Expect Japan to Recover from the Calamity Rapidly

Few weeks ago, a magnitude earthquake hit Japan, triggering great tsunamis and even the serious nuclear disaster that caused damage to life and property in the northeastern Japan. We feel deep sorrow at the calamity, mourn over victims’ death and hope Japan can recover from the disaster as soon as possible.

Japan plays an important role in the industrial development of APEC region and has enormous output values. In this time, the earthquake makes the economic activities of the northeastern Japan stagnate and ruins the production equipments. Not only does it affect Japanese economy, but also influences the economies of APEC which do business and have supply chain relationships with Japan. Therefore, it is necessary for APEC to help Japanese economy return to the right track by cooperation.

Caused by the magnitude earthquake, the crisis of supply chain is the new type of the economic crisis, which mostly occurs in the production sector. There are two forms of it. One is that a Japanese factory which is a supplier of key components will affect downstream firms to acquire key components once its production is disrupted; the other is that a Japanese company which produces finished goods or engages in selling products will influence the production of upstream firms if it no longer imports parts and components from them.

Japanese nuclear disaster also gives rise to another kind of economic crisis which the nuclear radiation would contaminate products in disaster areas and affect Japanese export. Meanwhile, foreigners’ intentions to be engaged in commercial activities or investment in Japan would be influenced.

In this issue, the key point is to probe into the economic crisis triggered by Japanese magnitude earthquake. In the section of Crisis Alert, we discuss whether Japanese great earthquake affects inflation outlook in the international economy and the trend towards inflation. The earthquake even increases the threat of inflation. Furthermore, we invite experts to talk about how to deal with the problem of inflation and about the reasons of the US financial crisis. Our center’s expert deems that the global economy will never have high growth like before because each economy cooperatively implements measures to restrain inflation.

This issue also includes a special interview with Steven Ko, CEO of O’right company. We discuss how O’right successfully uses marketing and brand strategies to increase its business performance during the financial crisis. O’right successfully makes a difference between their own green products and other goods on the market. Thus, when customers reduce a number of brand products, O’right is still favored by customers.

In addition, we select the most concerned news and interpret these contents for readers, including the impact of Japan 11th March earthquake on Japanese economy, as well as on the global economy and the continuous existing of global inflation with no sign of relief. Moreover, we introduce Raj Patel’s book “Stuffed and Starved: The Hidden Battle for the World Food System” to readers, which was published in 2007. The book completely reveals the invisible hand of the food crisis.

So far the effect of disasters caused by the magnitude earthquake has continuing in Japan. It shows the effect of natural disasters on economy cannot be underestimated. We will emphasize the effect of natural disasters in future issues, especially the impact of natural disasters on production halt and inflation.

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The powerful earthquake that hit Japan on 11th March 2011 created a massive tsunami (tidal wave) and also caused severe damage to a nuclear power plant, leading to a potentially dangerous nuclear incident. The earthquake and tsunami had a direct negative impact on industry and the regional economy in the Tohoku region of the northeastern Japan, and it is anticipated that the loss suffered by Japan will be in the range of JPY 10–20 trillion.

What with the damage caused to factory buildings and production equipment in the disaster zone, combined with the disruption to transportation networks and electric power supply, several major industries—including IT and electronics manufacturing, plastics manufacturing, the chemical industry and automotive manufacturing—have had their supply chains disrupted, which has had a knock-on effect on downstream manufacturers that rely on key components produced in Japan; the economies where these downstream manufacturers are located have thus also been affected by the Japanese disaster.

The most direct impact of this natural disaster in Japan on the global economy as a whole is that the shortage of supply of key components and products resulted in the disruption of industrial development of other economies. Of course, the impact of these shortages will not necessarily be entirely negative. With respect to some products—such as automotive components and certain types of IT and electronics components—it may be possible to find alternative sources of supply, thereby benefiting other economies.

With respect to those products where alternative sources of supply are not readily available, given the lack of production capacity for these products outside Japan, in the short term, the production will be affected, but this is unlikely to last long. As production recommences in Japan, or as manufacturers in other economies expand their scale of production or create new production lines to make up the shortfall, equilibrium between supply and demand will be restored. Nevertheless, the price of these products can be expected to rise in the near term, although not to the extent that it would affect overall consumer prices of the globe.

The temporary cessation of production by Japanese iron and steel producers and plastics and chemical manufacturers will lead to a fall in demand for certain types of raw materials in Japan. However, it can be anticipated that the fall in production in Japan will be compensated by other economies. Therefore, the impact on demand for raw materials will be limited in global terms. This is clear from the fact that there was no significant downturn in global commodity markets in the aftermath of the Japan earthquake. In fact, the needs of post-earthquake reconstruction work will ensure a pronounced increase in demand for iron and steel, base metals, cement, etc., thereby causing the price of raw materials to rise.

The damage caused to the nuclear power plant
at Fukushima and the subsequent nuclear incident have led to a reduction in nuclear power generation in Japan; other sources of energy—including petroleum, coal, natural gas and solar energy—will have to be used to take up the slack. It can be anticipated that the problems at Fukushima will also encourage other economies to reduce their reliance on nuclear power, leading to a rise in international energy prices. The NYMEX price for light, sweet crude oil rose to USD 106 per barrel on 23rd March, and the Brent crude price reached USD 117 on 18th March.

It can be seen from the above that the Japan earthquake will do little to halt the current inflationary trend in the global economy as a whole, and may even exacerbate it. Besides the upward pressure that will be created on the price of raw materials (including crude oil), the Bank of Japan has already pumped JPY 40 trillion (approximately USD 490 billion) of extra liquidity into the capital markets in the space of just one week, from 14th March to 21st March; this is nearly as much as the second round of quantitative easing (QE2) in the US, which involved an infusion of USD 600 billion. The extra liquidity is sure to put upward pressure on global prices.

The threat that inflation poses to the global economy is still a serious one, with inflation rates remaining high in many major economies. While cereal prices are showing signs of falling, they are still high compared to June 2010 levels. The inflation rate in Vietnam has continued to rise, climbing from 12.17% in January 2011 to 12.31% in February. In Russia, inflation remained a significant threat in February, which stayed around 9.5%; in Brazil it rose slightly, from 5.99% to 6.01%. South Korea saw a substantial rise in the inflation rate, from 4.01% in January 2011 to 4.5% in February. Inflation has also continued to worsen in the Euro-zone, reaching 2.4% in February. Only a handful of economies—including Singapore and Indonesia—have seen inflation fall in February compared to its January level.

The inflation rates given above are for February 2011. It is anticipated that the Japan earthquake will not lead to a slackening of inflation in March, and for several months from April onwards, developments in the aftermath of the earthquake will even increase inflationary pressure for most major economies. SMEs in APEC member economies should continue to monitor the threat posed by inflation carefully.
In February, the US unemployment rate was 8.9%, the first time that the unemployment rate has fallen below 9% since April 2009. About 13.67 million people, however, still cannot get jobs. There was a big gain in construction and manufacturing employment. The most notable feature of the February employment figures was that overall private sector employment increased sharply, compared to the 30,000 decrease in public sector employment. The increase in employment has sustained consumption, which is 70% of US GDP. Still the increase in consumption during this recovery is much less than in previous recoveries.

According to a recent survey, economists expect US GDP to grow at 3.3% in 2011, up from November’s prediction of 2.6%, and higher than last year’s actual growth of 2.9%. For 2012, economists expect GDP to grow at 3.4%. However, the labor market is expected to recover only slowly. The unemployment rate is expected to be at 9.3% in the first quarter of 2011, and 9.0% by the fourth quarter. Even at the end of 2012, the unemployment rate is expected to be above 8%.

The Federal Reserve Governor Bernanke appears to firmly believe that high unemployment will undercut the economic recovery. That is why the Fed is still pursuing a nearly zero interest rate policy. It seems quite unlikely that the Fed will raise interest rates any time soon. The Federal Reserve’s current policy is to lower the unemployment rate by holding short-term interest rate close to zero and finishing its QE2 plan—the USD 600 billion quantitative easing—announced last fall.

Fed policy makers are unlikely to change course unless higher energy and food prices spark a sharp general rise in the inflation rate, perhaps to 4 to 5%. Some US lawmakers have questioned whether the Fed’s quantitative easing bond buying program would pump so much extra money into the economy, causing inflation rates to soar. Some lawmakers and economists have called for the Fed to narrow its mandate from pursuing both employment and price stability to just pursuing price stability. A focus solely on inflation rate targeting, such as that by the European Central Bank, would help US monetary policy become more predictable.

As opposed to the inflation hawks, in fact, there are some Federal Reserve monetary policy board members who say that a sharp spike in oil prices should be an impetus to further loosening of monetary policy, not tightening. These board members believe that a sharp spike in oil prices can cause another recession, and the Fed should loosen with QE3. Inflation, no matter how high it is, the Fed should worry about later, when the unemployment is lower.

The US banking sector is still weak. Unless...
the housing market improves through higher employment, the current banking situation is unlikely to improve. The number of banks at the risk of failing made up nearly 12% of all banks, in the third quarter of 2010. In all of 2010, there were 157 bank failures; US banks failed the most since 1992, at the height of the Saving and Loan crisis. The failures were mainly small banks. In 2008, 25 banks failed and in 2007, only three banks failed. Smaller and regional banks are vulnerable, because they primarily lend to developers and the real estate sector, hard hit by the crisis.

Canada.

In January, the Canadian inflation rate was 2.3%, pushed up by higher commodity prices. This higher than expected inflation rate makes it highly likely that the Bank of Canada will raise interest rates to 1.25% by late spring. This increase in interest rates is in spite of the still high 7.8% unemployment rate. (The author is Professor at University of Southern California.)

Northeast Asia

Devastating catastrophes occurred in the northeastern Japan
Sayuri Shirai

In the afternoon of 11th March, the earthquake with a magnitude of 9.0, followed by repeated huge waves called Tsunami, attacked the Great North East Region (covering the Tohoku and Kanto Regions) of Japan.

The worst is that the earthquake and huge waves damaged nuclear power reactors at Fukushima Daiichi Nuclear Plant in Fukushima Prefecture by flooding the plant, thereby forcing the whole site to lose the ability to maintain reactor cooling systems. This gave rise to not only power shortages in the Great North East Region, but also elevating radiation levels in the neighboring area as a result of accidents incurred on the reactors.

As the radiation levels increased and exceeded the normal levels to a significant degree, the government ordered citizens to move away from the 20 kilometer zone centering the Nuclear Plant. To cope with the problems, plant workers, firefighters, and self-defense forces have been making tremendous efforts to trying to spray water on the reactors. With the completion of power source restoration, it is hoped that the radiation problems are getting to be resolved in the near future.

Overall, people in the Kanto Region (including the Tokyo Metropolitan area) remain calm and their lives are gradually becoming normalized.

The official death toll reported as of 20th March is 7,508, but the number may go up to over 19,000 once missing people are counted. In addition, the number of injured people is reported to have reached 2,583. The number of buildings damaged is estimated to have recorded about 117,570.

Although it takes time to come up with precise figures on the entire damages (including the damages related to infrastructure and buildings), various private sector sources have provided tentative estimates in the range of between JPY10 trillion (about 2% of Japan’s GDP) and JPY 20 trillion. The average of these estimates is roughly equivalent to the actual damages caused by the Kobe Earthquake (or Great Hanshin Earthquake).
with a magnitude of 6.9, which had erupted in the West Region of Japan in 1995. The Japanese economy may suffer more if foreign firms refrain from investing and operating in Japan in fear of radiation exposure (even though the level in the Tokyo Metropolitan Area is reported to be non-harmful to the human being).

A wide range of impacts have been already felt. First, many manufacturing firms, including SMEs, had to stop operations, because (1) the damages directly incurred on their factories by the catastrophes, (2) the stoppage of inputs and materials from their suppliers, and (3) a shortage of fuel supplies to the affected region. A large number of Japanese firms export high technology-intensive electronic inputs and high-performance materials, which have been used largely for environmentally-friendly cars, smart phones, aircrafts, etc. Therefore, the interruption of production has not only disrupted Japanese manufacturers, but also those in the United States, mainland China, Korea, Chinese Taipei, and other Asian countries.

Second, some listed firms decided to delay or cancel the plan to issue bonds or stocks in the presence of unstable capital markets and uncertainty related to risk appetite of investors. One pharmaceutical firm postponed the date of IPO scheduled at end-March on the JASDAQ stock exchange (affiliated to Osaka Stock Exchange). The Nikkei 225 index plunged sharply from about 10,300 on 11th March to 8,200 on 15th March. The US, and European, and Asian stock prices—such as those in mainland China, Korea, Chinese Taipei, Hong Kong, etc.—have also subsequently dropped.

Third, the yen appreciated sharply to the highest level of in the post-war period. In the morning of 17th March, the yen rose by JPY 3 against the USD within 20 minutes, whose pace of appreciation is abnormally rapid. The yen then swiftly rose to JPY 76 against the USD and went over the 1995 level (JPY 79 against USD) in the same day. The appreciation was attributed to the speculative yen-buying activities on the basis of the assumption that Japanese large-scale insurance firms, which will have to make a large sum of insurance payouts to the damaged region, may end up selling their foreign assets (including US treasury securities). The facts that Japan has been the largest net external creditor economy in the world and the second largest foreign investor in the US treasury securities have prompted such speculative activities, notwithstanding that Japan’s economic growth forecast for 2011 is likely to be adjusted downward by 0.2-0.5 percentage points.

This level of the yen exchange rate is unjustifiably high from the standpoints of Japan’s current economic fundamentals. Therefore, growing concerns emerged that the yen’s sharp appreciation may generate a third shock to the Japanese economy in addition to the earthquake (and Tsunami) and damages caused by the accidents at the Fukushima Daiichi Nuclear Power Plant. This has certainly enhanced anxiety among many exporters.

In response, the government and the Bank of Japan have reacted promptly to contain yen’s appreciation on 18th March. A G7 (Group of Seven Industrialized Countries) Finance Ministers’ and Central Governors’ conference call took place in the morning of 18th March. Japan then asked for a coordinated currency intervention. The recognition that Japan’s problems may destabilize global financial markets and affect adversely the global economy enabled Japan to persuade other monetary authorities. An agreement that a joint action would take place through selling Japanese yen on the same day was reached.

The intervention so far successfully lowered the exchange rate to JPY 82 against USD. The last coordinated intervention by Japan, Europe, and the United States was in September 2000, when the euro depreciated sharply to USD 0.9 against the euro and thus the monetary authorities decided to support the euro. The joint action also helped to raise the stock prices not only in Japan, but also in the United States, Europe, mainland China, Korea, Chinese Taipei, etc.

To help stabilize the financial market, the Bank of Japan has also injected massive monetary liquidity to the market consecutively since 14th March. On 14th March, the Bank of Japan also decided to expand the so-called “Quantitative Easing” monetary policy by expanding the amount of purchasing treasury securities and some risk assets (such as commercial papers, corporate
The Vietnamese currency depreciation of 9.3% on 11th February 2011 was the fourth depreciation since November 2009. Just after this, six banks in South Korea got bank-run problems. Many worry that this is the start of another Asian financial crisis. A report by Credit Suisse stated that Vietnam and its neighbours, Thailand and Malaysia, have similar economic structures. In this instance, Vietnamese currency depreciation may be good to promote its own exports but it will undermine and create pressure on neighbouring economies’ exports. This crowding out may cause other economies to competitively devalue their own currencies, increasing the risk of a currency war.

The 1997 financial crisis was initiated by currency devaluation in Thailand, which is a principal reason for the concern over Vietnam’s depreciation. May this be the start of another Asian financial crisis?

The simple answer – No. At least, not now.

Why not?

First of all, after the 1997 financial crisis, East Asian economies became more cautious with their monetary policy, credit expansion, external deficit and exchange rate regimes, which can be seen in most East Asian currency appreciations against the Euro and the US dollar last year. Current exchange rate regimes in East Asian economies have become much more flexible in the last 15 years.

Thailand

In the past ten years, before the 2008/2009 global recession, the growth rate was stable around 5% and it recovered well after the downturn in 2008/2009. The CPI has been steady, rising to 5%, ignoring the effects of the financial crisis, and credit growth has been kept under 10%. The Thai baht has been appreciating against the US dollar and the Euro for the past eight years. In the past
three years, external trade has been in surplus. Overall, the economy looks solid.

**Malaysia**

Malaysia’s economy is of a similar structure to Thailand, but the money supply and credit growth is much more volatile. Their exchange rate has been appreciating since 2003, and their trade surplus has been high for the past eight years.

**Indonesia**

Indonesia’s GDP growth has been stable around 5% since 2002. CPI inflation has fluctuated in the past, but is now steady at 10% after the global recession in 2008/2009. However, money and credit growth is very volatile with high variance. Exchange rate with the US dollar has been stable except for throughout the 2008 financial crisis, and has now recovered. And the trade balance has been in constant surplus since 2003.

**Philippines**

There was a large GDP shock in 2009, with GDP falling about 5%. Inflation has been kept below 9%, except in 2008/2009 and although money and credit markets are very volatile, they have much less variance compared to Indonesia. The exchange rate has a small appreciation trend. There are huge trade deficits, because of their reliance on imports and remittances (remittances totalling 11.17% of GDP).

**Singapore**

Singapore is the most mature economy in East Asia. The fact that growth suffered during the 2001 US-led recession shows how open and mature the economy is. The small-open economy also means that money and credit growth is very volatile. The exchange rate has seen a strong appreciation against the US dollar and there has been a strong trade surplus since 2002, even through the 2008/2009 recession.

Second, comparing external economic scale and regional influence of Thailand and Vietnam, we can see that Vietnam is only one third of Thailand’s size and influence. In 2008, Vietnam exported USD 63.73 billion and imported USD 79.37 billion. In 2010, Thailand exported USD 197 billion and imported USD 181 billion.

Third, the 1997 Asian Financial Crisis was thought to be due to the rapid growth of Chinese exports crowding out other exports. Today, the Chinese currency is under appreciation pressure, as opposed to the 1993-1996 depreciation pressure. “China factor” is not a factor now.

Fourth, former Harvard economist Professor Jeffrey Sachs compared the 1997 financial crisis with the classic bank-run problem. Prompted by a sudden shock, contractionary fiscal and monetary policy was implemented on the advice of the IMF. But now, even with Vietnam’s hot economy, the IMF has been very mild in its assessment of Vietnam. Its report last year does not show over concern about Vietnam.

Fifth, another exogenous shock that the economy will not face today was the hand-over of Hong Kong sovereignty on 1st July 1997. Although today there are Jasmine revolutionary movements in Arab region, East Asia economy has not suffered from this.

Finally, in 1997, hot money flowed out from Asia to developed economies, such as the US, due to their strong recovery. However today, we are still waiting for confirmation of a strong US recovery. The EU is still suffering from problems in Greece, Ireland, Italy, Spain and Portugal. So, where would the money go?

In summary, there may be a financial crisis somewhere, but it will not be in East Asia soon. (The author is professor at the Renmin University of China, Beijing and The University of Birmingham, UK.)
Regional Reports

Australia

The economy is still dealing with the aftermath of the natural disasters that hit earlier in the year. The government has established a review board to assess the Australia insurance industry as it relates to natural disasters. Expectations reflect an uncertain outlook. AiG-Deloitte’s CEO Survey for 2011 notes that while growth in the near term will be affected, the economy is expected to improve over the year. The Sensis Small Business Index for Nov 2010-Jan 2011 noted that confidence levels of Australian SMEs stalled due to concerns about consumer spending and the impact of the recent floods and cyclone, yet expectations for the first quarter 2011 showed an improving outlook.

The immediate economic impact on Australia of the appalling disasters in Japan has been a decline in the value of Australian uranium shares; in most recent days the AUD has shown resilience.

2010’s December quarter GDP growth reflected a subdued economic performance. The economy grew at 0.7% (seasonally adjusted) for the quarter and yearly at 2.7%. However, company profits declined 2.8% during this quarterly period. ACCI’s Small Business Survey for the December quarter saw a fall in SME business confidence.

The government recently announced its intention to set a price for carbon effective from 1st July 2011, to lead into an emission trading scheme in three to five years. One of a number of factors being considered by a parliamentary group is the price, which has yet to be determined. The prospect of a carbon price has led to serious political divisions in the economy; concerns of how to compensate high-emitting, trade sensitive industries and low income people who will be affected by rising electricity prices, are particularly important political matters. Newspoll released a poll from 8th March showing that 11% more people are against a carbon price than for it, a reversal of earlier public sentiment.

WHK’s SME Pulse Survey notes that as many as 85% of SMEs believe that their interests are not being reflected in government policies, while 80% are of the view that the recent natural disasters will negatively affect the economy. A similar proportion of SMEs note that access to bank loans has not eased and perceptions of bank disloyalty have increased by 12% to 94% from 82% in August 2010. NAB’s Monthly Business Survey notes that in February Business conditions lifted 4 points but still remains negative at -2. ANZ-Roy Morgan consumer confidence dropped nine points from December to 108.2 in February, a declining trend since early 2010. Westpac-Melbourne Institute Consumer Sentiment Index recorded a similar drop of 2.4% from January to 106.6% in February.

Notwithstanding these negative perceptions, the unemployment rate has remained relatively low and steady at 5.0% and the RBA notes that growth in the period ahead is expected to benefit from investment by the corporate sector by companies which are cash-rich or which can tap global capital markets directly.

Australia’s Current Account Deficit (CAD) has been decreasing steadily in recent months, due in part to Australia’s banks reducing their reliance
on foreign savings. For the December quarter, the CAD was recorded at 2.1% of GDP and yearly at 2.6%. The Australian Bureau of Agricultural & Resource Economics & Sciences (ABARES) revised Australia’s commodity export gains to increase by 14% next fiscal year due to rising prices, from AUD 220.6 billion this fiscal year to AUD A251.3 billion. Australia’s trade surplus in January, however, narrowed by AUD 143 million to AUD 1.9 billion.

India

The economy grew 8.2% on an annualized basis, during the December quarter. India’s industrial output rose in January by 3.7% and UNIDO has listed India as one of the top ten manufacturers in the world for 2010. Merchandise exports rose in February by 49.8% from a year earlier to USD 23.6 billion. A demand crunch in developed economies has forced Indian exporters to look towards Latin America and Africa, where exports have increased 108% and 41% respectively, in the first half of the fiscal year.

The budget was released last month to a mixed response by some commentators, because of a lack of reform-focused policies although efforts to reform agriculture (and to contain inflation) included the prospect of reduced subsidies on major food stables, fertilizer and fuel. The government intends to introduce a Goods and Services Tax and to contain the budget deficit at 4.6% in the next fiscal year. Success in achieving this will be based in part on revenue from the 3G network auctions.

Notwithstanding political pressures, the government has determined not to impose price controls on food and fuel, each of which shows no signs of early abatement, but rather, as noted, to reduce subsidies on these major consumer items. While food prices did ease in late February, the inflation index in February showed an increase over the year to 8.31%, from a y/y increase of 8.23% in January. Real income of an average Indian salary-earner for fiscal year 2010 declined for the first time in five years. In response to these concerns, the cash rate has been raised 25 basis points to 7.70/7.75%.

India’s current account deficit rose over the first six months of the fiscal year to 3.7% of GDP, due to slackening non-merchandise trade, a decline in investment income and private transfer receipts. FDI from April to December 2010 declined by 23% to USD 16 billion from USD 20.8 billion in the same period in 2009. Investment is not assisted by security concerns which have lead one risk analysis firm to categorise India’s economy as “extreme risk”. There are also complaints of environmental policies impacting on investment.

Despite the variable investment environment, Israel has invested INR 400 billion into agriculture, horticulture, aquaculture and dairy sectors in Madhya Pradesh. The investment processes within India are also being simplified and an online market for venture capital is expected to be opened soon. The government and the Reserve Bank are reviewing regulations for non-banking finance companies and consideration is being given to the further liberalization of FDI policy to attract USD 1 trillion for infrastructure development.

The government is continuing to struggle with the issue of corruption, with the Supreme Court convicting the new anti-graft chief of corruption; and charges are now expected to be brought against India’s former telecoms minister and two companies suspected of corruption. The Court has referred to corruption in over 50 rulings in the last year. In response to the opposition party’s actions, the government intends to introduce reforms.

KPMG recently released a survey noting that the type of corruption in India is reaching levels involving billions of rupees, especially in the real estate and construction sectors.

An IMF working paper on India has suggested that India’s increasing working age population will increase the income of poorer states as well as overall income levels.

New Zealand

A JP Morgan report has indicated that the Christchurch earthquake would cost up to USD 12 billion. The government indicated it can cover the costs of reconstruction and avoid a credit rating downgrade but will need to borrow more funds. Since the economy is already under pressure, the government’s ability to borrow funds easily
is being called into question. The New Zealand dollar fell to its lowest level against the Australian dollar in a decade last month, and fell to 74 cents against the US dollar. The IMF has indicated it will downgrade its growth forecasts. NZIER and ASB have both reduced their first quarter growth estimates to 0.3%.

Flat growth is expected over the period June 2010 to June 2011. The government is considering making changes to interest-free student loans and the Working For Families program, and the Reserve Bank reduced official interest rates by 0.5% to 2.50% in March.

A trade surplus of NZD 11 million was recorded in January, with exports and imports rising 4.3% and 14% respectively to NZD 3.3 billion each from a year earlier. Since Japan is New Zealand’s fourth largest trade partner, and a key source of tourist income, New Zealand could be adversely impacted, in the short-term at least, by the disasters now besetting Japan.

The banking sector is making efforts to provide easy credit, but business interest has been subdued, focusing instead on debt repayments. (The author is Director, Australian APEC Study Centre at RMIT University.)

Macro-prudence takes time and patience

Cheng-Mount Cheng

Peru Central Bank raises reserve requirements and policy rates again

The Central Bank of Peru (BCRP) raised reserve requirement once again on 27th February. The authority announced a new hike of reserve requirement on both local- and foreign-currency-denominated bank’s obligations by 25 basis points, taking them to 9.50% from previous 9.25%. This is the second tightening of reserve ratios in 2011, following a 25 basis point raise in January, and complements the policy rate hiking cycle resumed early this year. According to BCRP statement, the tightening of reserve ratios seeks to keep inflation expectations anchored within the 1-3% inflation target range. At the same time, an increase in reserve requirements also serves the double purpose of restricting credit growth, while sterilizing the potential effect on credit stemming from capital inflows the reacted to interest rate hikes.

The inflationary landscape in Peru appears increasingly challenging as food prices rise from supply-side shocks and turmoil in the Middle East has led to further pressures on energy prices. The government has reacted by freezing fuel prices, but the resources available in the Fuel Price Stabilization Fund (FEPC) would only last three months given current differentials between international and domestic fuel prices. If situation in international markets proves permanent rather than temporary, then the government may have to make a substantial adjustment to local fuel prices eventually. In addition, recent tax cuts by the government put additional burden on the central bank to cool the economy. Given that credit to private sector continued to grown strongly, with
PEN-denominated credit expanding 21.1% year-on-year in January, the effect of recent tightening measures on credit growth will likely take some time.

Not surprisingly, the BCRP raised the policy rate again on 10th March by another 25 basis points to 3.75%. The marks the third consecutive rates hike in a row. The BCRP noted that the move was largely prevented in nature, given rising food and energy prices globally. The BCRP President Julio Velarde said the Peruvian economy is likely to grow 7% in 2011. CPI inflation reached at a five-month high of 2.23% in February.

**Brazil Central Bank raises policy rate again by 25 basis points**

In a unanimous decision, Brazil’s monetary policy committee (COPOM) decided to hike the benchmark Selic rate to 11.75% from previous 11.25% on 2nd March. The statement was very short, just mentioning that the decision was a process of continuous monetary tightening. This is contrary to previous statement which also mentioned macro prudential actions were part of this tightening cycle. On 10th March, the meeting minutes showed COPOM has a more benign view on the inflation outlook. In particular, the minutes mentioned that supply shock (coming from food prices), seasonality, and the high concentration of monitored prices increases are behind the recent spike in CPI inflation early this year. On activity front, the minutes recognized the still small slackness in the economy, especially in the labor market, despite the recent signs of deceleration. With this dovish tone, some economists now expects April rate hike may be the last one, while some still forecast further rate hike of 100 basis points ahead.

**S & P upgrades Colombia sovereign credit rating to investment grade**

Rating agency Standard & Poors raised Colombia’s foreign currency sovereign credit ratings for its long-term and short-term to BBB- and A-3, from BB+ and B, respectively. This places the ratings at investment grade. In addition the outlook for these new ratings is stable. On 18th March, Colombia Banrep increased the policy rate to 3.5%, a move that was in line with market expectation. The communiqué pointed out that interest rates are at historically low levels and both financial and monetary conditions are still supportive of domestic demand and production growth. Economists believe the policy rate could reach 4.5% by year-end, which suggest a total of 150bp in hike through 2011.

**Chile Central Bank surprises with a 50bp hike**

The Central Bank accelerated the pace of monetary tightening with a 50bp rate hike to 4.0% on 17th March, above market consensus forecast of only 25bp rate hike. According to the statement, political tension in Arab economies and the earthquake and tsunami in Japan led to greater uncertainty and volatility in financial markets and raw materials. Thus, even though inflation has behaved as expected, the Committee decided to take a forward-looking approach and to reduce monetary stimulus in the coming months. (The author is Vice President, Citi Taiwan.)

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Column 2 | Regional Reports
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The month under review was dominated by three distinct concerns, two of which were external and one of which was internal. Firstly, the on-going humanitarian crisis in Libya and its implications for oil prices and political stability in the wider region. Secondly, the earthquake, tsunami and nuclear crisis in Japan. And finally by internal economic policy debates in the EU with respect to the coordination of economic policies by Eurozone states through a ‘Euro pact’. All these developments are assumed to have major short, medium and long-term economic and policy implications, some of which will impact the SME sector in the APEC region – mainly indirectly.

At the same time, the threat of inflation, which was earlier assumed to be an immediate worry, is perhaps receding as a critical issue with commodity and energy prices showing signs of decline. Unemployment however remains very high throughout Europe, while the recovery continues to be uneven across the EU, with different economies moving at different speeds, so the old challenges of restoring growth and employment remain.

Three other specific issues that will have implications for APEC economies and investors, and perhaps the SME sector in the APEC region are:

- The ratification of the EU-South Korea free trade pact
- A proposal of the EU’s Industry Commissioner for a regulatory body to oversee foreign investment into the EU. The objective: to limit the action of sovereign wealth funds, and other forms of ‘predatory’ acquisition that many foreign investors will see as an opportunity to expand rapidly and cheaply into the EU market.
- The announcement of the Greek government of the sale of EUR 50 billion of state assets in an effort to reduce the deficit.

Developments in Libya continue to dominate EU and debates at various levels. Setting aside humanitarian and political debates, the EU has deep concerns about the effect of these developments on the price and security of energy (which could endanger the fragile recovery of some economies, and make the recession worse in others), and the potential damage caused by the arrival of a large number of refugees. EU economies are increasingly sensitive to immigration issues (legal and illegal) and any major inflow of refugees could trigger a political backlash across the EU. A side effect of such a development would be further delays in expansion, or policy consolidation with respect to the Single Market.

Developments in Japan could have equally profound consequences. Japanese companies are expected to withdraw investments from the EU to invest in Japan’s reconstruction, which will slow the recovery in the EU further. Moreover, Japanese demand for EU products is likely to fall sharply, again making the situation worse. And Japan’s nuclear situation is causing the EU to rethink their energy model, and to put on hold plans to diversify away from oil, coal and gas to nuclear energy. Debates surrounding this issue are just beginning, but are sure to fundamentally affect the future structure of EU energy policies.

The pre-eminent issue during the month was
however the intense negotiations over a ‘Euro pact’ designed to clarify the European Central Bank’s role and powers; institutionalise economic policy coordination to prevent a recurrence of the sovereign debt crisis; and other measures to put limits on debt, and improve the harmonisation of tax policies (particularly in the corporate sector). Only 17 of the 27 member states (those that have adopted the Euro) are party to this agreement, raising questions about the viability of the EU. It is also thought that these measures will be a prelude to other tough measures, including a stricter stress test for banks of EU member states as part of a banking reform policy.

Given the impact of the Libyan and Japanese situation on the EU, it is difficult to assess what the effect of these recently-agreed policy measures on the debt market will be. Next month’s report may address this issue. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)

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**East Europe**

**East Europe region seems sound, caution on the earthquake in Japan**

*Kuo-Yuan Liang*

In every aspect, several major developments occurred during the past month. This started with the Middle East unrest, inflation vigilance of ECB, the downgrade of Greece’s credit rating, and finally, an earthquake at “where the sun first rises”, triggering a nuclear crisis that could potentially become an inflection point of the current business cycle’s upward momentum.

**Moody’s downgrade on Greece to be neutralized with aid extension**

On 8th March, Moody’s investor service downgraded Greece’s sovereign credit rating by two notches from Ba 2 to B1, which is equivalent to a downgrade from BB to B+. This is an indication of an implementation risk, in which the effects of Greece’s efforts to curb debt might fall short of meeting the terms required for extending the EU-IMF financial aid package. The ratings change has had a mere minor effect on the market place, as other ratings agencies have already lowered Greece to similar credit levels much earlier.

However, as it turns out, following the agreement during last week’s European summit, the EU agreed to extend the aid package’s repay period from 3.5 years to 7 years, while collecting 100 basis points less of interest. This swift decision was perhaps partially due to the unfortunate disaster in Japan, which has raised global uncertainty, and thus prompted the EU to avoid further escalation of systemic risk.

**Regional currencies stood strong amid uncertainty**

Amid the events mentioned above, in which global and local issues all have the potential to create widespread impacts, the performance of East Europe’s major currencies performed quite well as a whole. From 14th February through 14th March of 2011, the Euro appreciated 3.2% against the US dollar, and the Zloty, Koruna, and Forint each raised 1.7%, 3.4%, and 2.7%, respectively. Poland seems to be slightly weaker than her peers, but nonetheless in a time of uncertainty and global
funds retreating from emerging markets, such developments are still considered strong. But as there were already some doubts from last month’s article considering Poland’s service and industry sectors, a weaker than average exchange rate trend may signal a need for a closer look at the relevant economic data.

**Economic sentiment gaining in the region as Poland shows strength**

From the ESI (Economic Sentiment Indicator) report of February, we can find most economies improving in February, with the notable exception in the Czech Republic and also Lithuania at a lesser extent.

Starting from Poland, which drew attention in the previous month’s column, sentiment in all its five major sectors had risen during February. By focusing on the industrial and service sector components, only “production trend observed in the recent three months” continued to fall, while all the other components in the industrial and service sectors improved, leaving us with little doubt about Poland’s positive development.

Turning our attention to the Czech Republic, its industrial sector was once again a key highlight. While its weakness in the demand expectation was not repeated, its order books and export orders have started to fall. Although the two were the only components in the industrial sector that fell, it was still able to drag the whole sector into decline. Other sectors in the Czech also fell as well. Looking into all the subcomponents, the source of decline were related to labor market concerns and negative prospects on household finances. This will be an issue to follow in the next few months as employment in Europe has begun to regain a little momentum, according to the PMI (Procurement Manager Indicator) report by Market.

In Lithuania, the other economy we noticed last month, the retail sector sentiment did not plunge again. However, the overall sentiment was not dragged down by declines in the industry, service, and consumer confidence. Instead, by looking into the components, the declines were pretty much widespread, and unlike the case of the Czech, there was no clear particular source of decline. This may suggest Lithuania’s economy is in a position of starting to slow down. We will need to wait for the release of additional statistical data in the coming one or two months to confirm if this has been occurring.

Finally, with particular mention to Greece, as it was downgraded, in February we actually saw the ESI rise relatively everywhere, excluding the service sector, albeit from a very low level. In addition, what kept the service sector from rising is a declining employment expectation, but otherwise the service sector components performed rather well. From the ESI point of view, the downgrade doesn’t mean there is an immediate risk.

**Conclusion**

The February ESI data was released before the downgrade and the earthquake, thus we still need to keep notice of forthcoming reports. But before that, Lithuania’s problem is more significant, and Czech’s case would need a follow up to see if the aforementioned developments continue. After so many events in the past weeks, it is too early to say whether if, and if, how much, the region will eventually be affected. Constant observations will need to be made. (The author is President, Polaris Research Institute & Honorary Professor, and Professor College of Technology Management, National Tsing Hua University.)
Russia and Middle East

Russia benefits from rising oil price caused by the Middle East tension

*Ming-Hsin Kung*

The tumult continues in the Arabian world including the Middle East and North Africa this month. Bahrain has announced state of emergency, and the leader of Libya Muammar Gaddafi has also taken his opportunities to further his military actions as all the world is concerned with the tsunami and nuclear fallout in Japan. There is also a noteworthy likelihood that the internal conflicts of the Middle East and North African economies may develop outwardly into regional conflicts.

For instance, Saudi Arabia dispatched more than one thousand troops to Bahrain in the name of the Gulf Cooperation Council (GCC), aiming to contain the anti-monarchy emotions of the Shiites. The action, however, has complicated and worsened Bahrain’s internal problems: it not only enhanced the dissatisfaction among Bahrain protesters, but also caused Iran, who backs the Shiites under the table, to publicly reproach Saudi Arabia. Consequently, tensions between the two economies have been increased and there will be more uncertainties concerning international oil price.

In addition to the oil price, the Middle East and North African turmoil still has more impacts on the international arena, which nonetheless have not received too much attention, and which include such factors as food security and other non-traditional security. Even though the Middle East and North Africa are not major food-producing areas in the world, the two regions hold about 57% of the world’s trade of phosphoric acid and 46% of trade of sodium tripoly phosphate. These two elements, importantly produced in the Middle East and North Africa, are significant raw materials of chemical fertilizer for wheat, and therefore it is necessary to pay particular attention to the continuous impacts the situations there would have over the international food price.

As to Russia, its recent economic situation is generally stable. At the end of March its government estimates the annual economic growth rate in 2011 as 4.2%, while the rate estimated by other economic institutions ranges from 1.5% to 4.1%. Two of the greatest factors that influence Russia’s economic performance this year are how the oil price impacts the export of Russia’s energy sector, and how the large entrepreneurs invest.

In terms of the oil price, the official estimation of the annual average oil price is USD 81 per barrel. According to the estimation of an economic forecasting institution in Russia, each USD 10 by which the oil price rises will enhance Russia’s Gross Domestic Product (GDP) by 0.3% to 0.4%. Under the current circumstance of tension in such oil producers as Libya, Saudi Arabia, etc., the soaring international oil price may benefit Russia’s energy export in the short term. It remains to be observed, however, as to the question of whether the decrease in demand caused by the great economic damage in Japan will lower the oil price in the second half of the year.

When it comes to the issue of investment, there are more disagreements over it. The Russia government predicts the fixed investment growth rate to be about 9%, and it also indicates that the enforcement of large state projects will play an important role. In the market, however, another viewpoint sees that the policy of a higher amount of enforced social insurance from this year onward will lead to a more conservative trend in the large
entrepreneurs’ investment and employment. As Russia’s monetary policy has become tighter and the long-term interest rate has begun rising since January, the actual fixed investment growth rate will probably turn out to be lower than the official estimation. In other words, it is the performance of the export sector—especially the export price of the energy sector—that is a more important determinant of Russia’s economic performance this year. (The author is Vice President, Taiwan Institute of Economic Research.)

Global Commodity Market

Japan’s nuclear risks will become a factor in rising energy prices following the commencement of reconstruction efforts

Hwa-Nyeon Kim

In the last one month period (mid-February to mid-March in 2011), there have been persistent warning signs of a crisis in the global commodity market. Although commodity price indices have shown slight downward trends from early March, crude oil prices broke this year’s high again on the back of increasing uncertainty in the Middle East and North Africa (MENA). Both Brent and Dubai crude oil prices increased to above USD110 /barrel and the WTI price to above USD 100 /barrel. However, for a few days following the catastrophic earthquake in Japan, oil prices declined slightly due to the woes over reductions in oil demand.

Crude oil prices clearly gained the most attention during the last month period on fears that the disruptions in Libya’s supply will be prolonged. The situation in Libya is still out of control, with clashes between the Libyan governmental and civil forces occurring more frequently. Libyan governmental forces stormed the Ras Lanuf port which is the territory of the Libyan rebels. Even more troubling is that several oilfields have stopped producing as a result. Experts believe that the loss in output figure is even higher at some 1.2 million barrels per day (mb/d), which is over 2/3 of Libya’s regular production. Protests in Libya continue to spread to other parts of the MENA region including Bahrain and Saudi Arabia.

Despite what was expected to be a “day of rage” on 11th March, protests in Saudi Arabia were small and in only a couple of cities. However, the violence in Bahrain has reportedly escalated. Opposition forces are continuing to hold strong protests. As a result, several people were killed and several hundred more were wounded while police and GCC troops cleared out the protesters. Therefore, as the geopolitical risk in the MENA region escalates, crude oil prices will experience an upward pressure within the next month.

The top two commodity indices, the CRB spot Index and LME non-ferrous index, have shown slight increases from mid-February to mid-March. The CRB spot index (year 1967=100) moved up from 552 to 573 and the LME index (April 1999=1,000) from 4,085 to 4,436. The averages for the CRB index and the LME index, from mid-February to mid-March, increased 1.7% and 0.3% respectively. Such changes are much smaller than those of the previous month. This implies that upward trends and steep slopes within the commodity indices are weakening. In terms of
price variations, the daily price changes of these two indices were less than those seen during the mid-January to mid-February period, indicating a decrease in investment risk in commodities.

As for energy prices, the WTI near month futures price moved within the range of USD 84.99 and USD 105.44 /barrel and Dubai crude prices between USD 96.96 and USD 111.18 /barrel during the same period. Both the minimum and maximum values of the Dubai price were larger than those during the mid-January to mid-February period.

Among non-ferrous metals, or more commonly known as base metals, tin and aluminum prices rose the most following the previous period, with the average price of tin and aluminum rising 5.1% and 2.5% respectively. 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 29,030 /ton and USD 2,546 /ton, respectively. However, the prices of copper and lead revealed decreasing variations.

Currently, Japan’s Fukushima nuclear risks are receiving the most attention in the global financial markets. The earthquake and tsunami devastated nuclear power plants located in Eastern Japan. And as the nuclear sector has been totally shutdown in the region, the use of thermal fuels such as oil, natural gas (LNGs) and coal will increase to replace the loss of electricity generation of the nuclear sector.

Japan’s LNGs and thermal coal demand may jump with significant percentages, putting additional upward pressure on the already high gas and coal prices. In base metals, the short term impact of Japan’s risks could be negative, but this will likely reverse over the long term. The Bank of America expects long-term price increases in steel and raw materials such as iron ore and coking coal as the reconstruction efforts begin.

Consequently, the ongoing outage of Japan’s Fukushima nuclear power plant will boost energy prices including crude oil prices. Therefore, SMEs in energy resource importing economies will face aggravated difficulties due to high raw material costs. (The author is Research Fellow at Samsung Economic Research Institute.)

<Table> Changes in Raw Material Prices - 16th February to 15th March 2011

<table>
<thead>
<tr>
<th>Index</th>
<th>Crude Oil (USD/barrel)</th>
<th>Non-ferrous Metals (USD/ton)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CRB</td>
<td>LME</td>
</tr>
<tr>
<td>Min</td>
<td>552</td>
<td>4,085</td>
</tr>
<tr>
<td>Max</td>
<td>573</td>
<td>4,436</td>
</tr>
<tr>
<td>Average</td>
<td>563</td>
<td>4,313</td>
</tr>
<tr>
<td>Last Month Average</td>
<td>554</td>
<td>4,301</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.
The diversity of SMEs, including variations in size, the variety of sectors in which they provide goods and services, and the intensity of competition, means that they are, as a general rule, subject to the vagaries of major price movements caused by factors outside their control. Input price movements, whether caused by changes in energy supply or disruptions to commodities and raw materials, or if imported, to variations in exchange rates, are factors that all firms have to manage, but this is particularly relevant for SMEs.

SMEs are subject to the risks caused by vagaries of major price movements

Apart from the vagaries of sharp price movements, SMEs in many economies of the Asia Pacific region are under-served by the region’s capital markets for medium to longer-term loans. This exposes those SMEs that borrow in foreign currencies to risks in exchange rate movements.

Considering first, the inflation outlook, most recent data in the Economist commodity price index shows year-on-year rises for all items in the Dollar index of just over 46%, with food prices increasing by 48% and the industrial index rising by 45%. Non-food agricultural prices have risen by 96% and oil by nearly 30%.

Many factors are impacting on the rise in the price index. Following the financial crisis and a period of low global growth, price levels will have a tendency to rise as global economic activity picks up. Recent natural disasters in commodity producing economies have already caused sharp food and mineral price rises and disruptions in supply in the oil sector are important factors in the rise in the index. Some of these causes may be short-lived. However, a long-term trend in food demand for wheat and other foodstuffs may reflect more of a structural change which could have a lasting upward impact on prices. Demand in China and India for minerals may and probably is leading to a long-term firming of prices.

Monetary easing in major economies as part of the stimulus package to offset the impact of the financial crisis and continuing low interest rates have created the basis for a general inflationary bias. Rather surprisingly, however, this is not being reflected in inflation rates in major western economies at this time. Inflation remains at relatively low levels in those economies; for example, the year-on-year increase to 11th March in the US is 2.1% and in the Euro area is 2.2%. Compared with the developed economies, inflation in the major emerging economies, China and India, is running at 5.0% and over 7% respectively. Both China and India are implementing measures to counter rising prices.

The US and the Euro zone will face rising inflationary pressures as economic recovery takes
hold but this should be offset by policies reversing monetary expansion and rises in official interest rates.

In short, while it is difficult to judge the global inflationary outlook over the next two years or so, actual price outcomes could be less dramatic than those that might be expected on the basis of the year to year movement to March 2011, noted above. Spikes in prices growth will occur as a consequence of sudden supply changes. But the impact of the recovery in global growth (after the 2007 financial crisis) on general price levels may already be reflected in the global price index. This may be so even though growth in employment and in investment in the US and in Europe has some considerable way to go before those regions reach trend growth levels seen in the last two decades or so.

**Fiscal imbalances challenge major economies**

All major economies, both developed and emerging, continue to be challenged by significant imbalances. The imbalances vary across economies, but they include for some massive fiscal deficits and low savings, and for others the accumulations of foreign exchange reserves and under investment in domestic infrastructure and social services.

Success in responding to those imbalances is a determinant of macroeconomic policy frameworks and the flexibility by which an individual company or a SME manages its business. Success will also require coordinated policy responses by the world community.

At the national level, success for the US and the Euro zone will be measured by a structural decline in budget deficits, an increase in savings, a rise in employment levels and private investment. For China and India, a rise in domestic investment in infrastructure and social services and for China in particular, but also for other Asian economies, a slowing down and a reversal of foreign reserve accumulations. More responsive exchange rate policies to facilitate adjustment will be important to China and some Asian economies where exchange rates regimes are managed.

In the US and the Euro zone, the serious challenge is to reduce the level of public debt and to wind back the massive sovereign debt overhang related to the salvaging of financial systems. The key point is that the adjustments just referred to will only be achieved over time and with determined adjustments to public policies by all major economies.

The forces that come into play as the adjustments are effected, assuming there is effective international coordination, will have some implications for inflation over the medium to longer term period. But the general global macroeconomic impact could well be one where the relatively high levels of global trend growth seen in the recent two decades or so is unlikely to surface again for some considerable time. The likelihood is that the bias in terms of global inflation over the medium term will be moderate to subdued.

In the circumstances, whether SMEs provide domestic goods and services or rely mainly on exports, they will likely face more modest growth in overall economic activity and more competitive markets. Such circumstances suggest a greater focus on sourcing inputs and the price of inputs and on innovative ways of marketing to consumers. Public policy advocacy by SMEs in Asia should favour support for flexible exchange rate regimes, fiscal policies that provide for balanced government budgets over a business cycle and that promote savings and investment, and monetary policies that adjust smoothly to offset prices growth. These sets of policies will best facilitate adjustment to price inflation.

**Bond Markets as a source of SME financing**

Medium to longer-term funding needs of SMEs is of increasing relevance to SME financing in the Asia Pacific region. Measures are underway to deepen domestic capital markets. The intention of economies and forums involved in promoting Asian bond markets, such as measures supported by the Asian Development Bank and under the Chiang Mai Initiative is to encourage bond markets where Asian savings can be made available to fund long-term bonds issued in Asian markets by corporates or by governments or by pooled SME issues.
Great opportunities exist but have yet to be fully developed where longer term funds needed by SMEs can be pooled into SME bond issuance in Asian domestic markets. Some Korean SMEs are benefitting by such arrangements in Korea but under-developed capital markets in other Asian economies means that those markets are not adequately serving the SME communities of the region.

The development of corporate bond markets would increase competition by financial service providers to SME sectors and reduce exchange rate risks to those SMEs which do borrow in foreign denominated currencies.

The promotion of domestic corporate bond markets in Asian economies should also be a matter of urgent public advocacy by SME communities in the Asia Pacific region. (The author is Director, Australian APEC Study Centre at RMIT University.)

What Caused the US Financial Crisis: Conclusions of the Financial Crisis Inquiry Commission

Robert Dekle

Recently, the US Financial Crisis Commission published a report that sought to explain the causes of the crisis, which started in the fall of 2008. The Commission’s report is quite standard, placing the blame of the crisis on excessive risk taking by financial institutions, especially in their origination and packaging of household mortgage debt. The Commission also blames the US monetary authorities for excessively loose monetary policy that led to the real estate bubble from 2002 to 2007, and the US regulatory authorities for not properly supervising the financial institutions.

Specifically, the Commission stresses the following causes for the US financial crisis. First, the Commission believes that more than 30 years of deregulation and reliance of self-regulation by financial institutions has stripped away key safeguards. This approach had opened up gaps in critical areas with trillions of dollars at risk, such as the over-the-counter derivatives market.

Second, the Commission believes that dramatic failures of corporate governance and risk management at many systemically important banks and investment banks were a key cause of the crisis. Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding. Compensation systems too often rewarded the quick deal, without concern for long-term consequences.

Third, the Commission believes that the combination of excessive borrowing, lack of transparency, put the financial system on a collision course with a crisis. In the years leading up to the crisis, too many financial institutions and households borrowed to the hilt. For example, in 2006, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating on extraordinarily thin capital. By one measure, their
leverage ratios were 40 to 1, meaning that for every USD 40 in assets, there was USD 1 in capital. Less than a 3% decline in asset values could wipe out the firm. What was worse, much of their borrowing was in the overnight market, meaning that the borrowing had to be renewed every day. But financial firms were not the only ones doing the borrowing. Households borrowed too. From 2001 to 2007, the amount of household debt per household rose by more than 65%.

Fourth, the Commission believes that the US government regulatory system is also to blame. Key government players—the Federal Reserve Board, the Treasury Department, and the Federal Reserve Bank of New York—were ill prepared for the events of 2007 and 2008. They were hampered because the government was confused, and did not have a full grasp of the financial system that they were regulating. The financial market was not transparent, and government regulators did not fully understand the financial instruments such as derivatives. While there was some awareness of a bubble developing in US financial markets, US regulators could not believe that the bursting of the housing bubble could threaten the entire financial sector. In addition, the government’s inconsistent hand—the decision to rescue Bear Sterns, and then place Fannie Mae and Freddie Mac into conservatorship, followed by the decision not to save Lehman, and then to save AIG insurance—had confused and increased panic in the financial market.

Finally, the Commission believes that there was a systematic breakdown in accountability and ethics in causing the crisis. The percentage of borrowers who defaulted on their housing loans within just a matter of months doubled between 2005 and 2007. These people likely took out loans that they could not repay—loans that were advanced by unscrupulous mortgage lenders. Lenders got bonuses for making borrowers take out expensive loans for which they were not qualified. Lenders made loans that they knew borrowers could not afford and could cause massive losses to investors in mortgage securities.

There have been critics, however, of the Commission Report. An important criticism is that the Commission Report focuses too narrowly on US regulatory policy and supervision, ignoring international parallels. A credit bubble appeared in both the US and in Europe. There were housing bubbles caused by excessive credit in the United Kingdom, Spain, Australia, France and Ireland. This leads to explanations that are broader than just US housing policy, regulation, and supervision. Part of the explanation of the crisis should focus on factors common to both the US and to Europe. Any explanation that relies too heavily on the US regulatory and supervisory system is likely to be insufficient in explaining why the same things happened in Europe. This moves the topic of inadequate international liquidity and capital standards as the leading cause of the crisis.

This alternative narrative relating inadequate international liquidity and capital standards to the crisis goes like the following. Starting in the late 1990s, China and other large emerging market economies, including the oil producing economies, built up large capital surpluses, causing interest rates to fall. Credit spreads narrowed, meaning that the cost of borrowing to finance risky projects declined. A credit bubble formed in the US and in Europe, the most obvious manifestation being an increasing in housing prices.

Fueled by this cheap credit, banks and mortgage companies in the US and in Europe originated vast numbers of high-risk, nontraditional mortgages that were in some cases deceptive and beyond the ability of mortgage borrowers to repay. Managers of many financial institutions in the US and in Europe amassed enormous concentrations of housing risk. Some bet on housing risk knowingly, while others did not know they carried such high housing risk on their balance sheets. Managers of financial firms amplified this housing risk by holding too little capital relative to the housing risk on their balance sheets.

When rising housing prices could no longer be sustained, many financial institutions in the US and in Europe failed because they made similar failed bets on housing. In quick succession, the failure or near failure of these financial institutions created a global financial panic. Confidence and trust in the financial system eroded as the health of almost every large and midsize financial institution in the US collapsed. The financial shock and panic
led to a severe contraction of credit to firms and households in the US and in Europe, leading to a severe recession.

In conclusion, it appears that both the Commission Report and its Critics put the failure of financial institutions at the core of the global financial crisis. It would be interesting to examine what happened to banks in Asia during the recent financial crisis. (The author is Professor at University of Southern California.)

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CM Knowledge

Column 3

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Pursuing Differentiation through Green Branding: O’right’s Remarkable Path to Growth amid the Adversity of the Global Financial Crisis

Chia-Wen Huang

O’right, with the ambitious goals of building an “Ever Better Earth” and “Ever Prettier World,” is grounded on the spirit of “Nature and Purity.” Established in 2002, O’right was then a franchisee of overseas brands of hair care products, but it has taken the initiative since 2006 to develop their own brand as a part of their self-branding operational strategy. Throughout the vicissitudes of the global financial turmoil from 2008 to 2010, O’right steadfastly maintained an insistent commitment to brand operations, making their sales volume witness phenomenal growth from NTD 30 million to over NTD 130 million. Achieving such remarkable 400% sales growth over their competitors during the unpredictability of such rough time is largely attributable to their stalwart reliance on the brand of O’right and their careful adherence to a set of core success strategies.

Differentiation: Way to the blue ocean

“Our company pursues differentiation from competitors, and finally our products become an inevitable choice for customers among other equivalent brands.”

O’right’s primary clients consist of professional hair salons. During the 2008 financial crisis, CEO Steven Ko conducted a crisis simulation, finding that “customers would likely be operationally forced to cancel a number of brand products to reduce costs,” and thus it became imperative to reemphasize their brand’s distinctiveness from competitors through their adherence to eco-friendly green principles, ensuring that they would remain as one of irreplaceable choices for their customers.

For example, a typical client hair salon might use about five to seven hair care product brands. Since the salons might be expected to reduce their overhead expenditure during the crisis by reducing the number of product lines they carry, CEO Ko strategized to persuade clients to reduce from among those lines with a degree of uniformity and replaceability, while retaining the

CEO, Mr. Steven Ko
distinctive products with future trend such as the O’right brand products. Why was it that O’right merited retention? The critical focus was on their conformity to the emerging trend for green consumers and resurgence of the green economy.

O’right had consistently been dedicated since its establishment to offering eco-friendly, pure, and natural products, which enabled it to distinguish its products from more than 200 competitors in the global marketplace that emphasizing glamour and extravagance, while O’right solely remained committed to meeting the growing demands for eco-friendly purity.

**Reinforcement: Rewarding allegiance of loyal customers with rebates**

“Packaging products in sets with best selling items, and then offering discounts to loyal customers, helps enhance sales performance…”

Differentiation or persuasion at best could only retain existing clients temporarily, but O’right reasoned this would be inadequate. Therefore, they deployed a strategy to strengthen the relationship with their loyal customers, and in 2008 began efforts to secure one-year comprehensive agreements with their clientele. These loyal clients’ one-year contracts were rewarded with annual discounts, allowing salons to reduce their overhead costs.

During the financial crisis, customers are naturally expected to reduce their inventories and secondly to reduce costs, so the loyal customer contracts helped ensure cost reduction for their customers. These advanced arrangement helped O’right accurately forecast production requirements, and the customers also enjoyed discounts around 10-15%. At the same time, O’right took advantage of the high demand for best-selling products to provide product sets at discount rates, resulting in greater overall performance.

Another example of their success in client retention efforts arose during the 8th August natural disasters. In August 2009, O’right had their only month with no net profit, so they decided to provide free product replacement for all their clients who had suffered rainwater infiltration or flooding losses, which gained their customers lasting appreciation, and the next month’s sales immediately rebounded robustly to new high levels.

**Experience: Linking up with eco-friendly spirit**

“During the advent of a financial crisis, one must be more assiduous, efficacious, and honest in facing the challenges, to ensure no waste and a speedier and efficient capital turnover.”

To achieve effective inventory management and forecasting, O’right provided local sales representatives with client order history analysis, so they could understand customers’ product palettes before the financial crisis and across the seasons. Based on this recognition, local sales will be able to design the marketing strategy, and therefore secure orders in advance.

**Change: Emphasis on domestic procurement**

Greatly enhancing domestic procurement was another sound strategy deployed by CEO Ko. He recognized that in the event of a financial crisis, it is best to have one’s “capital in hand”, and the company needs to do their best to preserve ready cash access to reduce any emergent cashflow constraints. Though procurement from the producers of Mainland China can enjoy lower cost, as much as 30% of the payment will be requested to pay in advance when ordering and purchasing from them. Overseas procurement imposes additional one-to-two month inactivity for capital turnover. The other outlays, such as in overall overhead and warehousing costs, order preparation, transport readiness, storage, customs clearance, and the like, meant that all things considered, any cost advantages from lower unit prices were decreased at the end of the day.

On the other hand, even though domestic procurement meant higher unit costs, domestic purchasing allowed for advantageous use of financing terms from float periods and clearing. It is sure that overhead costs were more expensive in some respects, local purchasing reduced cash flow pressures significantly, deploying the principle of earning less but having greater access to cash flow.
Lessons Learned: Innovation and change while facing a crisis

For their strategic crisis management efforts, O’right steadfastly adhered to the principles of “Innovation and Change.” CEO Ko remarked, “If we had remained stolid in maintaining our prior approaches to cope with new crises, we would have been defeated by these challenges.” In other words, resistance to necessary change would have meant further sales deterioration, for which the only effective remedy is constant innovation, and transformation, with renewed alacrity.

“When facing a crisis, it’s only all the more imperative to develop brand!” Brand growth requires a spirit of innovation, with value conveyed being more important than unit pricing alone. So, brand creators must consider how their products can facilitate added-value to their clients, and adhere to the principles of innovation and investing in the next generation of young brand managers. To ensure the requisite alacrity, it is imperative that one not merely flow with the tides during good times, while in the bad times, trying not to lose control of the rudder and considering how to transform challenges to opportunities. Managerial leadership must thus remain cognizant of these demands for strategic planning and alternatives, to ensure readiness in the sudden onslaught of emergent challenges.

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“APEC SME Economic Crisis Monitor” is calling for papers for this Column—CM Best Practice. We welcome SMEs and related associations to submit their successful experience in overcoming economic crises. All submitted papers must be at least 1,000 words, but no more than 1,200 words and should be mailed to scmceditor@tier.org.tw. All papers should be in English, and be sure to include author’s name and contact information. Remuneration will be provided once your paper is accepted for publication.
Effects on Japan's Economy by the 11th March Earthquake in Japan

After 11th March earthquake in Japan, many organizations successively published their evaluation of the economic impacts of the disaster on Japan. Goldman Sachs estimated that the loss from the damage of buildings and manufacturing facilities will reach USD 1,930 billion, accounting for 3.3% of GDP in Japan. Merrill Lynch lowered Japan's economic growth rate in 2011 to 0.2-0.3% and the seriousness of damage on economy will depend on how long and how broadly the restriction on electricity supplies will be in Japan. World Bank, in its Report of East Asian and Pacific Economic Update, assesses that the loss in Japan's earthquake and tsunami disaster will probably be more than USD 2,350 billion which is equivalent to 4% of its economic output. The reconstruction work will take about five years, and affection on GDP will be fermented in the first half of this year. Asian Development Bank suggests that Japan may fall into a brief recession.

On the other hand, after the earthquake, Japanese yen continually appreciates to hit a new record high over the past 16 years, JPY 76.25 versus USD 1, more than the highest level in April 1995. Since the sudden rise in Japanese yen will probably damage Japan’s export, hinder recovery in economy boom of Japan, and also hurt the global economy, Group of Seven (G7), including the United States, Britain, the European Central Bank, Canada, and Japan, sells Japanese yen in the market to make the yen against the dollar remain at around JPY 81. The possibility of further joint intervention can not be eliminated if the Japanese yen surges in the future.

The nuclear disaster, limited electricity, communications and traffic disruption triggered by the Japanese earthquake and tsunami cause the varying degrees of impact on industries. Among them, the insurance industry, fisheries, agriculture, tourism, manufacturing and other businesses bear the brunt. The related aquaculture facilities and equipments are damaged in the northeast region and meanwhile, the sale of the agricultural products is banned due to the concern of radioactive pollution, increasing the loss of agriculture and fishery industries.

In tourism, since tourist facilities were destroyed, most foreigners cancel traveling to Japan and Japanese tourists going abroad also significantly reduced. Tokyo Disneyland, having 2,500 million visitors a year, may even close out for a long period of time as a result of insufficient electric power supplies. About the impact in the manufacturing, in addition to taking more time to return to normal production activities in the northeast Japan, the influence caused by restricting electricity supplies and the traffic disruption is very wide. It has been inevitable to reduce the export of Japan's main exporting products such as electronics, machinery and automotive goods.

Effects on World's Economy by the 11th March Earthquake in Japan

World Bank, in its Report of East Asian and Pacific Economic Update, evaluated the influence of the 11th March earthquake in Japan on developing economies of East Asia. Over the past five years, the amount of Japan's trade accounts for about 9% of total foreign trade in East Asia. If Japan's GDP growth rate dropped 0.25%—0.5%, exports growth rate of East Asia may drop 0.75%—1.5%. In addition, in the short term, Japanese companies may reduce foreign investment due to the need of capital of domestic reconstruction. However, in the long run, Japanese enterprises and enterprises from other economies will also start to reconsider the diversification of...
production locations to reduce the possible risks.

Japan, the world's third largest economy, has close trade relationship with economies all over the globe. The surge of Japanese yen after the earthquake further worsens Japanese economy and therefore implicates regional and even global economy, whose direct impacts are especially on the economies depending more deeply on Japan. Inflation and rising import prices in the economies mainly depending on imports of Japanese commodities has been more serious since Japanese yen continues to rise to record high and results in the imported inflation problems. Appreciation of yen may also make these economies unable to afford Japan's high-price goods and turn to trade with other economies, leading to a severe situation of Japanese export. However, this transfer effect on critical materials and components is still limited.

Since many economies rely on Japanese materials and components, the disruption of production on panels, semiconductors, automobiles, plastics and other products in the disaster areas generates a gap in the supply chains of these industries. Among them, semiconductors, LCD panels, precision instruments, machinery equipments, and auto parts cannot be delivered on time. In the automotive industry which is famous for “Just In Time” production, the GM Korean plant and minivan plants in North America encountered production reduction or suspension because of the lack of critical components stocks. Automakers in Germany are forced to suspend production and Japan automotive electronic chip can not be shipped as well. If the power shortage continues, the impact of industrial material shortage will emerge in the second quarter and even spread the range of the suspension.

In the short term, even though Japanese earthquake reduces the demand for raw materials, the need of the reconstruction materials will surge in the mid to long term. The use of nuclear energy is reassessed all over the world after Japanese earthquake and the demands for alternative energies including coal, natural gas and fuel oil will increase, possibly pushing up the global price.

Global inflation has not been alleviated

United Nations Food and Agriculture Organization (FAO) points out that until February, food price index has risen for eight months to 125 points, a new high since 1990. The ban of Russian wheat will be extended to the end of 2011 and the situation of global food supply remains tight. Also, under the impact of the situations in the Middle East, futures prices of crude oil of New York in April had risen to USD 103.17 per barrel and that of Brent North Sea crude oil in May had reached USD 116.15 per barrel, hitting two year high. The price of raw materials needed for reconstruction are also bullish after the earthquake.

Even though the central banks of many economies are raising interest rates, Japanese earthquake and the rising food and oil prices seem to worsen global inflation. Peru, China, Colombia, and Indonesia raised interest rates in February. To deal with its 3.1% of CPI, Russia, unexpectedly, raised 0.25% of the interest rate by the end of February and that is the first time since 2008. The Russian central bank also increased the loan rate to 8% and the overnight deposit rate to 3% and required the non-Russian banks to increase deposit reserve rate from 3.5% to 4.5% and other banks from 3% to 3.5%. South Korea, Thailand, Vietnam, Brazil, China, and India have also announced to raise rates again in March.

To curb inflation, many economies have adopted subsidy measures. It made less effect on the economies owning substantial fiscal surplus, but for the economies with poor financial situation, the subsidy policy will endanger the financial system in the long term. Also, subsidization will encourage people to spend, making it more difficult to stabilize prices. Moreover, adoption of measures to regulate prices will discourage manufacturers to produce and the supply reduction will finally drive prices up.
In recent years, international climate negotiations convene continuously symbolizing that there is a concern for the global climate crisis. The immediate victims of climate change are the farmers depending on the weather and the indirect ones are human beings depending on this unstable food system.

Raj Patel authored *Stuffed and Starved: Markets, Power and the Hidden Battle for the World Food System* in 2007, revealing the driving force behind the food crises. The author suggests that climate change attributes to external factors in the issue of the food crisis and the core problem lies in political and economic relationships among the world food system, markets, and power. The author points out that there is invisible operation of political and economic power in every part of the large system behind food production and market, where the profit makers dominate the development of the market.

In the first place, the author starts from the rural areas, highlighting how the political pendulum affects farmers’ choices. After the globalization of markets, farmers not only involve in domestic markets but international markets as well, which are extremely larger than domestic ones. Export crops are controlled by international markets and administrations. Consequently, farmers no longer have the right to choose which crops to plant and there are many risks that they cannot stand due to the uncertain factors in the international markets.

The author indicates that the characteristics of farmers have changed significantly after some free trade agreements. Instead of benefiting from free trade agreements, some information-disadvantaged farmers in the economies and small-scale crop producers suffer a serious loss. Since free trade agreements make them exposed to competition with international agricultural powers, their products have no ability to meet such competition.

In addition, the author describes how dominant international agriculture companies manipulate farmers, force them unconsciously hand over their own ownership, and devour the interests of farmers step by step. According to statistical data, the international agriculture enterprises control over 40% of total world food trade, and 20 of them monopolize trading of coffee. The author also proposes that a key contradiction in the food system lies in the situation where the competition or antitrust committees are often not able to restrain enterprises from conducting mergers under the market mechanism. This situation cannot avoid but generating a force tending to mergers, resulting in reduction of competition in the market, and leading to some large enterprises in charge of the market.

Furthermore, large food companies would even lobby the government to create the economic environment fitting for their own interests. As a
result, such situations as affecting the market by political power are everywhere within the food system, inducing an ambiguous boundary between legal and illegal acts. Finally, enterprises rewrite the history of the various economies that makes people believe the development direction they lead is the only choice.

With a clear framework of the food system, the author discusses the core issue of it: Starvation. According to the data provided by World Food Programme (WFP) of the UN in 2010, over 10% of the world's population is in hunger and there are still 22 economies classified as undergoing the long-term food crisis. Ironically, much more overweight population appears in the same time when numerous people of hunger exist. In fact, this contradiction is pointing to an invisible political and economic operation behind the food system.

Further, the author takes agriculture in the United States and in Cuba for illustration and discusses the effects made by two different political and economic operation modes. In the United States, agriculture is dominated by private enterprises and the decisions within the food system are also controlled by them. And, to them genetic modification becomes the only way to solve the problem of starvation. Oppositely, in Cuba, the food system is led by the government, so scientists just play secondary roles. Under the guidance of the government, the genetic engineering is strictly prohibited. However, even though there is a different way of developing agriculture in Cuba, they are still constrained by the world agricultural system and in the weak position.

Ultimately, the author clarifies a main reason why the modern food system is so consolidated. That is because most people meet the world food system in the supermarkets, not at farms or in factories. Therefore, supermarkets have become the most powerful agribusinesses and dominated the political and economic power behind the food system.

In the end, the author presents a reflection of how the current food system limits the customers and even humanity. Perhaps the customers need to regain their own power and try to relieve the restriction to farmers made by those power relationships and hopefully set up a new food system. Otherwise, we will never get rid of such control under the political and economic system.