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Political Risks in the International Economy

Recently in the North Africa, uprisings burst out one after another in Egypt and Libya. Since both economies are important oil producers, the political turmoil has a great impact on the production and transportation of their oil. Therefore, the global oil price has soared dramatically, and the menace of inflation has enhanced. The worldwide shadow of inflation will not only influence the economic development of the APEC members but also threaten the living of their people.

From the current North Africa events, we see poignantly the political risks in the international economy, and how such risks can influence the operation of the SMEs. During the past decade, the political risks that had a lot to do with the global economy usually occurred in the oil producers in the Middle East. The Middle East is an area where the political turmoil or wars were more frequently occurred. The turmoil and wars would not become such significant if this area did not hold control of oil—the global economic lifeline. And these are also the reasons why oil is usually closely related to political risks.

For the APEC members, the effects that political risks bring to them are often generated from the external environment. The soaring of oil price has made them suffer from imported inflation. Because this unstable situation is beyond their control, most of them can only take some stopgap measures to alleviate the increase of commodity price. As to the present Middle East political events, now we can only hope that no more or larger turmoil would burst out.

This issue, therefore, attempts to keep a continuous track of the current inflation circumstances. In Crisis Alert, this issue examines the possibility of stagflation in selected economies. Our basic view is that each economy ought to deal with its own conditions of inflation with policies that are most suitable for it. Meanwhile, we invite experts to discuss inflation triggered by the increase of food price, and whether Japan can keep its interest rates low in the long run. According to the analysis of our experts, the conditions for the happening of food crisis in 2008 are now all in place again, and the global economy will continue being threatened by this type of inflation in 2011.

Also in this issue, we interview the General Manager of System and Technology Corporation, Mr. Lan Ming-Chuan, who talks about how his company has avoided the menace of global financial crisis by its successful adoption of Blue Ocean Strategy. Mr. Lan insists that innovation is the core value of a company; hence, Blue Ocean Strategy and crisis prevention strategies have made the crisis a new opportunity for it, rather than a frightening challenge.

We also select some of the most concerned news, interpreting as well as reporting them for the readers. Selected news include: the food crisis about to hit, the situations getting tougher for global inflation, important consensus reached in the G20 finance ministerial meeting in Paris, etc. Besides, we also introduce a book written by Dr. Stephen Leeb in 2009: Game Over: How You Can Prosper in a Shattered Economy.

As now the inflation triggered by the increases in oil price and food price still remains in place, we will not only keep a close eye on the developments related to the situations in the Middle East and to food supply, but also keep track of other risks, such as the flow of hot money.

Robert Sun-Quae Lai, Ph.D.
Executive Director
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Recently, economies throughout the world have been experiencing increased inflationary pressure. In many economies, the prospect of continued economic growth is threatened by the rising price of food and oil. The price of wheat peaked on 9th February at USD 8.93 per bushel and then experienced violent fluctuation; the price of soybeans also rose and then fell, while the price of corn has remained consistently robust. Overall, food prices have remained at a high level. As regards international oil prices, the NYMEX light, sweet crude oil price hit USD 103 per barrel on 24th February, while the Brent crude oil price rose to USD 119 on the same day. These skyrocketing commodity prices have put economies throughout the world at risk from import-led inflation.

While rising food prices can have a major impact on ordinary people’s quality of life, it is the rise in the price of crude oil that will incur prices rising across the board. Besides its use in the transportation sector, oil and oil products are also widely used in many other sectors; as a result, rising oil prices put upward pressure on prices throughout the economy. The serious inflation of 2008 was caused by high oil prices; even the spike in food prices that occurred in 2008 was in fact triggered by the rising price of oil.

While rapid economic growth in emerging markets has undoubtedly led to rising demand for oil, judging from past experience, this increased demand alone cannot explain the currently high level of oil prices. There are actually other two main factors behind these soaring oil prices: the political unrest in the Middle East, and the impact of hot money. The uprisings in Egypt and Libya have affected oil production and caused the recent oil panics. The situation in Egypt seems to have calmed down, but the unrest in Libya is still in progress, so the impact of political factors on oil prices remains significant.

It is in any case worth noting that the recent rise in oil prices did not start because of the unrest in Egypt. The price of oil was already beginning to rise back in August 2010; the disturbances in the North Africa have merely served to exacerbate the situation. The one factor contributing to high oil prices that has remained constant since August 2010 is hot money. Political factors have provided an excuse for speculation.

Figure 1 shows the severity of inflation in various major economies as of January 2011. Of the 15 economies selected for inclusion in the figure, 10 had inflation rates in excess of 3%. While the inflation rate in the Euro zone was less than 3%, it had exceeded the ECB’s target of 2% for two months in a row. The only economies that did not experience a rise in the inflation rate in January (compared to December 2010) were India, Mexico, Chinese Taipei and Japan. In India, the inflation rate stood at 9.3% in January; although this was slightly lower than the 9.47% recorded in December, India is still experiencing high inflationary risk. The economies with high inflation rates listed in Figure 1 will find that inflation is
offsetting the high economic growth they have been achieving, and there is a strong possibility that these economies will begin to experience stagflation.

We can see from Figure 1 that, while most economies are facing a rise in inflationary pressure, the severity of inflation varies significantly between economies. To some extent this difference reflects disparities in the way in which the inflation rate is calculated, but it also shows that, besides the systemic factor of rising commodity prices, economies are also affected by factors that are specific to the individual economic conditions. In addition to rising commodity prices, these factors may include the inflow of hot money, loose monetary policy, or a high level of demand driven by strong economic growth. While all the four factors can be seen operating in most emerging economies, the relative significance of each factor varies considerably.

What this means in practice is that each economy has to deal with its own particular inflationary conditions, and must devise its own individual strategy to deal with them. Many emerging economies have begun to raise interest rates, which can help to combat the inflationary pressure created by loose monetary policy and buoyant demand. Other economies have revalued their currencies upwards to mitigate the impact of import-led inflation. As regards hot money, although some analysts have been suggesting that inflation has caused hot money to withdraw from the emerging economies and flow towards the developed economies instead, an examination of exchange rates shows that the U.S. Dollar remains weak, and that the currencies of the other major emerging economies have remained strong; except in the case of South Korea and Chinese Taipei, there is little sign of hot money pulling out.

Small and medium-sized enterprises (SMEs) located in economies that are experiencing high inflationary pressure will need to keep an eye out for the visit of stagflation, and take suitable measures in response. Other SMEs that trade with those companies are advised to check the financial health of the enterprises they do business with. As a rule, in doubt of rising commodity prices, SMEs may need to secure long-term contracts with raw materials suppliers, and to avoid becoming too dependent on suppliers in any one region. To cope with the impact of rising oil prices, besides implementing energy saving initiatives, SMEs can also try to develop substitute products that require less oil (and oil products) input.

![Fig. 1: Inflation Rates in Selected Economies, January 2011](source: TradeEconomics.com)
United States

US GDP grew at a 3.2% annual rate in the fourth quarter of 2011, up from the 2.6% pace in the third quarter. The expansion was in large part fueled by growth in consumer spending, a crucial change from earlier in the recovery, when growth relied mostly on investment, exports, and the building up of inventories. Consumer spending, which accounts for 70% of the US economy, climbed 4.4% in the fourth quarter, compared to a 2.4% increase in the third quarter. Rising net exports from US companies helped push up growth last quarter, as imports declined. Net exports, however, are not likely to keep contributing to this expansion. As companies rebuild their inventories, it will also lead to greater imports, which is a drag on US demand.

Consumer sentiment continues to be strong, with the index rising to 60.6 in January, compared to 53.3 in December. However, many economists question the sustainability of this increase in consumption, as US employment growth is still sluggish. Housing, which is a large part of consumer wealth, is also weak.

The US unemployment rate unexpectedly declined in January, as 162,000 people dropped out of the labor force. Still the decline in the unemployment rate is good news, and implies a labor market on a slow mend.

US home prices declined in November falling to new lows in many cities, suggesting the continued weakness in the US housing market. The Case-Shiller home price index, which tracks prices in 20 major cities, fell 1.6% in November from a year ago. Home prices declined under excess housing supply, worsened by foreclosures. At the same time, Americans are reluctant to buy amid the still high unemployment.

The US inflation rate in January rose to 1.6% at an annual rate. The core inflation rate, which excludes the effect of food and energy prices, increased at 1.0%. Given that the US Fed’s unofficial inflation target is a core inflation rate of 2.0%, the actual inflation rate is quite low. However, commodity prices including oil have been increasing at double digit rates, suggesting that inflation rates are likely to rise over the medium-term as commodity prices pass through to a broader set of prices.

While the actual inflation remains low, concern that an improving growth outlook and the rise in food and energy prices will spill over into general inflation has raised long-term interest rates and the expectation that the Fed will raise interest
rates later on this year. Yields on 10-year Treasuries have risen to 3.7%, the highest since last April. Futures markets put the chances of a Fed interest rate increase by December at 100%, up from just 25% in late February.

Canada

In December, Canada’s overall exports surged by 9.7% and its exports to the US surged by 10.8%. Given the export surge, Canada’s GDP growth for 2010 Q4, and GDP growth and inflation rate forecasts for the next two years have increased, making it likely that the Bank of Canada will increase its policy interest rate from its current 1.0% to 1.25% by May 2011. (The author is Professor at University of Southern California.)

Northeast Asia

A Shock Caused by the Downgrade of Japan’s Sovereign Credit Rating

Sayuri Shirai

Japan

Japan’s sovereign bonds were downgraded their credit rating by Standard & Poor’s on 27th January from AA to AA minus. Amid growing concerns over Japan’s debt sustainability issues, this shocked Japanese politicians and the public, temporarily causing a yen’s depreciation. The downgrade reflects not only an already astonishingly high level of general government debt outstanding, but also its ever growing trend. According to the IMF data, the general government debt to GDP ratio expanded from 100% in 1996 to 217% in 2009—the highest among the advanced economies—and is expected to reach 232% in 2012.

Premier Naoto Khan’s administration is particularly concerned about a growing gap between social security-related expenditure and tax revenue, which has been financed mostly by the issuance of sovereign debt securities domestically. Therefore, Premier Khan appointed Mr. Kaoru Yosano as Economic Minister in 14th January who has been a strong advocate of the need to establish a more financially-sustainable social security system together with a consumption tax increase — notwithstanding that he had been formerly a member of the then ruling Liberal Democratic Party (LDP) and had openly criticized various fiscal and social policies performed by the current ruling Democratic Party of Japan (DPJ). With Mr. Yosano’s support and newly-established panels of experts, the government is expected to present a proposal on the social security and tax reform package by June 2011.

Nonetheless, the long-term bond yield so far remains only at around 1.3%, much lower than that of the United States, Germany, and other advanced economies. This is attributable to the fact that sovereign debt issues have been relatively easily financed domestically, thanks to abundant households’ financial assets (about USD 17 trillion) and larges public and private institutional investors. Japan’s fiscal situation also differs from that of Greece and other European fiscal deficit economies because of its largest net external creditor position in the world, and continuous current account surpluses. While these differences help mitigate investors’ concerns over Japan’s short-term debt sustainability, the government definitely needs to launch at comprehensive fiscal and social security reforms with a credible medium- and long-term fiscal consolidation plan. The delayed response
will make it even more costly in the event of an adoption of a fiscal consolidation strategy in the future. Japanese firms and consumers will eventually suffer from a substantial increase in taxes and a massive expenditure cut, thereby dumping domestic demand and economic growth.

**China**

Since the second half of last year, China has been struggling to contain inflation. The headline CPI inflation rate increased from 4.6% (on a year-on-year basis) in December 2010 to 4.9% in January 2011. Indeed, the January inflation rate had become higher than the released rate of 4.9% if the same weights adopted until last year were used. The government adjusted the weight on foods downward in order to better reflect more realistic household expenditure patterns.

While core CPI (excluding food and energy) inflation appears to be well contained with the rate rising only from 1.7% to 2.3%, the rate of increase on residence (from 6% to 6.8%) is a worrisome sign. Moreover, the major factor contributing to the overall price hike has continued to be food prices, which grew by 10.3% in January — jumping further from a 9.6% increase in the previous month. The food price increase reflects bad weather conditions in the Northern region, growing domestic demand for foods, a global food price hike, and speculation driven by abundant monetary liquidity.

To cope with the inflationary pressure, the government ordered local governments to implement detailed measures to limit housing purchases by households (such as a restriction on the number of housing purchases to one par household, as adopted by the City of Shanghai last October) by mid-February. The People’s Bank of China (PBC) raised banks’ benchmark lending and deposit rate — by 25 basis points in the case of one year rates — on 9th February. Furthermore, the PBC increased the reserve requirement by 0.5% to 20% in the case of large banks. On 9th February, furthermore, the government announced ten measures to expand food production, including investment in irrigation facilities and provision of subsidies. The expectation of a further monetary tightening has dampened stock prices.

In the meanwhile, manufacturing SMEs operating in the coastal area has been suffering from rising production costs caused by increases in minimum wages and raw materials. In particular, finding low-cost workers who are willing to work for long hours from rural areas has become increasingly difficult. Since a rapid pace of urbanization has enabled workers to find jobs relatively easily in local areas, many now choose to work in neighboring local cities in order to take care of their parents and children in spite of lower wages.

The wage increase together with a gradual appreciation of the Renminbi is likely to stimulate domestic demand, thereby accelerating the shift from an export-oriented to a domestic-demand oriented economy. However, the transition process may severely affect manufacturing SMEs in the coastal region owing to the shrinkage in their already small profit margins. Accordingly, some SMEs have begun to shift their production locations to the inland area, while others have been attempting to diversify production locations into other economies. (The author is Professor of Economics, Keio University.)
Capital Flow and its Impacts: Vietnam Case

Zhenya Liu

The Vietnamese central bank depreciated its currency on 11th February 2011 by 9.3%. This is the fourth currency depreciation in the last 14 months, following devaluations on: 26th November 2009 of 5.44%; 10th February 2010 of 3% and 17th August 2010 of 2.09%.

Of course, the depreciations are directly connected to Vietnam’s external imbalance in trade deficits and capital outflows. It is well-known that the Vietnamese trade deficit was USD 12.4 billion last year, but people usually ignore the capital outflow, which is very important for both policy makers and investors. In the macroeconomic view, a large outflow of money from one economy could cause undesirable consequences, suffered a decade ago by some East Asian economies. In the microeconomic view, investors are concerned about the location of global capital so that they can make wise investment decisions.

With respect to last years’ international capital flow, where did the money go? The recent study by the UBS economist Jonathan Anderson (UBS Global Economic Research, Anderson, 9th Feb. 2011) gave a clear answer shown in Table 1. The table shows the ratio between the aggregate net non-FDI capital inflows in 2010 as a percentage of each economy’s GDP.

Correlations can be seen between capital flow and equity market performance. When equity market performance worsens, stock price falls; thus, this opportunity of falling price will be taken and shares bought at a cheaper price, causing capital inflow. As the stock market performance improves, international entities will sell their shares at higher price moving money out of the economy. This has various outcomes: equity market bubble burst, capital outflows and domestic currency depreciates. The sequence of events is as follows: weak domestic equity market $\rightarrow$ capital inflow $\rightarrow$ equity prices go up $\rightarrow$ bubble burst $\rightarrow$ capital outflow $\rightarrow$ currency depreciation.

It is not surprising then, that Vietnam which has the second largest capital outflow, depreciated its currency on 11th February 2011.

Another interesting point shown in Table 1 is that Hong Kong is also in the right-hand side of the table. But due to the Fed’s recent quantitative easing policy, QE2, there was a large inflow of capital to Hong Kong over the past two or three months.

Of course, the relationship between the capital flow and equity market performance is far from exact. There are many exceptions.

### Table 1: Net non-FDI capital inflows, 2010 (% of GDP)

<table>
<thead>
<tr>
<th>Above 8%</th>
<th>6%~4%</th>
<th>4%~2%</th>
<th>2%~0</th>
<th>0~2%</th>
<th>-2%~4%</th>
<th>-4%~6%</th>
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<tbody>
<tr>
<td>Turkey</td>
<td>Ukraine</td>
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<td>Israel</td>
<td>Poland</td>
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Because the UBS data is based on the top-down methodology, this theory does ‘not work’ to economies where official flows are not recorded in the central bank accounts, i.e., major fuel exports and other economies with large and active sovereign wealth funds. As a result, the above table does not show the Gulf States, Nigeria, Venezuela, Kazakhstan, Singapore, or Malaysia” (UBS Global Economic Research, Anderson, Feb. 9th 2011).

Table 1 also shows that Thailand, Philippines, and Indonesia have high net inflow. It is important for these East Asian economies with high capital inflows last year, to monitor closely where this money went. The monetary authorities in these economies should be especially cautious of their equity prices and equity market performance so as to prevent the equity price bubble. (The author is Professor at Renmin University of China, Beijing and The University of Birmingham, UK.)

South Pacific (India, Australia, New Zealand)

Natural disasters are troubling Australian economy

Kenneth Waller

Australia

Queensland has continued to be ravaged by natural disasters, with Cyclone Yasi carving its own path of damage soon after the floods receded last month. The economic damage resulting from the cyclone has yet to be fully calculated. However, both disasters have significantly affected agricultural and mining industries, contributing to rising world commodity prices. Crop prices were expected to rise by at least 10% as a consequence of the natural disasters. To meet the costs of repair and restructuring the government has proposed a one-off “flood tax”.

The Reserve Bank of Australia (RBA) left interest rates unchanged at 4.75%, noting that reconstruction is unlikely to have a major impact on inflation in the medium term. Consumer prices increased by 0.4% in the December quarter, and 2.7% on a yearly basis - but remains within the target inflation price range. Consumer sentiment recovered in February, rising 1.9% to 106.6 from 104.6 in January. However, growth forecasts have been revised downward by the RBA to 3.25% over the year to the June quarter 2011. Activity in the services sector contracted in January in response to the floods. The AUD against the USD remains at around parity.

Current business sentiment about the state of the economy is sombre. NAB’s (National Australia Bank) Monthly business survey saw business conditions fall sharply in January in the aftermath of the floods. Telstra’s Back to Business Survey examining small businesses in Australia, released this month, highlights the fact that 35% of respondents believe the economy is worse than it was six months ago increasing by 13% from last year. Furthermore, 38% of businesses have said they are in worse financial condition than six months ago, up 12% from last year. The prime concerns for small businesses relate to the steady rise in official interest rates (five rises in the period since December 2009) and the proposed introduction of a price on carbon. Tax reform is an emerging issue. MYOB recently noted that the internet is being highly underutilized by most businesses, since only 35% of Australian businesses have a website. This is despite MYOB
finding that over a half of business owners believe a website is crucial for marketing and promotion and that a business with a website can expect to see increases in revenue.

The Prime Minister announced a new-job program to resuscitate economic reforms and to address a growing skills shortage, targeting 1.6 million Australians who are either underemployed or outside the labour market.

Policy actions by Chinese authorities to curb inflation are also a cause for some concern by Australian businesses increasingly reliant on a booming China market. Nonetheless, Australia is now gaining a reputation for assuring energy security. A Korean consortium recently making a bid to buy Whitehaven Coal Ltd., valued at USD 3.5 billion.

India

Issues of corruption continue to impact on community perceptions of government and political stability. At the heart of the problem is the complexity of government by a coalition of parties. A recent cabinet reshuffle in response to corruption charges was deemed inadequate, solidifying the perception that the prime minister has lost his reformist ambitions. Other actions taken in response to corruption scandals include officials being named in an independent inquiry into India’s telecoms ministry. A former minister and an executive have been arrested in relation to the telecom scandal probe. The telecommunications regulator has suggested charging a one-time penalty fee of RUP 45.72 billion per megahertz of radio bandwidth that mobile operators hold beyond their initial allocation, to be implemented with effect from last April.

Inflation also continues to burden the Indian economy, with rising world prices of oil and food flowing into India’s already high inflation rate. Food inflation rose above 17% in the week ended 21st Jan., with unseasonal rains contributing to constraints on food supply. Notwithstanding the fact that inflation eased in January from 8.43% in December to 8.23%, the RBI (Reserve Bank of India) raised repo and reverse repo rates by 25 basis points each to 6.5% and 5.5% respectively. Banks responded with rises in borrowing rates. The government has also granted state oil retailers cash subsidies to help control inflation.

India’s banks are still struggling with maintaining liquidity, due to sluggish deposit growth at 16.4% year on year, compared to credit growth at 23%. While the RBI has chosen to extend its additional liquidity facilities until April 8th, banks have been in the international market for funds, including in bond issuance in the Swiss francs.

GDP growth remains buoyant. The growth estimate for the fiscal year ending March has been revised to 8%. The HSBC Markit Business Activity Index rose marginally to 58.1 in January from 57.7 in December. The seasonally-adjusted HSBC Composite Purchasing Managers’ Index, measuring the service sector, rose in January to 59.6 from 58.9 in December, being the 21st straight month the sector grown. The National Council for Applied Economic Research forecasts a rise of 67% in the Indian middle classes (i.e. families with an annual income between Rs 340,000 to Rs 1,700,000) over the next five years.

Foreign direct investment dropped 24% to USD 19 billion between April and November in 2010 compared with the same period a year earlier. Nonetheless, inflows into equities and bonds rose 48% to USD 32.8 billion, and Indo-US bilateral trade is expected to increase by more than 30% in 2010 to reach USD 50 billion. The US Secretary of Commerce on a recent visit to India noted that India’s foreign investment policy continued to impede the inflow of foreign capital.

India has also signed comprehensive trade pacts with Japan and Malaysia in February and has committed to double trade with Indonesia to USD 25 billion a year by 2015.

New Zealand

New Zealand continues to struggle to emerge from the aftereffects of the GFC, reflected in rising unemployment and falling house prices. The unemployment rate increased more than forecast in the fourth quarter of 2010 to 6.8% from 6.4% three months earlier. GDP growth is flat but stronger growth is anticipated as the year progresses. Strong commodity prices, low interest rates, the Rugby
World Cup, and earthquake recovery work are all expected to help improve the current situation. Nonetheless, the economy is vulnerable to the vagaries of international financial markets and to rising global inflation.

Capital inflows into New Zealand from Australia are also expected to increase after a protocol was signed that would allow most Australian investment with a value less than USD 360 million avoid regulatory scrutiny. (The author is Director, Australian APEC Study Centre at RMIT University.)

Latin America

Searching for Ways to Fight Inflation without Overvaluing Local Currencies

Cheng-Mount Cheng

While Latam economies continued to fight a currency war, recent sharp rise in food prices has once again put central banks in this region into a dilemma. Brazil’s inflation ended 2010 at 5.9%, exceeding the 4.5% mid-point of central bank’s inflation target by a large margin. To deal with inflationary pressure, Brazil’s COPOM (Central Bank Monetary Policy Committee) decided to hike the Selic rate by 50 basis points in January, after being on hold for about three quarters. The monetary authority hinted that the tightening cycle is not over and economists believe Brazil central bank could raise Selic by an extra 150 basis points before the end of first half.

But the dilemma is that real interest rates in Brazil are already too high and nominal rates net of expected appreciation are even higher. Raising interest rates could attract more speculative capital inflows causing more real appreciation at a time the BRL is, arguably, already overvalued. While the Brazil central bank’s strategy apparently includes using complementary monetary tools to sterilize the inflows, the question is why attract the inflows in the first place. Brazil’s dilemma is not different from that faced by other emerging markets in and out of Latin America and we are likely to see more policymakers in emerging markets to choose macro-prudential measures to help fighting the pressures of inflation and currency appreciation.

Brazil government announces a plan to cut expenses

The Brazil Minister of Finance Mantega announced BRL 50 billion of spending cuts for 2011 on 9th February, higher than some market participants’ forecast of BRL 45 billion. This amount signals that the government seems to be willing to help the central bank to tame inflation expectations through diminishing its contribution to domestic demand growth. Given the lack of clear information on where these cuts will come from, some economists are still doubtful whether the government will actually deliver these cuts. But this move should be view as positive to curb inflation.

Peru Central Bank follows up with a 25bp rate hike to 3.0%

The seven-member board, led by bank President Julio Velarde, raised the benchmark rate by 25 basis points to 3.0%, following January’s
unexpected 25 basis point rate hike. The move was widely expected by market participants as inflation expectation jumped in January. Consumer prices rose a greater-than-expected 0.39% month-over-month in January, more than double December’s rate, on higher food and electricity costs. Economists forecast that CPI inflation could reach 3.3% in 2011, higher than the central bank’s target of 1-3%. Thus, the rate hike in February is interpreted as a preventive move by market observers.

**Venezuela CPI inflation stayed very high**

Caracas CPI inflation stood at 3.6% month-over-month in January, which implies a yearly 28.9% inflation rate for January. In addition, the overall consumer price index rose 2.7% on a monthly basis, bringing its yearly print to 28.5%. Main drivers were healthcare prices, rising 4.5% month-over-month, followed by food and beverages, which rose 4.0%. January’s CPI inflation was higher than market expectation and showed that despite government’s efforts to control prices directly, currency devaluation seemed to have transmitted to CPI basket components. Some economists expect inflation to remain high in 2011, likely posting a 30% annual growth by year-end.

**Mexico announces gasoline price hike**

On 12th February, Mexico Finance Ministry announced a new increase in gasoline prices, which will become effective on 12th February. The price of Magna will rise 10 cents, while the Premium type will see a price increase of 6 cents. Given the weight of gasoline in the CPI (4.2%), the new increase for the year would have an impact of 10 basis points on inflation. Using futures market prices as a reference, with the new price increases, the differential between the average price for domestic gasoline (Magna) and its foreign equivalent will fall from nearly 10.0% to 8.0% in 2011. Some market experts believe this move will reduce government subsidy, but not likely to have an impact on inflation.

**Chile Central Bank resumes monetary tightening with a 25bp hike**

Chile Central Bank raised the overnight rate by 25 basis points to 3.5% on 17th February, in line with market expectation. This is the eighth rate hikes in recent nine months as Chilean economy continues to recover from last year’s earthquake and inflation expectation threatens to exceed the central bank’s target. Policymakers in Chile reaffirmed that they probably will continue to raise borrowing costs to control inflation. (The author is Vice President, Citi Taiwan.)
The month under review was dominated by political events in Tunisia and Egypt, even while important economic policy measures were being implemented with respect to the continuing debt crisis; contemplated with reference to coordinating fiscal discipline across the Eurozone through an initiative led by Germany and France.

At the same time, the spectre of inflation is beginning to worry central banks and policy makers, with food and energy prices showing sharp increases, and both the ECB and the Bank of England warning of interest rate rises in the near future.

European statistics also confirmed the slow rate of economic recovery, with an annual increase of just 1.7% in the Eurozone. The belief in a two-speed Europe, with some economies growing rapidly (such as Germany and Poland) while others continue in recession (Spain, Greece, Portugal and Ireland), seems to have been confirmed. No one is quite sure of the implications of this situation, other than to recognise that the best policy option for recession-hit economies is probably devaluation and a spending stimulus, while the best policy option for growing economies is probably fiscal consolidation.

The UK finds itself between the position of Germany and that of Greece, with growth very low and inflation beginning to manifest itself. Prospects of the UK exporting its way out of recession now seem to have receded, and recovery is now seen as a long-term prospect.

EU economic sentiment was also shaken by news of widespread fraud in the carbon trading market, and its temporary closure.

On the positive side, the debt crisis of several EU member states is apparently inching towards a resolution through enhanced funding availability and greater ECB support for the bond market. Long-term measures to prevent a recurrence are however proving to be more difficult to agree upon. Germany’s proposals are likely to be watered down over the coming months.

Concern with the situation in North Africa turned to alarm when the prospects of serious civil unrest in Egypt began to appear. However the quick collapse of the regime, even if not complete, seems to have calmed the situation, while encouraging others to try a similar strategy. The EU’s fear is at two levels: firstly that the process may become confrontational and violence may spill over onto its territory, and secondly that migration levels will increase sharply. The first seems to have been exaggerated (so far), while the second has hit the EU more quickly than they expected with a surge of boat people arriving in Italy, Malta and Southern Europe. Emergency measures are now being contemplated to halt the flow of illegal migrants.

Current rumblings of discontent in Libya, Algeria, Bahrain, Yemen, Syria and Iran will - it is believed - affect the EU both directly and indirectly, in both the economic and security fields. European policy attention is likely to be focused on this issue for some time - at least until there is a stable new regime in Egypt and elsewhere.

A quiet but profound change is also taking place within the EU, through the new found powers of the European parliament. Until recently,
the European parliament had little or no power to interfere with the policy or decision making process; but now they enjoy equal powers with the Consilium (which represents member states), and have flexed their muscles on several occasions.

They have recently rejected three of the four nominees to the new institutions created to regulate the financial services sector, and have called for a more transparent selection process, and better people. They have also exercised increasing initiative in dealing with the vexed issue of the EU budget, which is to be negotiated for the period 2013 - 2020. Across the legislative and regulatory board the European Parliament is showing increasing interest and engagement.

For the SME sector, both within the EU and elsewhere, a couple of developments seem to be important. Plans to give SMEs greater access to government contracts are moving ahead steadily, while a new European Patent (covering 23 of the 27 member states at this stage) is also likely to be approved. Although the impact of both these measures is difficult to assess, there is no doubt that it will make investment in the SME sector of the EU more viable. What the implications of this are for foreign SMEs is difficult to assess.

Competitiveness assessments from within the EU suggest that with the exception of a couple of states, the EU continues to lose ground to the US, Japan and emerging economies. Questions of how to reverse this trend continue to dominate the debate. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)

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### East Europe

**Reduced Euro debt concerns help regional economic stability**

*Kuo-Yuan Liang*

Over the past month, several international developments regarding European debt have helped to provide a friendly atmosphere for economic development in the East Europe region. One of them is the easing of concerns on the European debt problem, as bond auctions starting from Portugal in January were smoothly made. Another key event is the fact that Germany and France urged Euro Area members to sign up on a plan that would include putting debt limits in the law of member states. This sent a message to the market that Germany and France were willing to take a step further toward Euro Area integration, which is a favorable long-term solution to fixing the structure of the Euro.

**Financial markets positive in the past month**

Remarkably, amid the reduced tension on European debt related issues, over the past month, the CDS (Credit Default Swap) of more indebted European economies have all dropped significantly, including countries in the East Europe region, such as Hungary, Poland and Greece. In Romania, the drop was less evident. The declines have shown just how much the fear and anxiety has receded. From Figure 1, we can see that from 10th Jan thru 9th Feb. of 2011, the CDS prices of Poland fell 21.35 basis points (bps) or 25%; the CDS of Hungary fell 131.514 bps or 40%; CDS of Romania fell 27.719 bps or 9% and the Greek CDS fell 293.23 bps or 22%.

From the currency market, we can also see healthy developments that signal the situation has stabilized in respective regions. During 10th Jan.
thru 9th Feb. of 2011, due to relaxed concerns of the Euro’s future, the Euro rose by 5.4% against the US dollar, while East Europe local currencies also increased with the Euro, as the economic conditions in Europe may stabilize with less turmoil from the debt issues.

The Polish Zloty was up by 5.7%, the Czech Koruna up by 7.5% and the Hungarian Forint also rose by almost 8% against the US dollar, respectively, signaling a positive market response to the recent developments.

In ESI data, search for declines in orders or demand as consumption season ends

In terms of the economic performance and confidence in the past month, we shall return to the ESI (Economic Sentiment Indicator) report of January. Before the data release, one would be wary if the report shows a drop in January, as the end-of-year consumption season came to an end and the fact that the general demand throughout Europe was weak due to austerity measures, such as value-added taxes, taking effect. Therefore, in this month’s data we will look for clues in whether components related to demand, sales and order books may appear as unpleasant noise.

It turns out that although the ESI general score only slightly went down in both the Eurozone and European Union, some East Europe economies performed a bit worse. The ESI went up in Hungary, Greece and Estonia, and fell somewhat in Poland, the Czech, and the other two Baltic states. When we look into what contributed to the fall in some economies, it was related to a retreat in the industrial and service sector for the Czech, Poland and Latvia. But in Lithuania there was a sharp drop in only the retail sector confidence, which is a bit more concerning.

Poland industry and Lithuania retail needs special attention

As we look closer, in Poland’s industry the downfall comes from its order books and production trends and expectations. While in the service sector, largely everything has retreated, especially in employment and demand expectations.

The fall in these segments in Poland will need future attention as economic data is gradually released in the upcoming months. Nevertheless, on the bright side, consumers of Poland do not seem to have lost faith even as they access the current economic situations as less favorable.

In the Czech’s industry, the fall is due to reducing the selling price expectation and production trend, while in the service sector the decline attributes to a slightly reduced demand trend and expectation. We notice the Czech doesn’t have problems with its order books. Hence, by comparing Poland and the Czech, concerns on the former will be higher.

In Latvia and Lithuania, the ESI only fell slightly in both economies. In Latvia, the declines in the industry and service sectors mainly consisted of jobs and demand, which isn’t surprising after seeing the cases of other economies. In Lithuania, all the sectors aside from the retail trade went well. Only did the retail sector fall sharply together with all its components which make it unusual. We will need to follow up on Lithuania’s retail sector in the next few months to determine whether it is an issue for concern.

For the other economies with ESI advancements, Hungary’s consumer confidence did not advance with the other sectors, in fact its consumer confidence has been trending downwards for three months, which stems from its austerity measures. In Greece, the ESI was up in January, albeit at a low level, but the falling trend in consumer confidence still continues, which is not particularly surprising. Finally, in the first month after joining the Euro Area, Estonia enjoyed a fairly successful month in the ESI, where only the industrial sector fell slightly due to a drop in order books and past production trends.

Conclusion

In conclusion, we will have to keep a closer eye on the Polish industrial sector and the Lithuanian retail sector, with slightly more attention on the Czech and Polish services. All in all, East Europe enjoyed a calm month that allowed their respective economies to function without outside disturbances, a welcomed development.
for the region’s stability. (The author is President, Polaris Research Institute & Honorary Professor, and Professor College of Technology Management, National Tsing Hua University.)

**Figure 1 CDS prices of selected economies**

(Source: Bloomberg)
The domestic political turmoil currently faced by the Middle East economies has the most widespread impacts in decades. The turmoil first burst out at the end of January, when the Egyptians demonstrated to depose then President Hosni Mubarak. Other economies such as Libya, Bahrain, Iraq, Jordan, Algeria, Yemen, Kuwait, etc., are now also faced with more or less political demonstrations, leading to a certain negative chain-effect fermenting in the economy of the Middle East and North Africa.

The most straightforward economic impacts are reflected in the stock market. International investments are about to withdraw from these emerging markets in large scale, causing a great fall in the stock markets of the Middle East economies. The Tadawul All Share Index (TASI), the largest stock exchange in the Middle East has dropped by 5.8% since 25\textsuperscript{th} January. On the last trading day of the third week of February, the TASI fell by nearly 100 points, or 1.59%, and other stock markets including those of Kuwait, Abu Dhabi, and Dubai also fell by more than 1.3%. The falling stocks include most industries with the exception of concrete industries, and among them the financial and fossil fuel industries have dropped to the greatest extent. It can be observed that the investors not only remain confident in the infrastructure in the medium and long term, but also plan to withdraw from the Middle East market.

In addition to the prominent impacts on the capital markets, tourism, infrastructure and manufacturing in Egypt have also been seriously damaged by the unrest, according to the government of Egypt, which lies at the center of the turmoil. As revealed by the official statistics, Egypt lost at least EGP 12.9 billion during the eight days from 29\textsuperscript{th} January to 5\textsuperscript{th} February. Among them, the losses in tourism were about EGD 7 billion; 210 thousands of tourists left the economy in the last week of January, causing a great loss in its hospitality industry. Losses in manufacturing industry were about EGD 3.7 billion, which occurred primarily in the cities along Suez Canal, the greater Cairo area, and Alexandria, and among which the industry of food manufacturing suffered more damage than others. Also, 90% of the economy’s infrastructure has been halted. The government of Egypt is currently conducting a more detailed statistical survey over the losses, and Egyptian economists have also predicted that the unemployed population will increase to nearly EGD 2.45 million due to the turmoil, with an unemployment rate of 9.5% that will be an extra enormous pressure on the government.

For the SMEs of the APEC members, the Middle East is apparently not a good targeted area for investment and marketing, and therefore Russia is a relatively more stable area. However, attentions must be paid to the possible frictions in Russia and Japan’s economic relation caused by the two economies’ dispute over Southern Kuril Islands. Now the industries that are most likely to be directly impacted include fishing, aquaculture, and fish processing industries.

The Japanese government is being deeply concerned about the China and Russia’s cooperative project of a fish processing plant on the islands. Prime Minister Naoto Kan made a statement in person to the press that, this Sino-Russian cooperation is against Japan’s stance of hoping to see no third economy involved in the
Global Commodity Market

Geopolitical risks in the MENA region will provide an additional layer of support to future oil prices

Hwa-Nyeon Kim

In the last one month period (mid-January to mid-February in 2011), there have been persistent warning signs of a crisis in the global commodity market. Commodity price indices have shown upward trends and the prices for most of the main commodities such as crude oil and copper broke past last year’s highs on the back of massive amounts of global money liquidity. Copper prices hit a historical high of above USD 10,000 per ton. Among crude oil prices, the Brent price in particular, increased to above USD 100 per barrel and the Dubai price to almost USD 100 per barrel. However, the WTI price remains below USD 90 per barrel due to the pressure of a relatively high level of Cushing inventory.

Again, food prices gained the most attention in the last month period. A continued tightening in the grain market balance has raised the upside risks to prices. Grain markets marked a decrease in supply due to an environment of strong demand and abnormal weather conditions. For example, China became a net corn importer from the second half of 2010, affecting corn prices to sharply increase and this trend is expected to continue in 2011. More evidence is that the US corn stocks-use ratio decreased to 5%, the lowest since 1995/1996 according to a recent report from the US department of Agriculture (USDA).

The problem is that higher food prices threaten emerging economies more than advanced economies because inflation in the emerging economies is much more sensitive to the increase in food prices. Although most emerging economies including China, India and Brazil have raised their benchmark interest rates several times since last year, the current food price level has already raised the threat to their sustainable growth for this year.

The top two commodity indices, the CRB spot index and LME non-ferrous index, have shown gradual increases from mid-January to mid-February. The CRB spot index (year 1967=100) moved up from 541 to 566 and the LME index (April 1999=1,000) increased from 4,072 to 4,478. The averages for the CRB index and the LME index from mid-January to mid-February increased 6.3% and 3.7% respectively. 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 the LME index were higher than those in the mid-December to mid-January 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 84.32 and 91.19/barrel and Dubai crude prices moved between USD 91.9 and 99.29/barrel during the same period. Both the minimum and maximum values of the Dubai price were larger than those during the mid-December to mid-January period.

Among non-ferrous metals, or more
commonly known as base metals, tin and nickel prices rose the most following the previous period, with the average price of tin and nickel rising 11.6% and 10.5% respectively. The price of copper recorded a new historical high of USD 10,148/ton in February. Other base metals such as lead and zinc also showed rising price patterns. The maximum prices for lead and zinc during the last one month period were USD 2,720 and 2,508 per ton, respectively. The prices of aluminum also revealed increasing variations.

Currently, geopolitical risks in the Middle Eastern and North African (MENA) regions are receiving the most attention in the global financial markets. Riots and violence in Bahrain, Yemen, Iran, Iraq and Libya continue and clashes between police and protesters are becoming more frequent. The MENA region is home to the world’s largest oil and gas reserves and production. Consequently, ongoing geopolitical tension in the MENA region has already boosted oil prices. These geopolitical issues are likely to have an additional effect in raising future oil prices. Commodity experts say that these tensions will raise oil prices by at least USD 5 to 7 per barrel. Therefore, SMEs in oil importing economies will face aggravated difficulties because of high raw material costs. (The author is Research Fellow at Samsung Economic Research Institute.)

<Table> Changes in Raw Material Prices - January 17th to February 15th, 2011

<table>
<thead>
<tr>
<th>Index</th>
<th>Crude Oil (USD/barrel)</th>
<th>Non-ferrous Metals (USD/ton)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>CRB</td>
<td>LME</td>
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<tr>
<td>Min</td>
<td>541</td>
<td>4,072</td>
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<tr>
<td>Max</td>
<td>566</td>
<td>4,478</td>
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<tr>
<td>Average</td>
<td>454</td>
<td>4,301</td>
</tr>
<tr>
<td>Last Month Average</td>
<td>505</td>
<td>3,965</td>
</tr>
</tbody>
</table>

Note:
1. The 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.
Food inflation revisited

Cheng-Mount Cheng

Food price risks have received plenty of attention in the past few weeks. The FAO Food Price Index (FFPI) rose for the seventh consecutive month, averaging 231 points in January 2011, up 3.4% from December 2010 and the highest since the index has been backtracked in 1990, according to Food and Agriculture Organization of the United Nations. Prices of all the commodity groups monitored, including sugar, oils and fats, cereals, dairy, and meats, registered strong gains in January compared to December, except for meat, which remained unchanged.

The basic problem is that the weather-induced food supply shock that emerged in the northern hemisphere’s summer of 2010 might be growing more systemic. Not only is the food supply situation unclear, but demand is strong: output gaps in many emerging economies are close to disappearing, and monetary conditions in many places remain relatively loose, which raise the risk of contagion from food prices to the rest of CPI. On top of that is an additional threat to food prices that wasn’t apparent in the summer, in the form of rising energy prices. This combination was a key component of the 2007/08 food price shock.

The food price shock of 2010 hasn’t produced a huge wave of inflation surprises

So far in the emerging economies inflation surprises, defined as actual inflation figures minus market consensus forecast, haven’t yet come into hostile territory as they did in 2008. So far only a few important emerging economies have some nasty inflation surprises in recent months, including China, Brazil, South Korea, Poland, and India. While these are pretty large economies, it is difficult to argue that the 2010 food price shock produced a systemic wave of nasty inflation surprises. Yet, food price shock can still have big implications, not just for CPI inflation, but for monetary policy as well. For example, the 2007/08 food inflation did result in some dramatic monetary tightening in the first half of 2008.

Food prices inflation remains a risk

If we assume food prices remained unchanged at January level during the first half of 2011, compared to 2010 average, food prices will still be up by 24.7%, the highest in three years. And there are two good reasons the suggest food price inflation will remain a big headache in 2011. The first one is related to the dynamics of the food market. The assessment of world food supply by the FAO is not uniformly encouraging for 2011. Especially the FAO thinks that any increase in cereals output in 2011 remain critically subject to weather conditions.

In addition, policy may also affect global availability. Take wheat for an example, Russia is responsible for 6.5% of global wheat production and 14% of global wheat exports. Russia
government banned cereals exports in August 2010 through to the end of 2010 and subsequently extended the ban for the first half of 2011. Whether this can be offset by liberalized wheat exports from Argentina remains to be seen.

On demand side, food consumption seems to be on the rise outpacing population growth, resulting in higher per capita food consumption. A study by the Hong Kong Monetary Authority suggests that food demand changes over time. This may reflect that increasing food demand is not only cyclically but also structurally driven, with both structural and cyclical forces are now pushing in the same direction.

Yet, food-related demand for cereals is only part of the story, since biofuels production is becoming a more important source of pressure on food prices. One of the many ingredients in the 2008 food price spike was that demand for corn, sugar and oil-seeds received an unusually large boost from rising biofuels output. For example: ethanol production, which accounts for around 80% of total biofuels output, rose by 35% in 2008, a much sharper increase than in previous years. Altogether, the production of ethanol and biodiesel rose by over 40% in 2008.

Another point is that the rise in biofuels output was almost certainly accentuated by the rise in energy prices in 2007/08. Biofuels become commercially viable at oil prices above USD 70 per barrel. With current crude oil prices much higher than this level, investment in biofuels capacity will likely boost such that biofuels output is particularly at risk of staging a large increase. If governments around the world implement the plans they have announced to raise biofuels output by 2020, the International Food Policy Research Institute (IFPRI) reckons that this alone would raise corn prices by between 23% and 72%; oil-seeds prices by between 18% and 76%; wheat prices by 8% to 30%; and sugar prices by between 12% and 66%.

**Food price inflation could cause a rise in headline CPI inflation**

Despite that the mechanism linking a rise in food prices to a rise in headline inflation aren’t perfectly known, the risks are there. Some argue that a rise in food prices is merely a change in relative prices, forcing households to spend less on other goods if they are forced to spend more on food. Besides, monetary policy in any case is a useless tool to deal with food-induced inflation: a central bank can’t cut food prices by raising rates. To some extent all these might be true, and it is certainly the case that food inflation appears to be a much more dangerous risk right now than other parts of the CPI.

But from the experience of 2008, we have seen that food price shocks with simultaneous energy price shocks can be associated with some big monetary policy responses. And the risk that food inflation can spread to other parts of the CPI is almost certainly greater, the stronger GDP growth is. This helps to explain why some of emerging economies have higher food inflation and headline CPI inflation.

All in all, a number of factors that explained the 2007/08 global food price shock are now in place. These include strong growth, adverse weather (especially in Australia), food trade protectionism, low level of food stocks, higher energy prices, and the dollar’s weakness

**Policy responses**

Some central banks of emerging economies have already started tightening monetary policy and if food inflation stays on the radar, the risks to interest rates in these economies will be to the upside, and that might make policymakers more inclined to pursue “non-conventional” means of managing unwelcome capital flows: more intervention in the foreign exchange market and more experimentation with capital controls. At the extreme, food inflation might cause a capital outflow, as evidence by recent sell-off in emerging equity markets. (The author is Vice President, Citi Taiwan.)
Why can Japan’s long-term interest rates remain so low?

Sayuri Shirai

The presence of Japan’s astonishingly high level of General Government debt outstanding has been well-known over the past decade. The debt-GDP ratio (including the Central Government debt in the Special Account for Fiscal Investment and Loan Program) reached about 200% in 2010, swelling from the level of about 100% in 1997. The debt ratio is well beyond those of the Euro Area (84%), Germany (76%), the United Kingdom (78%), and the United States (about 90%) for 2010, according to the estimates performed by the European Commission or OECD (see Chart 1). The ratio has been even greater than those of sovereign debt crisis economies, such as Greece (140%) and Ireland (97%).

Nonetheless, the long-term yields on Japan’s sovereign bonds have remained significantly low at around 1.25% and have been even lower than those of Germany (3.14%), the United Kingdom (3.7%), and the United States (3.5%). This situation has remained intact even after Standard & Poor’s downgraded Japan’s sovereign credit rating by one notch to “AA minus” in 27th January, thereby rating it below that of Spain (AA) and equivalent to those of China and Chinese Taipei. The downgrade was an action taken after a silence of more than eight years.

The S&P’s decision reflected concerns over a further expected deterioration of Japan’s fiscal deficit and insufficient coherent debt strategies. Moody’s also hinted a possible downgrading from the current “Aa2” in 22nd February by shifting the rating outlook from “stable” to “negative”, citing that the current political deadlock between the ruling Democratic Party of Japan (DPJ) and opposition parties might delay the progress on comprehensive tax and social security reforms needed to make pension systems more sustainable.

Japan’s unique situation is attributable to the fact that most of the Japanese Central Government Bonds (JGBs), which recorded about 134% of GDP in 2010, have been held domestically. Since foreign investors hold mere 5% of the total JGBs, the government does not need to worry about their fickle and risk-sensitive investment behavior. Moreover, domestic investors mostly consist of relatively stable institutional investors.

As of end-2009, about 43% of the JGBs were held by banks (of which, Japan Post Bank accounting for a half), 20% by life and nonlife insurance firms, 12% by public pension funds, 4% by other pension funds, and 7% by the Bank of Japan ([BOJ] maintained as a result of open market monetary operations). Banks have increasingly invested in the JGBs in recent years, thanks to firms’ increased deposits driven by accumulated profits and retained earnings, as well as their sluggish demand for credit. Households—which hold about USD 17 trillion financial assets or the second largest in the world after the United States—hold only 5% of the total JGBs, so it can be said that they hold JGBs indirectly through institutional investors in the form of deposits or pension contributions.

Moreover, monetary easing policy launched by the BOJ since the collapse of the bubbles in early 1990s has enabled the government to lower the long-term interest rates. The long-term bond yields dropped sharply from about 11% in 1990 to 1.77% in 1999, and have remained below 2% thereafter. As a result, net interest payments have been below 2% of GDP over the past two decades in spite of surging sovereign debt issues. The net
interest payment-GDP ratio has been lower than those of Greece (5%) and Italy (4%), even though Japan’s debt to GDP ratios has exceeded theirs.

The presence of stable and “home-biased” investors with low interest rates has helped the government to finance its fiscal deficit relatively easily, while enabling it to lower a debt burden. The side effect is that it has undermined fiscal discipline and thus allowed public debt to grow to a level whose sustainability could be questioned in the long run.

In June 2010, the DPJ has announced its medium-term fiscal consolidation strategy by indicating its plan to halve the ratio of a “General Government primary fiscal deficit” (defined as the difference between total expenditures excluding interest payments and revenues) to GDP by 2015 and turn it into a surplus by 2020. In January 2011, nonetheless, the Cabinet Office has hinted that the plan might be too optimistic by presenting its estimates that the primary fiscal surplus would not be achievable even in the case of an “economic growth scenario” (with average nominal GDP growth of over 3% and real GDP growth of over 2% in 2011-2020). Unless the government improves the fiscal balance by additional 2.5 percentage points of GDP in 2020 (and 4.2% in the case of a “baseline scenario” with lower growth forecasts), the estimates indicate that a primary surplus would not be achievable.

Japan’s fiscal problems arise from the growing gap between tax revenues and total expenditures. Tax revenues have not been sufficient enough to cover the growing expenditure, so that the gap has been mostly financed by newly issued sovereign bonds (see Chart 2). The ratio of Central Government Bond issues to Central Government Expenditures is expected to reach 48% under the 2011 draft budget, being similar to the level under the 2010 initial budget.

A main factor contributing to the increase in total expenditures has been related to social security expenditures (pensions, health, and elderly care) owing to the rapid pace of aging. The share of social security expenditures in total expenditures expanded from 17% in 1991 to 29% in 2010, and is expected to expand further to 30% in 2011. Meanwhile, a decline in tax revenues reflects not only sluggish corporate and individual tax revenues caused by pro-longed recession, but also various fiscal incentives provided by the government.

In the 1990s, the government introduced across-the-board individual income allowances and tax credits, and reduced personal income tax rates. As a result, the degree of progressive taxation declined with an erosion of taxable base. The corporate tax rate was also lowered from 37.5% in 1990 to 34.5% in 1998, and to 30% in 1999 and hereafter. The special tax credit for R&D expenses and the IT investment promotion tax break were also introduced for firms. While the consumption tax was increased from 3% to 5% in 1997, it could not stop a declining trend of tax revenues.

Therefore, it is clear that the most urgent issue is as to how to shrink the gap between tax revenues and total expenditures. It is increasingly understood that tax revenues could be added by raising the consumption tax rate from the current internationally-low level of 5%, as well as restoring progressive taxation through reducing individual income allowances and tax credits. Japan’s tax revenues as a percentage of GDP have been about 20%, standing below those of Germany (24%), France (27%), Denmark (47%), Sweden (38%), and the United Kingdom (30%), according to the OECD data. This indicates considerable room still available for a further tax increase in Japan. While an expenditure cut (such as a cut in personnel expenses and cost-saving social security reforms) is also necessary, the gap is simply too large to cope only with expenditure savings.

This is why the government is eager to launch at comprehensive tax and social security reforms. The government is expected to release comprehensive plans by June 2011. Since major opposition parties are also concerned about long-term fiscal sustainability, Premier Khan’s administration hopes that the fiscal issues could be tackled in a coordinated manner. Nonetheless, the political deadlock has enhanced uncertainty as to when a full-scale fiscal consolidation framework could be finally formulated and then implemented. (The author is Professor of Economics, Keio University.)
Chart 1. General Government Gross Debt as a Percent of GDP (%)  

Source: Prepared by the Author based on the Ministry of Finance (MOF), European Commission, and OECD data.

Chart 2. Central Government Tax Revenues, Total Expenditures, and Bond Issues (Unit: Trillion yen)  

Note: Excluding the central government special account. The 2001 figures indicate draft budgetary figures.  
Source: Prepared by the author based on the MOF data.

\[ \text{However, Japan’s General Government “net debt” as a share of GDP (excluding financial assets) becomes smaller than the gross debt ratio. The ratio for 2010 recorded 114%, comparable to Italy (103%) and Greece (97%).} \]
Transcending Competition with Blue Ocean Strategy: S&T Corp. Stands Unbeatable

Chia-Wen Huang

Systems and Technology Corp. (S&T) specializes in satellite tracking solutions, geographic information and automotive navigation systems. Its Global Positioning System (GPS) network has been exported to all over the world for many years. S&T has not only established a network of over 100 global distributors, but also gained numerous patents and product certifications from Europe and America. Because of its leading status in world’s GPS technology R&D, as well as its Blue Ocean Strategy, S&T has not been impacted by the 2008 global financial tsunami.

In fact, when the company first set sail into the course of the ‘blue ocean’, S&T had encountered the challenge from the 1997 Asian Financial Crisis. During that period, S&T relied on satisfying customers’ needs and continuing innovative R&D to open up a new course in an even borderless ‘blue ocean’.

Jumping out of the crisis: stick with innovation and sail into the ‘Blue Ocean’

“The 1997 Asian Financial Crisis had greatly impacted S&T operations. But S&T has not given up R&D. This makes us saved from the next financial crisis.”

During the 1997 Financial Crisis, S&T’s strategy to cope with the crisis was distinct from any other companies. Although the financial crisis dwindled S&T’s resource, the company did not cut its R&D expenses or number of R&D employees. Instead, S&T raised its R&D employees’ salary. General Manager Ming-Chuan Lan said that safeguarding the core competitiveness is the way to help the company to get through the difficulty and enter a vast blue ocean market. Because of this, S&T could survive the next financial crisis—the 2008 global financial crisis.

“General Manager, Mr. Ming-Chuan Lan

“We were growing underwater and water ripples don’t impact its bottom. Stirred water on the surface would not disturb us.”
S&T has not only been on the blue ocean, but also on the steadiest bottom of the ocean. Great waves are turbulent on the ocean’s surface, yet the ocean floor is inaccessible to them. Mr. Lan insists on the importance of innovation and R&D to raise the competition threshold—the higher it becomes, the more difficult it keeps others from entrance. Markets with high thresholds have fewer competitors. Despite a ‘tsunami’ is likely to happen, the impact would not be substantial for the market players. Mr. Lan calls this type of market as the “underwater market”. Although during a financial crisis, consumers tend to be cautious and indifferent towards innovative products, S&T’s brand new products had huge market potentials and lack competitors. As long as there is only a small portion of market share, this will contribute greatly to the company’s revenue.

“Our Blue Ocean Strategy has not caused us any serious damage during the crisis. It brought us profits instead. Our suppliers that were suffering from the financial crisis have lowered their prices to preserve the order from us.”

Looking back at the 2008 global financial crisis, Mr. Lan believes that innovative companies would treat the crisis as an opportunity because the crisis can eliminate other market competitors for them. Companies who have already had innovative capability can even make advantage of the crisis to create new gains.

Mr. Lan deems that if S&T engaged in a mature industry and blindly followed other’s steps, the financial crisis is certain to endanger the company. The slight changes during the economic boom can seriously impact the industry’s profitability and survival. In comparison, if it is in an emerging industry that is innovative, advanced, and prospective, it should be immune from the crisis.

Crisis and opportunity: The macroscopic mind and long-term strategy

“Long-term planning is necessary for R&D, so it would not become too late when the crisis hits.”

S&T crisis management is not run just when a crisis hits the company, but is built upon recognized presumptions to prevent a crisis from happening. “Crisis might happen anytime.” If the company has a long-term plan for R&D, the financial crisis would not bring any huge impact. The company should constantly maintain alert and be prepared for all management measures and strategies needed to cope with possible crises.

In the beginning of the 2008 financial crisis, S&T understood at once that this crisis will not greatly impact the company. However, S&T still treated the crisis seriously. To prevent any negative impact from happening, Mr. Lan examine financial reports daily and, as a response to the crisis, reduce the company’s growth target. “Crisis is a change for the better; the statement is true only for those who are prepared and those who have sufficient fundamentals.” Regarding the strategy to adapt with the 2008 global financial crisis, Mr. Lan said confidently that a crisis emerges to eliminate unprepared competitors. “It is to cause a differentiation between our competitors and us. It gives opportunities to people who are ready.”

Human resources and management: Keep it streamlined and planned

“Despite there is or isn’t a crisis, we need to be extremely streamlined. Don’t do meaningless things.”

Laying off staff when the economy is bad hurts you as well. It is necessary to be efficient on allocating human resources unexceptionally. The strategy to maintain company’s core competitiveness must be accurate, and structure of the company must be solid. Duties should not overlap; every person in the organization has to be clear of his/her specific profession. Follow these procedures and you will be able to recruit the right person for the job.

As for financial affairs, it is crucial to do some preparations during ordinary times.

“Always maintain good relationship with the bank and not only when you need a loan. Solely complaining to the bank is useless. The best method to interact with banks is to build the relations in accordance with the bank’s characters.”
S&T maintains an ongoing loan relationship with the bank, not because the company lacks funds, but because it is needed to establish trust between each other—a lesson learned from the 1997 Asian financial crisis. In addition to that, it is necessary to require the financial department to estimate the income and expenses of the coming two months, organize balance sheets, and submit reports to the general manager in ordinary times. On the ground of the above, the financial department should balance financial leverage and point out the upcoming problematic moments; and then, start to find the solutions one or two weeks prior to those pointed moments. Only with those measures can we get through the unpredictable difficulties safely.

S&T’s crisis prevention and Blue Ocean Strategy have turned the financial crisis from an upsetting challenge to a new turning point for the company.

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Food crisis about to hit

After the serious impacts of climatic anomalies on crop harvests in 2010 and the export prohibitions by food producing economies, the Food Price Index (FPI) announced by the Food and Agriculture Organization (FAO) of the United Nations has now averaged 230.7 points in January, 2011. The index has risen for the consecutive seventh months and has now even passed the historical highest point of 224.1 points during the food crisis in 2008. The FAO warns that the global food crisis is on the edge to burst out, while World Bank also concerned the food price as reaching to a “dangerous level.” The FPI increased by 15% between October 2010 and January 2011: the corn price has soared by 89%, and the wheat price has also risen by 80% over the past year.

Under the influence of climatic anomalies, food production has decreased by a great extent, thus reducing the global food stock to the historical low of less than fifty days. Under market manipulations, food price has increased incessantly. Various economies have begun to take actions to secure food for their economies and curb the food price. Russia, China, Indonesia and India have been listed by FAO as economies that have the most remarkable increase in food price. Russia and its neighboring economies have enacted food export bans as a result of the draught last year, and moreover they recently announced to extend the bans to July, 2011. In addition to controlling export, Chinese government has also released its food stocks to secure its domestic food supply.

The soaring of wheat price is very likely to push up the price of rice as the alternative food. Even though the rice price is still at a low point now as compared with the time of food crisis in 2008, the Indonesia government is boosting the economy’s rice stockpiles by one third. Meanwhile, it is also restricting food export, loosening restrictions on import, lowering import duties, and asking state-owned corporations to open bargain markets to sell products. As to India, it not only bars export but also has a trade treaty with Pakistan about onion import.

There is still a significant gap in global food now. Therefore, it is expected that seizing and stocking food in the market will continue to push up global food price in the short term. It is also noteworthy that, the soaring of global food price has caused re-production of many fallow farmlands and enlargement of crop-growing areas. According to the estimations of the Department of Agriculture of the US (USDA) and the International Grain Council (IGC), the crop-growing areas have been greatly expanded around the world. If the climate becomes stable again and food supply increases, chances are that the food price can decrease to a steady state as early as the second half of the year. Moreover, there are signs of downside reversal of the futures prices of wheat, soy bean and corn because the international market is concerned about the economy.

Situations getting tougher for global inflation

Both the rise of raw material prices and the recent gap in food supplies have led to an increasingly severe situation for global inflation. Emerging economies take active measures about commodity prices, the primary among which is to control inflation by raising the interest rate, with a hope to keep the commodity prices stable by means of tightening policy.

To stabilize the increasing prices, the Brazil government has raised the interest rate several times, and now the rate is as high as 11.25% in February, 2011. Besides, Brazil has already sharply
cut its budgets of public expenses and lowering import duties until 30th June, 2012 on 417 kinds of goods that are not produced in the economy, so as to control domestic commodity prices. Likewise, the India government has kept raising the interest rate in the past year, but its wholesale price index (WPI) still reached 8.23% in January 2011, and India continued to raise the repo rate to 6.5%.

Although China has raised the interest rate at several times, the consumer price index (CPI) still rose by 4.9% in January. Consequently, China took a step further to raise the benchmark deposit rate to 3%, and the benchmark loan rate to 6.08%. The largest economy in Southeast Asia, Indonesia, had its CPI of January higher than the same period last year by 7.02% and its core inflation having increased by 4.18%. This situation has prompted the central bank of the economy to raise its benchmark overnight interest rate 25 basis points to 6.75% in February so as to prevent inflation from rising; this is the first time of such action in Indonesia.

South Korea has lowered import duties, and it is also planning to buy agri-products futures to secure food supply and stabilize prices. The Singapore government, on the other hand, not only has declared its policies of tax cut, tax return, subsidy increase and cash distribution, but also increases social investments and allows some limited appreciation of its currency.

Compared with the emerging economies that are fully shadowed by the threats of rising prices, the US has its CPI of January higher by 1.6% than the same month last year, and by 0.4% than December, which is the consecutive seventh month of increasing. Also, the CPI of Euro zone in January grows by 2.54% to the new highest point of twenty-seven months. Nonetheless, the price rise in advanced economies is relatively more moderate, and therefore at present they are reserved about raising the interest rate. The inflation pressure is growing, though.

The recent soaring of commodity prices are mainly rooted in the increase of food price. As a necessary consumption, food expenses are likely to squeeze consumptions of other commodities, thus influencing the recovery of global economy and the economic growth of economies around the world.

**Important consensus reached in the G20 finance ministerial meeting in Paris**

Convened on 19th and 20th February in Paris, the G20 finance ministerial meeting had a purpose of promoting continuous economic growth in the economies, creating job opportunities, reducing economic imbalances, and boosting multilateral cooperation. It has three major agendas: reforming the global economic management, discussing the change in the global monetary system, and handling the fluctuations of commodity prices.

The main purpose of reforming the global economic management is to prevent a second global financial crisis, and to establish a mechanism that monitors the economy of different economies. The first step is to set up a set of indicators that measure the imbalances in the global economy, indicators that include the current account surplus of the economies as an external indicator, and the governmental debts, fiscal deficits, private savings, and the level of public debts as internal indicators.

This meeting only confirms to evaluate the indicators; as to the targeted figure of these indicators, however, there are no concrete regulations or sanction measures. The standard for evaluation will be discussed later in the April meeting, and yet a consistent set of measuring indicators will help to monitor the economic situations in the economies and thus to deal with them as early as possible.

G20 have reached consensus in various issues. Concerning financial monitoring, they will offer measures that deal with such new technologies in the financial markets as computer high-speed trading by June. With regard to protecting the financial consumption, they will complete the common principles on consumer protection in the field of financial services by October. As to monitoring financial institutions, they will sign a bill about the monitoring of banking system in November, on the basis of their study over how to deal with the impacts of banking system crises by strengthening financial security network, boosting the use of crisis-prevention loan instruments offered by IMF, and enhancing the management of global fluidity.
We are aware that Wall Street has been defeated entirely; inflation, nevertheless, is growing restlessly. From the soaring price of oil, progressively intense global competition, unpredictably changing stock market, to the resources that are getting scarce, for instance, oil, rare earth elements, fuel and others, are certainly the problems facing us. Although the economy is gradually recovering, these problems will not disperse or be solved any sooner. Many experts are even convinced that we will be facing serious financial problems in a very long period.

For this reason, Dr. Stephen Leeb has written *Game Over—How You Can Prosper in a Shattered Economy* for readers to further understand a major crisis—resource shortages. Ways on how to succeed in the middle of such crisis are also explained in the book. Dr. Leeb divides Game Over into four parts. He reveals his view towards the crisis which resource shortages might bring in Part One, anatomizes the challenges ahead in Part Two, focuses on the financial tsunami in Part Three, and finally emphasizes on how to invest during these chaotic times in Part Four.

Dr. Leeb believes that the world is gradually heading towards chaos as natural resources are dwindling. Emerging economies such as China, India, and the Middle East are causing the demand for resources to escalate. The author suggests the problems we are facing today as urgent and complex, and that the time for us to solve this crisis is getting shorter. The longer we wait, the higher prices for resources will become; that is, the more efforts are needed to solve these problems. Natural resources will be exhausted eventually because up to the present, through whatever means, no advanced technology can avoid using nature’s resources.

Thus, Dr. Leeb proposes that the urgency should shift before the trend becomes reality. Even if we start to make changes now, the transformation period of economic unrest remains unavoidable. But if we do not do anything, then the human civilization is prone to extinction. Dr. Leeb further verifies his arguments above on the first part of the book by explaining the consumption of natural resources (such as oil, metals and minerals), water shortage, developing economies’ increased demand for natural resources, complex connection between costs and resources, as well as Wall Street’s influence on commodity prices.

The second part of the book anatomizes the challenges ahead. Dr. Leeb sees the problems we are facing ahead as an issue easier said than done, and talks about the denial to recognize the fact that all resources will be exhausted someday. The stronger denial we have, the more likely it will cause human civilization to extinct. In a time of resource shortages, demand for resources keeps increasing without decline. In dreadful
circumstances where prices are rising ever more, we must deal with this problem as early as possible.

However, when oil and other alternative energies are unable to develop rapidly in the short run, we need to race with time. Nevertheless, the resources we have invested now are too few, and visible/invisible obstacles too many, and complex civilization systems making it difficult to communicate on science and technology, all causes to finding an effective and swift solution arduous. Moreover, if we continue to deny the possibility of resource shortages to happen, and assume everything has a solution while the situation will not go any worse, then solving these problems can get even harder.

The third part of Dr. Leeb’s book mentions about the economic tsunami which we will face; pointing to the ticking bomb called inflation, and that the solutions for inflation in the past will not be effective anymore. In Part Four, he discusses better ways to invest in today’s resource scarcity and unstable economy; which are by investing in gold, investing abroad, investing in wars for resource, and investing in the solutions. What’s special is that, Dr. Leeb stresses on how companies can propose and implement great solutions to bring tremendous wealth to investors on a period of crisis or resource shortage like today.

Yet before failing to find the solution to humans’ fundamental resource problems, the occurrence of economic tsunamis will possibly shorten in length of time, happen more frequently, and become harder to solve. Despite their being unable to solve resource shortages and economic unrest, small and medium enterprises can start hedge investments, by following Dr. Leeb’s advice: invest in companies related to natural resources, foreign markets and gold, and avoid risks.