district of Christchurch. The trade deficit, however, narrowed in November to NZD 186 million (USD 141 million) from a revised NZD 224 million in October due to demand from China and increased prices of dairy and lumber exports. Business confidence led by exports, consumer spending and construction are positive aspects of the economy and were factors which avoided a recession in 2010. Consumer confidence remained relatively consistent but easing two points to 112.2 in December.

The Reserve Bank also released new corporate governance requirements for registered banks. Key changes include imposing a minimum board size of five; requiring at least half of the directors on a board to be independent, with half of those independent directors to reside in New Zealand; a tightening of the definition of what an ‘independent’ director is; guidelines around the individual and collective knowledge and experience required by bank boards. (The author is Director, Australian APEC Study Centre at RMIT University.)

**Latin America**

**Fighting Currency War and Inflation Simultaneously**

*Cheng-Mount Cheng*

**Chile Central Bank announces highest FX intervention ever**

On January 3rd Chile’s Central Bank (CB) announced the biggest program of international reserves purchases in Chile’s record. The CB planned to accumulate additional USD 12 billion international reserve in 2011, with the first purchase of US dollar starting from January 5th to February 9th during which period the CB will buy USD 50 million per day. The last time the CB intervened in the foreign exchange (FX) market was in April 2008, when it announced a program to buy 8 billion of US dollar, also USD 50 million a day. However, it abandoned the program in September 2008 after having bought USD 5.75 billion. The CB said this time that it would announce in due course the next stages, depending on market conditions.

One reason behind the measure was the CB intention to increase international reserves to a level compatible with those of other economies similar to the Chilean economy. The planned amount represents roughly 46.1% of international reserves (USD 26 billion as of January 4th). Recent Chilean Peso (CLP) appreciation also motivated the CB FX intervention policy. In particular, recent run-up in copper prices has considerably contributed to the real appreciation of Chilean peso.

To avoid the impact of this FX accumulation program on domestic liquidity and inflation pressure, the CB also unveiled a program of sterilization, in which the CB will issue BCP bonds amounted to CLP 1.4 billion (around USD 2.9 billion) and BCU bonds (2, 5, 10, 20 and 30 years) for UF 177 million (around USD 7.9 billion). In addition, Chilean Financial Minister said the government would also flank fiscal policy to assist CB’s move by spending controls that should leave last year’s budget close to balance.

**Brazil Central Bank announces new FX**
The Brazil Central Bank (BCB) announced the introduction of 60% reserve requirement for short USD/BRL positions on January 6th. However, this reserve requirement is applicable only to positions that exceed USD 3.0 billion or the financial institution’s Tier 1 capital. The reserve requirement would have to be deposited in cash and non-interest bearing. The institutions will have a 90-day grace period to adapt. The official aim of the measure is to curb excessive FX exposure and to improve the market functioning.

BCB monetary policy director, Aldo Mendes, stated in a press conference that banks ended 2009 with a long cash USD/BRL position of USD 2.9 billion, but by the end of 2010 this position changed to short cash USD/BRL by as much as USD 16.8 billion. Mr. Mendes said that the new measure would have little impact on the spot rate as most of the spot market positions are hedged in forwards, and there would be no change in BCB’s spot market operations.

In a unanimous decision, the Brazil's Central Bank Monetary Policy Committee (Copom) decided to hike the Selic rate to 11.25% from previous 10.75% on January. This move was widely expected by market analysts to fight inflation, currently running at 5.9%. In the statement, the Copom members mentioned the beginning of an adjustment process in the interest rate, the effect of which, together with macro-prudential measures, will help inflation to converge to the target trend. Most economists believe more rate increases are inevitable and some worry that rate hikes could bring further appreciation pressure on Brazilian real.

Venezuela government announces the end of two-tier FX scheme

Almost a year after implementing it, Venezuela eliminated its two-tiered foreign exchange system that gave preferential treatment to certain goods. This follows a similar move introduced in January 2010 when Venezuela devalued the bolivar from 2.15 to 2.60 for goods like food, medicine. Now, starting January 1st, 2011 the government says rate moves to 4.6 bolivars for those preferential goods. Market observers expect the bolivar to devaluate in 2011 that will likely escalate CPI inflation pressure, which currently stands at 30% year over year. (The author is Vice President, Citi Taiwan.)
By EU standards, the month under review has been relatively quiet. The Christmas and New Year holidays saw millions going off on leave, and major commercial, industrial, academic and government institutions, together with parliamentary systems, taking a break of more than two weeks. This year, weather conditions made the situation worse with storms, snow and ice causing massive delays and disruptions to travel and holiday plans, which meant that the traditional return to work in the first week of January was delayed for many people and institutions.

Towards the end of December, the catalogue of unresolved EU problems remained quite long:

- Annual growth at between 0.3 and 0.5%;
- Unemployment high but stable at 10.1%;
- Retail trade down by 0.8%;
- Falling house and property prices in several markets;
- Debt issues for Spain and Portugal unresolved;
- Disturbing signs of growing inflationary pressures.

At the same time, the earlier sense of crisis that accompanied the Irish debt debate has largely abated. While solutions may not be forthcoming, and growth yet to materialise, the sense of confusion and uncertainty that characterised many events over the past three years, was absent.

Progress on some important issues relating to the stability of the banking system, debt and regulation of markets, with largely mid to long term effects, does also seem to have been made:

- Increasing the size of the emergency bail out fund is recognised as necessary, though no final agreement was reached on the final size of the fund, or of conditions;
- The outline of plans to deal with future crises, to ensure that bond-holders would share the risk of failure by 2013 was agreed;
- Financial services and financial markets have come under stricter institutional and EU level supervision, with Frankfurt (the European Systemic Risk Board – ESRB), London (the European Banking Authority – EBA), and Paris (the European Securities and Markets Authority – ESMA), hosting the key institutions.

For non-EU banks and financial service providers (such as banks, insurance companies and foreign investors) these developments could have a very significant impact. Both US and Asian economies have voiced concerns but perhaps it is too early to assess the implications of these measures, or their impact on banking and investor behaviour in a global context.

Discussion within the EU and within member states is also focussing increasingly on an issue that could fundamentally destabilise recovery and debt reduction strategies: inflation.

While inflationary pressure has been building in Asia and other emerging economies for some time, it is now beginning to affect input and
consumer prices in the EU very significantly and there are growing calls to take action.

Pressure on global commodity prices has been building for some time, attributed mainly, though not entirely, to speculative forces. An estimated EUR 60 billion has been pumped into global commodities markets by investors over the past year, pushing share prices significantly higher. At the same time, demand in Asia and other emerging economies continues to grow sharply, while supply has been hit by bad weather, floods, diversion of crops to biofuels, etc. Prices are thus rising across the board, and for the EU this is a major concern because of its dependence on imported energy, industrial raw materials and agricultural commodities. Indeed, these pressures are now feeding through to consumers and both the European Central Bank and the Bank of England have indicated that they will start raising interest rates soon.

This could precipitate a second recession, with companies and individuals borrowing less, saving more and spending less.

Of the various sectors, the most badly affected one would be the SME sector, which has been struggling during the past three years with the credit crisis, late payments by bigger companies, and a loss of market share. This issue therefore needs careful monitoring.

One other issue is being addressed in the EU context that could be of relevance to Asian SMEs: efforts to improve energy efficiency by 20% by 2020 could create significant new business opportunities, and the EU is likely to use regulatory measures to ensure that these opportunities work for European companies. Plans will possibly be finalised in February when Hungary chairs a major meeting on this issue. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)

East Europe

Estonia joins the Eurozone; East Europe recovery steady in December
Kuo-Yuan Liang

Estonia joins the Eurozone in Jan. 1st, 2011

Amid doubts about the shared currency, the Euro Area welcomed its 17th member state to officially adopt the Euro as their only legal tender. With the accession of Estonia, I would like to introduce its current economic status in this month’s column article.

Estonia’s public finances are outstanding

Since its re-independence from Russia, Estonia has pegged its member currency to the Deutsch Mark, and subsequently, the Euro upon formation of the Eurozone. To officially join the Euro Area on schedule, Estonia has strived to maintain a quality public finance statue. For instance, its annual government budget has been at a near balanced level for a long period. Its total public debt has been less than 10% of its GDP size, a remarkable feat given the public debt woes observed across Europe at the moment.

Before the financial crisis, Estonia enjoyed a period of prosperity
During the decade prior to the financial crisis, lying within the general trend of East Europe and in particular the development of the Baltic area, Estonia enjoyed a period of rapid growth and prosperity amid foreign capital inflow that stimulated investment in the economy. However, after the eruption of the financial crisis, foreign capital inflows ceased, and the small Baltic state suffered a collapsing retreat as its economy size shrank in double digit percentages on a year-on-year basis throughout late 2008 and most of 2009.

Economy rebounding from the financial crisis

As the global economy gradually recovered from mid 2009, Estonia’s recession in the fourth quarter of 2009 stopped when it posted a 1.4% quarterly GDP growth. From then on, in 2010 the Estonian economy showed signs of a promising recovery in almost every economic statistical category. Its GDP grew 1.0%, 1.9% and 0.9%, respectively, in the first three quarters of 2010. From a year-on-year basis, Estonia recovered particularly well in manufacturing related categories, with double digit growth rates in industrial production and new orders commonly observed throughout 2010.

While other sectors also rebounded remarkably from the bottom, the unemployment rate in Estonia is still quite high, peaking at 18.5% and still at 16.2% as of September. This would be the largest single challenge to deal with for the Baltic state in future years, which is also a common problem across Europe. Evidently, most of the remarkable growth in the recent quarters is due to its low base period in late 2008 and 2009, for the very least we can say with confidence the worst has already passed for Estonia.

Challenge for 2011 is curbing unemployment

Looking forward in 2011, after becoming a Euro Area member, the Estonian economy will benefit from savings in transaction costs that used to exist in foreign exchange. Meanwhile, the larger common currency, though not without problems, will provide Estonia with relatively better financial stability, lower inflation and eliminate the risks associated with currency convertibility, which was once a particular concern as Estonia is a small economy with substantial foreign investment. The major challenge for Estonia would be finding ways to reduce its high employment rate, though it is a tough task given the current high unemployment level. Yet, Estonia has more room to maneuver than other neighboring economies with its low public debt and deficit levels.

East Europe recovery steady in December

As for the other economies in the East Europe region, the ESI report in December 2010 shows that all economies in the region had modest improvements in the past month, except for Greece. Among the major categories, general improvement was observed in industrial confidence and retail trade, while service sector confidence also improved in several economies such as Poland, Czech, and the Baltics. As always, the industry sector is still the major force that is leading the recovery, and during the year’s end, its optimism in the retail trade sector is understandable as this is their time of the year. The service sector and consumer confidence was not able to generally improve, as consumers in some more indebted economies are now starting to feel the effects of austerity programs hammered out during the past year. This subsequently affects the demand for services, as the service sector relies more on domestic markets.

Overall, the progress of recovery in December is considered profound. As for the 2011 prospects, we expect the observed trend in the past year to continue, as recovery is still led by the industry. We will need to wait and see when consumers will feel satisfied enough to let the service and retail sectors to really start to improve. (The author is President, Polaris Research Institute & Honorary Professor, and Professor College of Technology Management, National Tsing Hua University.)

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Russia and the Middle East
speed up marketization

Ming-Hsin Kung

Over the past year, the GDP of Russia has achieved the expected growth of 4%; both its industrial productivity and investment show strong growth; the unemployed population has decreased by about two million; the stock market has risen over 20%, returning to the level before the financial tsunami. However, such natural diseases as drought and forest fires have caused not only an economic harm in Russian agriculture, but also an inflation beyond expectation. Generally speaking, Russian economy has achieved growth, and has incorporated various elements of reform leading to market modernization. In some sense, this phenomenon is an interesting contrast to how China imitated the Soviet model of economic development in the 1950s. In fact, the spirit of Russia’s reforms in 2010 is obviously identical to China’s reforming and opening up since 1980s.

First of all, the Russian government established the Innovation Center of Skolkovo, and provides those who participate in the Center with a series of policy incentives in tax and visa that were stipulated in the newly announced federal legislation. Moreover, RUB 85 billion will be invested into this Center in the following three years, signifying a big step towards the fundamental development of cluster economy and knowledge economy.

Besides, at the end of last November the Russian government also announced a series of projects of privatizing state-owned corporations, aiming to transform ten large state-owned corporations into private corporations between 2011 and 2013. In addition to the privatization, other facts such as entering World Trade Organization, promoting a custom union among Russia, Belarus and Kazakhstan, and launching the business of Ruble-Renminbi exchange, all demonstrate how determined Russia is to actively accelerate the marketization of its economy and participate in the process of regional integration when facing the violent competitions among the emerging economies.

In addition to these deeds, Russia has also actively developed its domestic market by drawing lessons from China’s experience of the Eleventh Five-Year Plan. Last March, it launched a program with RUB 20 billion subsidy to encourage sale of Russian-produced cars and has benefitted the buyers of 400 thousand cars by the end of the year. It is expected to receive more government funds of about RUB 13.5 billion this year to continue this program. What this program importantly demonstrates is that the domestic demand in Russia will continue being encouraged and supported by the government and its policies.

Similar situation can also be found in the Middle East. Those economies in the Middle East are likewise speeding up their process of modernizing their markets, and the potential for growth can be continuously seen in their consumer markets. As an emerging market that plays an important role in the global economy, the Middle East shows an optimistic prospect in terms of their market potentials in 2011. According to authoritative surveys on issues about the Middle East and North Africa, the consumer confidence index (CCI) increased widely in the Middle East in the fourth quarter of 2010, with Bahrain and Qatar as the two most remarkable instances, and with the exception of Lebanon, which was bogged in political turmoil. Most importantly, steadily
increase in CCI can also be found in Saudi Arabia, the largest economy in this region.

Similarly, the result of a survey among the citizens of Gulf Cooperation Countries (GCC) also demonstrates a general optimism about the current individual financial situations. Overall, most of the Middle East survey respondents expect the economy to continue getting better in 2011, and 49% of them also expect to see an increase in individual income.

In all, even analyzing the future development of the Middle East with the perspectives other than energy, we can still find that a great potential exists in the investment of modernization constructions, and especially in the increase of domestic consumption that will be too important to be ignored. (The author is Vice President, Taiwan Institute of Economic Research.)

Global Commodity Market

The rise of commodity price drives Inflationary concern in the global economy

Hwa-Nyeon Kim

In the last one month period (mid-December in 2010 to mid-January in 2011), there have been persistent warning signs of a crisis in the global commodity market. The commodity price indices have shown upward trends and the prices for most of the main commodities such as crude oil and copper broke last year’s highs on the back of massive amounts of global liquidity. Among crude oil prices, the Brent price in particular, increased to almost USD 100/barrel.

The recent focus in the commodity market has been on the adverse weather conditions such as the exceptionally cold winter in the Northern Hemisphere, the effects of La Nina on the Southern Hemisphere and floods in Australia. This abnormal weather has been severely restricting the supply and demand of commodities, which tends to increase prices. Although China hiked the bank reserve ratio by a further 0.5% point to fight against inflation in January, the commodity market seems to be unaffected and prices have kept increasing. However, in terms of demand, it is still uncertain whether commodity prices will continue rising amid the increasing possibility of a slowdown in the global economy, China’s monetary tightening woes, and reoccurring sovereign debt risks in the European economies.

Currently, inflationary concerns in the emerging economies are receiving the most attention in the global financial markets. Standard Chartered Bank expects that China’s CPI may surge, peaking at 6% in mid-2011, on the back of climbing food and commodity prices. Food inflation in many emerging economies, including China and India, is already in the double digits, raising fears that inflationary pressure could spread more broadly to other sectors.

According to the FAO’s latest report, record high food prices are moving to the top of the agenda for many policymakers in the emerging economies as the prospect of higher inflation in 2011 poses a major threat to the continuing growth. Consequently, escalating inflation in China and India may prompt government officials to curb expansion by raising interest rates, slowing growth in the emerging economies. However, monetary
policies need to be further tightened to make expectations of inflation subside.

The top two commodity indices, the CRB spot Index and LME non-ferrous index, have shown gradual increases from mid-December to mid-January. The CRB spot index (year 1967=100) moved up from 505 to 538 and the LME index (April 1999=1,000) increased from 3,965 to 4,268. The average for the LME index from mid-December to mid-January increased 8.5% while the average for the CRB index rose 5.6%. Such changes are positive signs that there are still upward trends and steep slopes within the commodity indices compared to the previous month. In terms of price variations, the daily price changes of both the CRB index and the LME index were higher than those in the mid-November to mid-December period, indicating an increase in investment risk in commodities.

As for energy prices, the WTI near month futures price moved within the range of USD 87.7 and 91.86/barrel and Dubai crude prices moved between USD 89.34 and 94.23/barrel during the same period. Both the minimum and maximum values were larger than those in the mid-November to mid-December period.

Among non-ferrous metals, or more commonly known as base metals, lead and copper prices raised the most as the previous period, with the average price of lead and copper rising 10.8% and 9.5% respectively. The price of copper recorded a new historical high of USD 9,754/ton in January. Other base metals such as nickel and zinc also showed rising price patterns. The maximum prices for nickel and zinc during the last one month period were USD 25,725 and 2,471/ton respectively. The prices of aluminum and tin also revealed increasing variations.

As mentioned above, the main risks this year, especially in the first half, will be inflationary pressure. Continuously rising commodity prices will contribute to the expansion of inflation. This means that governments will likely implement more tightening monetary policies though they still need to deal with the continuing risks, such as the European debt crisis and a slow economic recovery. For example, Korea is facing growing inflationary pressure mainly due to a rise in imported raw material costs, leading to the Bank of Korea raising its benchmark interest rate to 0.25% point in January 2011. Therefore, the possibility that SMEs will face aggravated difficulties because of both high raw material costs and decreasing sales is increasing. (The author is Research Fellow at Samsung Economic Research Institute.)
Building a New Regulatory Infrastructure for European Financial Services and Markets

Julius Sen

Introduction

Somewhat against the odds, four new EU level regulatory bodies with oversight responsibilities for all major areas of financial services and financial markets began functioning at the beginning of January 2011. Although this represented a major step forward in the institutional development of the European Union, there still remains the complex and politically charged issue of economic governance, dealing with future bailouts for the banking sector, and coordinated crisis response.

That this was achieved at all was remarkable. Differences of economic philosophy, opinion and thinking were finally reconciled with equally wide chasms in political thinking. Further improvements to the system can be expected over the next few years as experience develops with its functioning and implementation.

Questions for the global economy

In creating these institutions and vesting them with new authority, the EU has established a new regulatory regime that will also affect the way foreign financial institutions operate within the EU. There are legitimate questions as to whether this regulatory regime could impede the integration of global financial markets, by discriminating against non-EU banks and financial institutions, and whether a fortress Europe will develop, which will then be used as a base from which to dominate global financial systems.

While it is of course too early to draw any conclusions about the possible implications of these measures, it is worth reviewing the overall architecture of this emerging system and assessing its apparent implications for other economies.

Early responses

Initially, European strategies to deal with the crisis involved domestic and international policy coordination. Once the crisis phase was considered to have passed, attention switched to creating EU level systems and institutions that would prevent such a crisis happening again. This fell into three main categories:

- Economic policy convergence to underpin the stability of the Euro
- Debt and crisis management, and resolution strategies
- Reform of financial regulation

At the outset, all three looked impossible and beyond the capacity of an EU exhausted by constant expansion and bickering over the division of powers and the treaty structure. However, recognition that action in these areas was indeed needed, ingenious and complex solutions and
options began to emerge that did not necessitate the reopening of all the political debates of the previous decade, but would, at the same time, solve the underlying problem.

There was another level of concern: that the US would not be able to lead on this issue because of internal divisions, and no G20 initiative was likely to emerge. Action, if any, had to be taken at the EU level.

The overall design of the new regulatory system for financial services and markets

Europe’s political leaders broadly recognised, from early in the crisis, that several issues needed to be addressed simultaneously to prevent a repetition of earlier regulatory failures and oversights. The European Commissioner charged with this task describes the regulatory system that emerged as the ‘control towers and radar screens that the financial sector needs’.

They also accepted the reality that regulatory systems of individual EU members would not disappear and that the new institutional apparatus should work with regulators and governments of members to create a more effective regime.

For each of the distinct regulatory functions identified, a new institution has been created. These are:

- European Systemic Risk Board (ESRB), under the European Central Bank and based in Frankfurt, will look at risks to the system including speculative bubbles, and will alert governments and regulators of members, so that remedial action can be taken before they threaten the whole economy. Similar in design and function to the Financial Stability Board of the Bank for International Settlements (BIS).

- European Insurance Occupational Pensions Authority (EIOPA), also based in Frankfurt, and established to monitor Europe’s vast pensions and insurance market, and to protect pensioners from risk.

- European Banking Authority (EBA) based in London, and designed to work with regulators of member economies to create effective Europe-wide rules and regulations to help comply with Basel III obligations initially, and to preserve banking stability generally.

- European Securities and Markets Authority (ESMA) based in Paris and charged with the difficult task of creating rules and systems to limit speculative attacks and risk, especially for hedge funds, private equity and sovereign wealth funds.

The key ideas adopted in designing this system were in essence quite simple:

- To use information, transparency and early warning systems to alert regulators of member economies.

- To help coordinate regulatory, and where necessary, policy responses through the four institutions.

In effect these institutions have limited power, but have assumed a sort of collegiate leadership role for regulators of member economies. In terms of design and function, these are unique institutions and resemble, to a limited extent, the Competition regime of the EU.

Governance and the Euro

Beyond the creation of a bail-out facility and fund, discussion has now moved significantly towards creating a reasonably stable and permanent mechanism to deal with debt and bail-outs in future, but also to limit the capacity of governments of member economies to take economic policy measures that put the whole Eurozone in danger. Each of these is very major undertakings, and the key consideration here is prevention and early warning.

The next few months are likely to see significant developments in these areas, and my next essay will focus on this issue.

Implications for Asian economies

Interestingly, the emerging EU regulatory framework, together with recent decisions about state aid to banks, has started a process of contraction and consolidation, with banks
becoming smaller and more nationally based.

In time, this may be followed by a new round of M&A activity in the banking sector, but subject to stricter supervision and regulation both from these new institutions and from the Competition Commissioner.

Large Asian and international banks, insurance companies, and investors will find it harder and more expensive to operate in the EU, at least initially, and this will possibly mean the cost of capital will rise. SMEs, as major borrowers, could be affected. Compliance, transparency and regulatory costs could be significant, though it is hard to assess at this stage. Implications for SMEs in the APEC region is likely to be only indirect, but may in time prove to be significant.

A greater possibility is that the EUs regulatory framework will be adopted elsewhere in the world, particularly Asia, and this will drive up the cost of credit to borrowers. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)
Proud Sun Heat Treatment Company specializes in the heat treatment processing of ultrathin steel strips. Under tremendous challenges of the 2008 financial crisis that caused orders to precipitously decline below 30% of usual levels, General Manager, Ms. Joan C.Y. Huang indicated that they deployed the very characteristics of their products for being “soft” (agilely flexible), “thin” (optimally efficient), “solid” (realistic and pragmatic), and “consistent” (firm and invulnerable), like steel, to cooperate with their upstream and downstream stakeholders to pursue mutual survival through the financial crisis. As a result, miraculously less than a year after coming out of the crisis, they had been able to enjoy complete offsetting of any losses, and return to profitability.

GM Ms. Huang shared their successful experiences in overcoming the adverse economic climate. Their “soft” adaptive collaboration with upstream suppliers, banks, and customers, as well as operational changes and streamlining measures were introduced concomitant to the precipitous decline in orders. “Hard” adherence to production quality maintained clients’ consistent confidence, allowing for an expeditious rebound from the bottom of the barrel within less than a year. Moreover, they were able to work with the Small and Medium Enterprises Administration (SMEA), Ministry of Economic Affairs, in the “Localized Services for Community Care” project they deployed during the financial crisis, to enjoy government support to companies in the community for surviving and adapting through the financial crisis.

Soft: Flexible measures through mutual understanding and cooperation

“During the crisis, empty-handed clients were reluctant to accept anything we could offer,
unless we could assure them to move their product inventories through sales!”

Faced with the tumultuous task of persuading clients, the belief in Proud Sun relied on an attitude of “sacrifice and genuineness” in response. Recognizing the tremendous operational difficulties facing their clients, Proud Sun provided flexible prices reflecting only the barest overhead and established mechanisms to reduce clients’ inventory on its own initiative. Proud Sun realized that maintenance of excessive inventories would adversely affect their clients’ operational efficiency. To avoid pressuring clients to accept additional inventory, even though Proud Sun had previous orders in hand, it tended to conservatively engage in order fulfillment, allowing clients to maintain the most modest inventory levels to ensure their optimal efficiency and a brighter report to their stakeholders.

GM Ms. Huang precisely noted that the sacrifices represented the certain means of securing mutual survival. This allowed them not only to assist their clients in controlling inventory logistics and supervising inadequacy of their own inventories, but also ensure accurate reporting of the amount of demand to suppliers. So when the global economic climate took a turn for the better as well as overhead costs declined, they were able to appropriately lead the market with proper price adjustments to seize additional market share.

Pliability and flexibility remain core corporate principles, which enabled Proud Sun to maintain the long-term close ties with its client base, supply products to meet their clients’ needs, and engage in mutually synergistic cooperative relations.

Thin: Squeezing opportunities out of the crisis, operational streamlining and reforms

“Among our five furnaces, only two were running during the crisis. That alright, we can take the time for re-training our employees!”

In addition to make human resource adjustments in the crisis, Proud Sun undertook employee retraining and skills enhancements. Based on its own experiences in surviving the prior Asian financial crisis, Proud Sun cooperated with the SMEA during this crisis, to improve the weaker areas of the firm’s responsive capacities through offering employees the needed in-service training. Proud Sun also disclosed the information of the difficulties facing the firm to employees and encouraged them to participate in the coursework by including the participation as an integral component in their annual bonus evaluations.

To ameliorate overall climate of corporate confidence during the periods of lowest production output, “we had to make sure that no one was left unoccupied at that time, keeping all the employees productive and all the equipment for future operational readiness, undertaking periodic maintenance, and assigning our engineering department to research and development tasks”. GM Ms. Huang additionally noted that, “when business was down and equipment idle, we wanted to keep the corporate spirits up and ensure no minds were left unproductive and idle”.

Solid: Staying securely on firm ground with conservative strategies and operations

“Some banks withdrew significant portions of our available financing for operations, but thankfully we secured enough financial resource from the other banks that have cordial relations with us.”

For a long time, the firm has committed to conservative financial strategies, including carefully managing their operational finance leverage, and preserving their more than two decades of stable and fruitful cooperative ties with local banks. In terms of corporate communications strategies with banks, they adhered to the principle of transparency even during the crisis, while also working with banks to establish the creditworthiness of their up- and down-stream suppliers by disclosing the information of the operational performance status of their partners.

“So while we were no doubt faced with some challenges from those banks which were withdrawing funding, we were able to work even more fruitfully with some other more cooperative banking institutions”, explained Executive Vice
President, Mr. Morris Su. They did not merely seek the lowest cost of capital for operating lines of credit, but relied instead on long-term cordial ties with committed, supportive lenders. Though these lenders were conservative in any new lending activities throughout the financial crisis, they still redirected greater than usual capital resources to support Proud Sun as a long-term stable client.

As a result of the crisis, certainly banks were all the more conservative in selecting their partners for cooperation. During the financial crisis, many of the international banks experienced cash flow shortage and capital impediments, so they had no choice but to reclaim capital lent to customers to replenish their own reserves. Naturally Proud Sun had to do their best to comply with international lenders’ requests for reclamation of financing capital.

“Negative information travels on a whirlwind at the speed of light” noted GM Ms. Huang, “so when the international bankers demanded their funds back, if you did not immediately comply, they would think your creditworthiness may be having some problems, and then even the local banks might close off their funding to you”.

Consistent: product quality and corporate confidence as solid as rock

The success in establishing trustworthiness for the highest quality products allowed Proud Sun to receive their clients’ long-term support. During the supply crunch of early 2010, they were nevertheless able not only to satisfy their stable long-term client base’s requirements, staving off any threats from the supply crunch, but to support other firms and suppliers with inventory. This evinced the resolute production strength and the understanding they had achieved with their suppliers and stakeholders.

The Crisis is gone, but the relationship not

GM Ms. Huang explained that the first three months of the crisis proved to be the most challenging. But thanks to the dedicated commitment of suppliers and banks cooperation, they were able to survive those critical three months. Their strategy was to fully cooperate with their clients’ requirements, allowing maximal flexibility for their clients to stimulate their markets, so they could help rekindle demand in the marketplace.

In sum, at that time of the crisis, Proud Sun “provides maximally competitive prices, so that clients will be more motivated to stimulate sales in the market”. It, hence, is precisely that their clients were able to quickly engage in sales negotiations with their downstream marketing distributors, to deploy highly attractive prices to maximize profitability for these distributors to ensure higher sales performance for the product lines.
Temporary Relief of the European Credit Crisis

Following the successful selling of bonds in Italy and Spain, recently Greece, Hungary and Portugal have also issued their new bonds with success, bringing a temporary relief to the debt problems of the Euro zone. Japan plans to buy 20% of the first bonds issued by the European Financial Stability Facility (EFSF) with its foreign reserves, and China has announced to buy the bonds of Greece, Spain and Portugal, which will not only diversify the structure of its foreign reserves but also help to stabilize the Euro. Regardless of the successful issuing of bonds and winning other economies’ pledge to buy them, Portugal has seen its credit rating downgraded by Fitch, a downgrading that may probably happened in the Moody’s rating because of Portugal’s uncertain economic prospect, its increasing credit costs, and the problems in its financial sector.

In the Eurozone, debts of about hundreds of billion euros are coming due in 2011. Among them Spain and Italy have debts of about EUR 400 billion coming due in the first half of the year, requiring the two governments to raise funds or sell bonds. In the EUR 750 billion aid fund set up by EU and IMF, EUR 440 billion are allocated to the EFSF. Under the current complicated credit guarantee system, however, the actual loan amount is merely EUR 250 billion, which, limited by the loan regulations, would certainly be insufficient once the credit problems worsen in the future.

To solve this predicament, the Eurozone finance ministers met in mid-January to discuss over the EFSF aid fund—which to expand it or to take some other measures. In the meeting, though they agreed to revise the loan restrictions of the EFSF, but there was no agreement upon other proposed measures, including to purchase bonds issued by economies bogged down in debt problems, to lower the loan interest rates of the aid fund, to lower the collateral threshold, to loan directly, and even to levy tax on bank sectors.

Although the European credit problems are temporarily relieved, the governments will face their debts coming due one after another. In addition to the EU aid fund, other solutions are also needed by the European economies under the menace of crisis. For instance, Portugal is not only reducing its government budget deficit and increasing its export, but also selling bonds to other economies and trying to expand the source of its bond investors. Concerning the question of how the EU should help its financially troubled members resolve the debt problems, discussions are still currently limited to the structure of aid fund usage. It is also certain, nonetheless, that it is agreed among all EU economies that the Eurozone’s stability must be maintained.

The surge of commodity prices is causing inflation

In addition to climate anomalies that are frequently reported around the world, the cold of winter has also pushed up the international oil price to the highest level in the recent two years—Brent Crude Oil is now USD 98.46 per barrel, and West Texas Crude Oil USD 91, driving the prices of fossil-related products upwards at the same time.

As to the food price, the food price index released by the Food and Agriculture Organization (FAO) of the United Nations has kept rising for six months so far, under the impacts of droughts, cold, and floods in many places since 2010. The price is now even breaking the historical record created during the food crisis of 2008. The increase rates are especially high in the prices of sugar, wheat, corn, barley, and soybean, and a drastic rise is also
seen in special food materials such as spice and onion.

Facing heavy inflation pressures caused by the soaring of international food prices, the South Korean government has not only increased the supply of food such as vegetables and meats, but also planned to set up a grain-trading company in the US so as to control the domestic food price fluctuation by direct purchase of bulk foods. When it comes to Indonesia, it has cancelled the import duties on wheat, barley, and livestock feeds in order to reduce the impacts of price fluctuations. Also, the situation has prompted G20 to convene to tackle the food price problem. Some of the major food-producing economies may take measures to regulate exports for the purpose of securing domestic food, which will be even harmful to food price stability.

On the global level, the soaring food price may squeeze out expenses on other commodities, unfavorable for the recovery of world economy in the long term. Besides, the price of gold has reached a historically highest point, and the prices of major raw materials have kept rising, such as base metals, including aluminum, copper, lead, magnesium, etc. The prices of major raw materials will probably remain high in 2011 with increases in international industrial production.

New Capital Controls Launched in Emerging Economies

Under the pressure of the influx of hot money, the emerging economies are launching more restricted measures of capital control. The Brazilian Real, considered by Goldman Sachs as one of the most overestimated currencies in global major currencies, has dramatically risen by over 14% since May 2010. Therefore, the Brazilian government has announced new regulations: starting April 4th, Brazilian banks will have to deposit at the central bank 60% of the portion of their short positions that exceed USD 3 billion or 60% of their tier 1 capital, whichever is smaller; and the reserve will not earn interest. This means the banks will have to pay more to short US dollars, and speculations will decrease.

Besides, following its imposing a cap on banks’ foreign exchange forward positions in June 2010, South Korea has relaunched capital regulations on foreign exchange forward positions in January 2011, lowering the local banks’ foreign exchange position from 50% of capital to 40%, and those on foreign banks’ branches from 250% to 200%.

As to Chinese Taipei, starting 2011, the central bank has sharply raised the reserve rate to 90% from 9.775% for the portion of new deposits that exceeding the deposit amount of the 30th December 2010 in foreign investors’ NT dollar accounts. For those deposits below the 30th December 2010 level, a 25% reserve requirement is also applied. This regulation is aimed to prevent speculative foreign trading.

Meanwhile, the emerging economies, including China, have loosened their regulations on exporters’ income in foreign currencies since January; they can save such income overseas, and would not be forced by law to exchange the income into Renminbi as before. Indonesia also decided to require banks to set aside 5%, raised from 1% currently, of their total foreign-exchange holdings as reserves as of March 2011, and it is expected to be further raised to 8% by June. The aim is to absorb surplus liquidity of the bank system, relieving the appreciation pressure faced by Indonesian rupiah.

In South America, Chile has announced its plan to purchase 12 billion US dollars in the foreign-exchange market, and Peru extends its reserve requirements to overseas branches of banks. Moreover, South Africa and the Philippines have loosened their limits on capital outflow.

For many economies, the enforcement of capital controls reflects the inflation that is increasingly harder to suppress. Since each economy has its situation different from another, different types of capital regulations can be seen. Whatever type of regulation is imposed, however, the purpose is to raise the cost for foreign investments to discourage their inflows. This phenomenon, however, may harm the international flow of funds, going against the trend of globalization, and therefore regulations can only be taken as temporary measures in the short term.
Fault Lines: How hidden fractures still threaten the world economy

Author: Raghuram Rajan, Published by Princeton University Press, 2010

Ching-chia Lee

In his book entitled Fault Lines: How hidden fractures still threaten the world economy that published in February 2010, Prof. Raghuram Rajan of the University of Chicago and the former chief economist of the International Monetary Fund (IMF), examines how the underlying fissures in the world economic system are still with us by using a geological metaphor. Prof. Rajan was one of the few economists who have raised his warning before the global financial crisis had hit the world. In 2005, he presented a controversial paper at the annual Jackson Hole monetary conference that warned of the financial development has made the world riskier.

Prof. Rajan points out that the problems of the global financial crisis actually stem from the fundamental incompatibility between the goals of capitalism and those of democracy. As a traditional democratic entity, the US government needed to respond to the rising inequality politically by expanding lending to the households, especially the low-income ones. Nevertheless, with the nature of capitalism, the lending behavior has inevitably created distorted incentives, hubris, envy, and misplaced faith and herd behavior, especially within the financial sectors. The internal incompatibility within advanced economies, especially for the US, and its relationship with the rest of the world helped trigger the global financial crisis.

Following this analytical framework, Prof. Rajan identifies three important fault lines in the global economy. The first one, which is highly related to domestic political stress, is the US government’s goal to push for universal home ownership and its easy credit policy. The second one is the trade imbalance between the economies with debt-fueled consumption such as the US, and the export-led growth economies such as Japan, Germany, and now China with a politically strong but very inefficient domestic-oriented sector.

The problem is that the economies with debt-fueled consumption are used to make up the deficient demand resulted from under-consumption of expert-led economies. The structurally distorted global demand is a threat to the open world economy. The export-led growth of the developing economies has not only increased the burden on the rest of the world to absorb their goods, but has also accentuated the domestic distortions of their economic development.

The final set of fault lines develops when different types of financial systems from different forms of government and discipline come together to finance the trade imbalances. As Prof. Rajan points out, “They tend to distort each other’s functioning whenever they come into close contact.” Unlike most people who blame the financial sector and the greedy bankers for taking irrational risks that caused the crisis, Prof.
Rajan notes that the financial sector, however, was at the center of a number of fault lines where actors undertook reasonable actions from their perspectives, and unintentionally led to the crisis.

With regard to fixing the fault lines in the global economy, Prof. Rajan outlines the painful reforms we need to make in order to avoid the possible turmoil in the future. An interesting observation from Prof. Rajan’s viewpoint is how he touches upon the political factors and how the multilateral organizations should put substantial efforts on reforms. For example, the action that the US government has adopted after the crisis was to keep the interest rate low in the hopes that household will start consuming very soon since household consumption was the major source of US economic growth in recent years, while the Chinese government has intervened to make sure its currency stable enough without affecting its exports. Those actions, according to Prof. Rajan are myopic because they will affect the pattern of behavior in both advanced and developing economies which makes it hard to move away from the current unsustainable equilibrium. Change is needed in term of global economic cooperation otherwise the possibility of nationalism might occur like the history has taught us about fascist Germany right before the World War II.

Drawing upon his personal experiences with the IMF, Prof. Rajan concludes with deep skepticism that anything meaningful will come out of the ambitious G-20 Declaration because the bigger challenge is to make sure that growth strategies fit together to rebalance global growth, not just take on short-term strategy to pump up the economy. The important thing he emphasizes is for the world to recognize that good economics cannot be divorced from good politics, and there is a need to reform the global economic governance.

Finally, Prof. Rajan also points out two reasons for hope. One is the technological progress which has solved the century-old elusive problems, and the other is the economic reforms which have brought enormous change to the poor directly from the medieval living conditions into modern economy. In sum, by identifying the fault lines in the global economy, Prof. Rajan raises the global structural issue that helped trigger the crisis and what we need right now is to take painful but necessary reform on global political governance and coordinate in the global level to deal with the fault lines in the global economy.