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Global Economic Risks Remain High; Uncertainties Could Last until 2012

There has been appreciable concern arising over the third quarter of 2011 for global economic risk, as the major world economies face concomitant trends towards a recession. The US Federal Reserve Chairman has publicly stated that the US economy remains subject to considerable high risks; while five major Euro debtor economies sovereign debt crisis continue to exercise the greatest effects on the Eurozone’s economic climate; while the Japanese earthquake disaster has brought a tremendous economic decline and public debt problems, which have greatly enhanced Japanese economic uncertainty. As China begins monetary tightening policies designed to stave off inflationary pressures and housing prices, it may be hard to avoid some further cooling in economic growth trends.

As for economy outlook for 2011 and 2012, considering the major international economic forecasting organizations predictions for the third quarter, there indicates a clear trend towards a more conservative outlook. Although the anticipation of an imminent second global recession does not present the main voice of the market, there seems to be a developing consensus that the international economic picture will be bleaker than before expected.

Currently, global trends tend to evince a half pessimistic half optimistic status. In terms of the American economy, the US President recently announced his policies for a USD 447 billion jobs plan in his Congressional address, focusing on themes of tax reduction and expansion of public infrastructure expenditure; meanwhile the deficit plan proposed with planned measures to increase taxes on the wealthiest taxpayers, which will once again increase US political and economic uncertainties.

In addition, considering the Eurozone threats from the Greek sovereign credit crisis, currently a consensus of continuous ameliorative supports is gradually formed. From the most recent media releases, it appears that the Eurozone’s senior policymakers have been aware of the necessity to establish a credible and protective firewall for stability. Along with the concern and support from the global community, there is a glimmer of hope for stabilization of the Eurozone financial system.

In this monitor, our critical focus will be on the discussion about the risks of another global economic recession. The crisis alert has indicated that the European and American regions will continue to remain subject to sequential uncertainties, whether political or fiscal, any of which would result in triggering the re-ignition of an economic crisis.

Meanwhile, in this monitor we have extended an invitation to experts to draw discussions about the impacts of unabated global economic imbalances on small and medium enterprises (SMEs). The global economic imbalance from sustained low economic growth and financial system instabilities will continue to exacerbate global economic liveliness, but under this circumstance SMEs will be relatively less influenced thanks to their versatility and innovation.

Also in this monitor we have discussed important aspects which SMEs need to bear in mind when facing foreign exchange rate risks through an overview by Oakbridge Limited’s Principal Consultant John R. Rush explaining optimal currency risk measures among SME exporters.

In addition, we have also selected the most compelling news and provide in-depth analysis for our readers, including the latest debt crisis in the developing Eurozone that leads to declines in economic confidence indices (ECI), the US proposal with operation twist, with no positive responses from the marketplace, the hedge fund inflow resulting in massive exchange rate appreciation for the Japanese yen with Japanese official’s disinterests in curbing the rising trends for the yen.

Currently the risk for another global economic recession remains considerable. Given the globalization and interconnection of world economy, it is impossible for any economy to isolate itself from impacts. This monitor will keep monitoring all the major global economic trends, helping SMEs be aware of possible risks and influences with appropriate responsive strategies.
Being interviewed on 21st September, the international financial giant George Soros was asked whether he thought the US economy would face the risks of a second depression: “I think we are in it already,” he replied directly.

The current market condition is very likely to resemble the situations in the second half of 2008 when financial institutions’ lack of fluidity led to a drastic fall in the price of risky assets. Such situations reflect that the market is overshadowed by extreme fears—including the fear for a second depression, a replay of the Great Depression in the 1930s, as well as the fear for a financial crisis caused by the potential default of sovereign debt of certain economies in the Eurozone. A variety of financial institutions and investment funds, therefore, are currently converting various convertible assets to cash in case of accidents.

Ever since a European Central Bank (ECB) official modified his previous statement and admitted the possibility of a Greek default, conditions for Greece have become far more worrisome. At this time of Eurozone facing the danger of break-up, 29th September will be the key moment to see whether Greece can be rescued: the German Parliament will vote for whether to allow the European Financial Stability Facility (EFSF) to purchase sovereign bonds in secondary markets, and to expand from the current EUR 250 billion to EUR 440 billion.

In the scenario of Greek default, the debts include not only the debts of the government, but also those of enterprises, local governments, etc., with a total amount estimated as of about EUR 1.1 trillion and an impact far more serious than the bankruptcy of the Lehman Brothers investment bank. If such heavily indebted economies, for instance, Italy and Spain or even the entire European bank system all become impacted, there will be undoubtedly a catastrophic consequence.

The current economic and political situations in the US may be even worse than those in 2008. With a large amount of debts, the government seems to be unable to bailout the economy with trillions of dollars, as what they was able to do in 2008; as now the Federal Reserve has more than tripled its balance sheet, it would be extremely difficult for it to invest thousands of billion dollars or even trillions of dollars to the economy. Moreover, there are way higher political risks than in 2008: while the Federal government and the Congress were both under the control of one political party in 2008. Now they are evenly under bipartisan power. The Republican leaders in Congress even submit a warning letter to the President of Federal Reserve before the Federal Reserve interest rates meeting announced its resolution on 20th September. The bipartisan political factors have led to higher risks and uncertainties of US policy, becoming one of the main obstacles against the US economic recovery.

In general, the nature of global economy has changed, with different causes and ways of
economic depression. Thanks to globalization, manufacturing industries with low profits, high energy consumption, high dependence on raw materials, and high costs have all transferred to emerging economies, such as China. In the post-industrialized, capitalistic, advanced economies such as the US and Europe, easily and greatly rewarding businesses are dominant measures including printing money and trading various financial derivatives, while labor-intensive manufacturing industries have extremely shrunk. When borrowing money for pleasure has become a usual and popular idea, all the possible financial crises hereafter may become a common sign of economic depression, whose cause is no longer the production capacity surplus of entire manufacturing industries but the wealthy financial service industries.

In short, there will be more uncertainties in the US and Europe; be they political or financial, they are very likely to trigger an outburst of economic crisis. Even if they develop towards a good direction in the short term, capital speculators around the world will push problems worse in the longer term, including the sovereign-debt problems of some economies in Eurozone, the internal problem that the Euro Monetary Union lacks a unified fiscal and political support, and the US’s problems of political uncertainties and federal fiscal deficits. Once Pandora’s Box is opened, it would not be easy to close again.
The August unemployment rate remained at 9.1%. The US economy failed to add any jobs in August; this happened for the first time during an economy recovery. In the latest employment report, decreases in public sector employment entirely offset increases in employment in the private sector. Nearly all indicators of the labor market weakened, including average hours worked and average wages. A broader “lack of employment” measure that includes discouraged workers ticked up to 16.2%. The number of people employed part-time because they could not find full time employment increased to 8.8 million workers from 8.4 million workers. One bright point is that private sector job increases were depressed by a strike at Verizon Communications, a telecoms service provider, which has temporarily idled about 45,000 workers in August. The rehiring of these workers could lead to a rebound in private sector employment in the subsequent months.

Responding to the latest employment and the weak economy in general, in early September, President Obama unveiled a stimulating “jobs plan.” The plan calls for nearly USD 450 billion of expansion of public expenditure and tax cuts. Specifically, the plan calls for a cut in payroll taxes —or taxes used to fund retirement social security—from 12.4% to 6.2% (for employers and employees combined) in 2012, infrastructure investment, and an extension of unemployment insurance and new programs for the jobless. While it is likely that the payroll cuts will be extended, other aspects of his plan are likely to face stiff opposition from the Congressional Republicans. Economists expect that if the Obama “jobs plan” is enacted in its entirety, GDP growth in the US will increase by about another 1.4% in 2012.

A new feature of the latest “jobs plan” is that it includes provisions to cut payroll taxes for employers. The previous jobs plan included only payroll tax cuts for employees. The new Obama plan would halve the employer’s share of the payroll tax temporarily in 2012 to 3.1% from 6.2% on the first USD 5 million of a firm’s payrolls. About 98% of firms have payrolls of USD 5 million or less. This plan is expected to stimulate small business hiring to some extent. However, many US small businesses claim that their main constraint in expanding is not high taxes, but low demand for their products. It appears that small business employment will only expand when demand for their business picking up.

Small businesses are normally the drivers of US employment growth. However, small businesses have been slow to recover since the recession officially ended in June 2009. Small businesses are suffering from slow sales, while large corporations have been exporting more, earning more revenue overseas, and stockpiling cash.
Reflecting the weakening economy, economists are now predicting that the economy will grow by only 1.7% in 2011, down from the May prediction of 2.8%. For 2012, economists are forecasting growth of 2.3%, compared to an earlier May forecast of 3.2% growth. The weakening outlook reflects an economy that has struggled this year with a rise in gasoline prices, supply disruptions arising from Japan’s earthquake, a worsening of Europe’s debt problems, and the political rancor over the US debt problem. With this slackening growth, economists do not see much scope for a decrease in the unemployment rate. Economists are forecasting that for all of 2011, the unemployment rate will average 9.0%, and will average 8.7% in 2012.

Canada

The Canadian economy has taken a sudden turn for the worse and is in danger of shrinking in the second quarter of 2011. This is a sudden drop of a nearly 4% GDP growth in the first quarter 2011. The main reason for this possible decline is the weakness in the US economy and the strong Canadian dollar. Canadian second quarter growth has also suffered from supply chain disruptions caused by Japan’s Tsunami and overleveraged Canadian households who have a debt to GDP ratio higher than US households. (The author is Professor at University of Southern California.)

Northeast Asia

Euro’s Struggle and Its Lessons to Asian Region

Naoyuki Yoshino

Many Asians felt that the creation of common currency like Euro is one of the ways to keep close economic relations, both in trade and financial relations in Asian region, when the economic conditions in Euro region were converging and when there was no turmoil. However, the recent crisis in Euro area has made Asian people reconsider the common currency.

Britain did not join Euro from the beginning. When the Euro was introduced by Sir Alan Walters who was Margaret Thatcher’s economic advisor (who was my PhD thesis advisor) questioned at his lecture by the following points.

If big economic shock would hit Euro region and the impact of its shock would be different from one economy to another, there would be difficulties to cope with only one single monetary policy in the Euro region under such situation.

Conditions for Common Currency

After the sub-prime loan crisis, there are Common currency assumed the following conditions will be satisfied:

1. Free mobility of goods and services,
2. Free capital mobility,
3. Flexible labor mobility,
4. Identical tax rate on capital and corporate tax, etc.

However, the mobility of labor is limited and the coordinated tax rates were not easy to achieve.

There is only one single monetary policy namely using interest rate to keep the level of inflation as stable as possible. Each economy has to use fiscal policy to cope with economic fluctuations. However the Maastricht treaty binding the accumulated budget deficits should be below 60% of GDP and the flow of budget deficits lower than 3% annually. There is no mechanism to allow exchange rate adjusting to its exports and imports.

Merits of Euro

Merits of Euro have made people less worry about the fluctuations of exchange rates among
Euro area. Trade of various goods and services as well as capital flows became much smoother than before. Greece could issue its bond with lower rate than it would have been since it is mutually supported by economies in Euro area. Large economies such as Germany and France held Greece bonds which could earn higher rate of interest than their own bonds. Banks in France and Germany enjoyed higher rate of interest on Greece bonds until the interest rate went up all the sudden.

In Euro region, there is only one single monetary policy. Germany prefers very strict control of inflation, while some other economies prefer much milder rate of inflation. Fiscal policy can only adjust to their different economic conditions. Aging population is different from economy to economy, and pension scheme is different as well. The variety of fiscal spending in each economy made levying tax become not easy. Many people prefer lower tax rate and prefer to enjoy the higher level of benefits.

**Fiscal Rule to Keep Discipline Must Be Established**

Fiscal policy rule has to be established in more detail manner to keep Euro alive. It should follow the following fiscal policy rule.

\[
G_t = a_0 + a_1 T + a_2 (B - B^*) + a_3 (y - y^f) + a_4 G_{t-1} + a_6 W
\]

\(G_t\) stands for the level of government spending for year t. It should be determined by the following items: (i) the amount of tax collected T, (ii) the gap between the current level of the actual budget deficits (B) and its target value (\(B^*\), in Euro region, 60% of GDP), (iii) GDP gap (\(y - y^f\), the gap between the current GDP and full employment GDP), (iv) the level of government spending in previous year (\(G_{t-1}\)) and (v) the level of wealth which can be directed to purchase government bonds (W) where \(a_0, a_1, a_2, a_3, a_4, a_6\) are coefficients.

Fiscal discipline to follow the equation in each economy in Euro region must be strictly established to overcome the crisis.

**Lessons to Asia**

Asian region is much more diverse than Euro region in its economic level. Many Asian economies will face aging population and slower growth of population. (i) Asian economies have to establish strict fiscal rule in order to avoid accumulation of budget deficits. Turmoil in the capital market and the sudden rise of the interest rate would hurt the economy severely. (ii) Stable exchange movement will achieve smooth flows of goods, services and capital. Basket currency system would be preferable in case of large fluctuations of exchange rate due to big shock in the exchange rate market. (iii) Pension system has to be established based on long term perspectives, namely that it should not carry too much burden to the future generation. Savings type pension system will be preferential not to carry its burden to next generation. (iv) Loopholes of tax collection have to be amended.

Asia is enjoying its growth potential compared with other regions, and the sub-prime loan crisis did not hit so much to Asian region. However Asia has to be prepared for the coming structural problems such as aging population and pension system well before it becomes problems. (The author is Professor of Economics, Keio University.)

**Figure 1** Interest Rate on Government Bonds

<table>
<thead>
<tr>
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<th>(%)</th>
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<tbody>
<tr>
<td>Greece</td>
<td>19.82%</td>
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<tr>
<td>Portugal</td>
<td>10.86%</td>
</tr>
<tr>
<td>Ireland</td>
<td>8.71%</td>
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<tr>
<td>Italy</td>
<td>5.50%</td>
</tr>
<tr>
<td>Spain</td>
<td>5.19%</td>
</tr>
<tr>
<td>France</td>
<td>2.69%</td>
</tr>
<tr>
<td>Germany</td>
<td>1.85%</td>
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</tbody>
</table>
The global economic turmoil comes in reaction to a continuing series of bad economic figures from the US and Europe. In the US, data showed that no new jobs were added to the US economy in August, and the White House warned that the un-employment rate in the US was likely to stay at about 9% till the end of 2012. In Europe, figures showed that in August, service sector activity in the UK fell by its largest amount in more than ten years, while ultimo business confidence in the eurozone fell at its fastest rate since the 2008 collapse of Lehman Brothers.

How about the current situation of the East Asian Economy? What are potential economic problems in East Asia? In this report, we will give a brief answers about these questions.

1. Macroeconomic Overview

On 14th September 2011, the Asian Development Bank released a report stating that in Southeast Asian economies, the economic growth will be slower than in other parts of Asia, the region's economic growth next year will be between 5.4% and 5.6%.

Singapore's economy grew 5%-6% in the first eight months of 2011, through the service sector and external trade performance in the doldrums, and growing construction sector contraction. Philippine's GDP growth slowed down, and at the end of the second quarter of this year only grew 3.4%, lower than 4.9% in the first quarter, also below last year's 8.9%; Indonesia's economy has been growing at an average annual growth rate of close to 6% over the past four years.

2. Sovereign Credit Rating

On 11th August 2011, Fitch confirmed that Malaysia's long-term foreign currency issuer default rating is "A-", the long-term local currency issuer default rating is "A". The economic ceiling rating is "A" and short-term foreign currency issuer default rating is "F2". Rating outlook is stable.

On 19th August 2011, Standard & Poor's Ratings Services announced that to maintain Vietnam's "BB-" long-term foreign currency rating and "B" short-term foreign currency rating. Rating outlook is negative. On 25th August 2011, Standard & Poor's Ratings Services confirmed the long-term debt credit rating of Singapore was AAA. Rating outlook is stable.

3. Monetary Policy

Indonesia's consumer price index (CPI) rose 4.61% in July, slower than June's 5.54% and 5.98% in May, inflation is expected to remain manageable. On 8th August 2011, Bank Indonesia decided to keep the benchmark interest rate unchanged at 6.75%.

Bank of Thailand believes that inflation pressure is the biggest threat facing the economy. To curb inflation, in August 2011, Central bank of Thailand increased one day repurchase rate by 25 basis points to 3.50%. Since the current round of the tightening cycle launched in July last year, central bank has accumulated interest rates of 225 basis points.

The scale of exports is much larger than the USD 225 billion of the domestic economy, as the exchange rate rather than interest rates in Singapore has been taken as a tool to maintain price stability.

In April of this year, the MAS (Monetary Authority of Singapore) increased the policy midpoint of the effective exchange range, to help
contain the upward pressure on domestic prices.

4. Potential Problems and Risks

Economies in the East Asian region have distinctive export-oriented characteristics. For example, on 8th August 2011, the S&P cut rating of the United States, caused Indonesia's stock market to fall 5.0%. Currently, the United States, Europe and other developed economies are still facing many uncertainties; East Asia's growth will slow in the second half of this year. However, as internal demand remains strong, and regional trade increased, the growth of East Asian economies should maintain a good momentum.

In Vietnam, high inflation for the last five years has depreciated the currency and labor costs to rise (the Vietnamese government increased monthly minimum wage from USD 67.6 to 91.7 after October), which is squeezing hundreds of thousands of Vietnam's foreign company profits. Spiraling increasing land prices, due to the difficulties to obtain bank loans and infrastructure issues (lack of roads leading to the harbor) along with other negative factors, have increased the operating barriers for foreign companies in Vietnam, and foreign investment has subsequently declined dramatically.

There had been an escalation of tension in the South China Sea, as the economy claiming sovereignty over the islands in this region may face a deterioration of relations with the world's second largest economy (China) in trade and investment exchanges. (The author is professor at Renmin University of China, Beijing and The University of Birmingham, UK)

Fine Balancing Act between Maintaining Growth and Stabilizing Inflation

Kenneth Waller

Australia

The Reserve Bank of Australia (RBA) left its cash rate unchanged at 4.75% this month – the ninth straight month at this rate – due to uncertainty in international markets, weaker growth prospects both domestically and abroad, the effect of the strong Australian dollar on non-mining industries and poor consumer sentiment. Annual inflation accelerated to 2.7% in the second quarter. The RBA aims to keep underlying inflation in a range of 2% to 3% on average. A key cause for concern in the Australian economy were figures showing the jobless rate rose in August to a ten month high of 5.3%, up from 5.1% in July, with the economy shedding 12,600 full-time jobs in August. Some major Australian employers, for example, BlueScope Steel, Qantas Airways Ltd. and Westpac Banking Corp. have all announced plans last month to trim their workforces. The ANZ Survey of job ads found the total number of job advertisements in Australian newspapers and on the internet fell 0.6% which has now been in a downward trend for five months. Expectations are that Australia will see more subdued employment in the period ahead.

GDP growth increased by 1.2% in the June quarter, which is higher than the predicted number, 1%. The economy is recovering from the damage caused by the floods earlier this year. The rebound is being driven by AUD 82.1 billion of projected mining investment in the 12 months ending 30th June due to demand from China and India for coal, iron ore and natural gas.

However, the effects of the two-speed economy are apparent with poor performances in the retail sector, cautious behavior by households, the high level of the exchange rate, low productivity and trade impacting adversely on
broadly based growth. The strong dollar continues to hurt the retail sector by driving shoppers to international internet shopping, although it is claimed that this switch against local retailing is exaggerated. Certainly, the domestic tourism industry is less competitive as is the education sector for overseas students studying in Australia. Profitability in the mining sector is robust but modest in the manufacturing sector.

Most recent data points to some rebound in consumer confidence, due to the RBA's current interest rate stance and better than expected GDP figures for the second quarter. Most recent figures – issues on 1st September – pointed to stronger-than-forecast retail sales in July. However, the increase in unemployment and the deterioration of global growth continue to dampen expectations. 45% of consumers believe natural disasters had a negative impact on their personal finances, and nearly 25% of Australians say they are struggling to balance their household budgets. In general Australians have reduced expenditure patterns and neither consumers nor businesses are borrowing. Notwithstanding these mixed signals, the Westpac Melbourne Institute Index of Consumer Sentiment has risen 8.1% in September.

Confidence in the rural sector has dropped to its lowest level in two years over concerns about the global economic outlook, domestic government policies, such as the proposal to introduce a price on carbon emissions and a ban on live cattle exports – since lifted – as well as the strong Australian dollar. This pessimism is in spite of predictions that the 2011 winter crop will be Australia's fourth-largest crop on record.

A recent survey points to eight out of ten Australian SMEs believe that the business environment is tougher than it was 12 months ago. Reasons include the strong AUD, concerns with global uncertainties and prospective economic policies, such as the introduction of the proposed carbon price now being debated in Parliament and due to be implemented on 1st July 2012.

**New Zealand**

While the economy is showing signs of recovery from the recession and the devastating earthquakes earlier this year, opinions are divided about GDP figures to be released on 22nd September. The ASB Bank is predicting second quarter growth of 0.1%, while the ANZ is suggesting figures as high as 0.7%.

The Central Bank left the official cash rate unchanged at 2.5% in September and expectations are that there will be no change until early 2012 because of concerns over risks arising from the global financial situation. The Reserve Bank of New Zealand (RBNZ) has indicated it will not raise rates until concerns over the European crisis and over US growth have abated.

The rebuilding of Christchurch and the Rugby World Cup are expected to boost growth in the second half of this year but longer term prospects - until early 2013 - are for relatively slow growth due to lags in reconstruction in the Christchurch area. Estimates are that the Rugby World Cup will add as much as NZD 1.2 billion to the economy with about 95,000 international fans expected during the course of the tournament. The event is expected to boost New Zealand as a holiday destination.

Commodity prices remain strong for dairy, meat and aluminium but the high NZD is a concern for exporters generally. Weak growth in major trading partners will dampen economic expansion. The Reserve Bank forecasts trading partner growth to average 3.4% for the year to March, down from a previous forecast of 4.3%.

BusinessNZ Performance of Services Index (PSI) result for August show the PSI was 53.9. This was down 0.6 points from 54.5 in July. The average PSI value for 2009 was 48.8, while for 2010 it was 53.2. So far for 2011, it is 52.8.

Manufacturing has regularly been one of the strongest-performing industries in recent economic surveys, making up 12.5% of the gross domestic product. The Performance of Manufacturing Index survey showed manufacturing has slowed over the last three months, although overall trends remain positive.

Consumer confidence is relatively high, fuelling hopes retail sales could improve as households feel they are financially better off. The Westpac McDermott Miller Consumer Confidence Index was unchanged in the latest surveys taken during early September. Consumers were less confident about the longer term economic outlook but an increasing number now think it a good time to buy a major household items.
The government announced it has entered into a partnership with Carnival Australia to help the development of the cruise industry in the Pacific. The Prime Minister recently announced the public-private partnership noting that the cruise industry was the fastest-growing segment of global tourism, with average annual growth at 8.7% for the past decade, and that the move complements the government’s wider support for tourism in the region.

The government has plans to simplify rules around financial reporting for small businesses. Business compliance costs will be cut by an expected USD 90 million a year. These plans that reduce the regulatory burden on SMEs are similar to moves in Australia and will be welcome reduction in red tape for many businesses.

**India**

Signaling that inflation is still the key concern for the government, the Reserve Bank of India (RBI) again lifted the official rate to 8.25%, from 8%, the 12th rate rise since March 2010 and there could be further increases throughout the latter months of the 2011. Inflation reached a 13 month high in August at 9.78%, the highest in any developing nation, higher food and fuel prices and weakness in the rupee may keep inflation above 9%. The RBI has indicated that interest rate hikes will not end until inflation is tempered. This is in spite of other emerging economies containing rate rises to protect against global economic turmoil. India faces inflation of close to 10% in the September-November period but the RBI is hopeful that this could moderate by December.

The government is positive about growth prospects despite global turmoil and signs that the economy is slowing. The economy grew by 7.7% in the April-June period, well below the 8.5% growth rate in 2010. The deputy chairman of the Planning Commission recently stated the he expected India’s economy to grow by 7.5–8% over the next few years. The Asian Development Bank (ADB) has revised downwards growth projections for 2010 to 7.9% citing global turmoil as the cause of slowing growth. The main concern is poor industrial output figures of only 3.3% in July, the weakest performance in two years. Despite the aggressive interest rate stance, it is anticipated that Indian private sector investment will drive economic expansion.

In spite of the ADB’s predictions that global financial uncertainty will hurt the Indian economy the government is predicting the situation may in fact present new opportunities for India to emerge as a safe haven for global capital inflows. The Finance Minister has claimed that India’s robust performance in difficult times shows that it could actually come out stronger from any international financial crisis.

In trade news the US has called for greater transparency in India’s trade and investment policies as currently many small to medium businesses are struggling to invest due to unclear business conditions. Tea production has increased by 8% to 133.26 million kilogram in July, but exports have declined by 8% to 15.26 million kilogram. Talks which stalled in July with the European Union (EU) have been renewed in an attempt to overcome issues over market access in India.

The much-awaited decision over the National Manufacturing Policy (NMP) which aims at creating over 220 million jobs in the next 15 years, has been deferred due to inter-ministerial differences on proposals for giving exemptions from labour and environment laws to units in the proposed industrial enclaves. (The author is Director, Australian APEC Centre at RMIT University.)
Financial Market Turmoil Continues; Monetary Policy Reverses
Cheng-Mount Cheng

Global financial markets turmoil continued in September, with equity corrections appeared to spill over to currency and fixed income products. In particular, Latin American currencies were hit quite significantly. Brazilian Real depreciated 11.6% against the US dollar in the first 20 days of September, followed by 6.4% depreciation in Mexican Peso, 4.2% depreciation in Colombian Peso and Chilean Peso. By contrast, Peruvian New Sol, Argentine Peso, and Venezuelan Bolivar Fuerte stayed relatively stable and only down slightly against the US dollar in September. It seems that the opener the economy is, the easier it would be vulnerable to current financial market jitters. Foreigners looked like wanting to pull their money out of this region in a hurry due to very cautious risk-averse sentiment. Nonetheless, before the financial turmoil in August, most Latin American (Latam) economies were actually performing relatively well. Here are some of highlights in the past month.

**Brazil Copom Surprisingly Cut Selic Rate by 50 Basis Points**

On 31st August, the Brazil Copom decided to drop the Selic rate by 50 basis points to 12.0%, in a split decision. This was against market consensus view which unanimously expected the monetary authority to remain on hold. In a long statement, the Copom mentioned the deterioration in the global scenario was the main motivation behind the rate cut decision. The Copom thought there would be limited room for advanced economies to smooth current economic slowdown through monetary or fiscal policy. And several transmission channels via trade, capital flows, credit conditions, and business confidence would affect the Brazilian economy.

In addition, the central bank highlighted that the change in the domestic fiscal policy outlook also played a role in its decision for a “moderate adjustment” in the Selic rate. Brazil’s fiscal situations have improved in 2011 and the Copom believed the government can maintain a 3.1% of GDP primary fiscal surplus in 2012. The new policy rate would be more consistent with the convergence of inflation to the mid-point target of 2012. According to meeting minutes released on 8th September, the central bank has given a low weight to current high inflation rate, as it expected inflation to start a descending path in the direction of target in the next quarter.

More interestingly, the Copom provided some forecast results from its new stochastic equilibrium model that can address the impacts of the international crises on Brazilian economy. The hypothesis is a crisis a quarter milder than 2008/09 but with a slower recovery. That would bring about an inflation forecast that is lower than the usual models, which are already around the target in 2012.

Note that there were two dissenting board members who have asked for the Copom to remain on hold. They believe the current outlook has not yet provided the necessary conditions to start an easing cycle right now. However, there was a consensus that the scenario has changed substantially since the previous meeting. Apparently, the central banks now put more weight on down side risks of GDP growth than on inflation risks.

**IMF Warned Belize on Its Contingent Liabilities**

The IMF (International Monetary Fund) released a statement on 26th August on Belize, after a mission concluded its visit. The statement underscored that the economy “weathered the
financial crisis relatively well, when compared with other economies in the Caribbean Community”. According to IMF, growth in Belize is being driven by manufacturing and agriculture, and by an improvement in terms of trade. All these have allowed Belize to stabilize its international reserves at about three months of imports. The IMF encouraged Belize government to reduce its dependence on grants and oil revenue. In addition, it highlighted the need to significantly increase the primary surplus to lower financing requirements and public debt. The IMF also underscored the risks associated with contingent liabilities – namely, nationalizations. It also suggested keeping a close eye on the high level of non-performing loans.

S&P Raised Peru Rating to BBB from BBB- with Stable Outlook

On 31st August Standard & Poor raised Peru’s long term foreign currency debt rating to BBB with a stable outlook from BBB-. According to the rating agency, the decision was driven by the fact that the Humala administration has signaled “broad fiscal and monetary policy continuity” and that is also intended to maintain strong growth. In particular, the appointment of two respected technocrats, Julio Velarde as central bank President and Luis Castilla as Financial Minister, influenced the decision. Although the government will increase spending in social programs and investment, this will be done in a gradual manner so as not to threaten the declining trend in the debt-to-GDP ratio. Peru’s rating remained constrained by “still-evolving political institutions” amid a highly unequal society and a relatively large (albeit declining) degree of dollarization. S&P said the further upgrades would be conditional on further reduction in dollarization indicators, a diversification of growth sources and fiscal stability. (The author is Vice President, Citi Taiwan.)

West Europe

Report for Western Europe for the Period 15th August to 15th September 2011

Julius Sen

The month under review was again dominated by concerns over the contagion effect of the sovereign debt crisis of Greece and other peripheral economies of the Eurozone. At the same time a new fear began to emerge: that Greece would eventually default on its debt and thus destabilise the EU and global banking system. French and German banks were thought to be particularly exposed to potential losses, and hence vulnerable, but many US and UK banks were also thought to be exposed through their refinancing operations.

Through the course of this month, two things became increasingly clear:

· Firstly, that the policy objective of the Eurozone had shifted from trying to restructure Greece’s debt towards engineering an orderly default to minimise the contagion effect in the banking sector.

· Secondly, to find significant resources to deal with the possible new requirement of some German and French banks in the event of a Greek default. Any measure in this area would need government and taxpayer support in both economies.

Although negotiations and deliberations with respect to these issues continued almost throughout the month, they had yet to reach a definitive conclusion at the time of writing.
Indeed, with a possible second banking crisis looming, coordinated Central Bank measures covering the Eurozone, the US, Japan, and the UK were taken to ensure continued liquidity in the market through the supply of additional dollars – the world’s trading currency.

This step however has done little to address the underlying problem, for which a policy solution is still eluding member states.

Part of the problem relates to the domestic mood in Germany, Holland and a few other EU states: they do not want to provide more support to Greece until further major reforms are enacted. Popular opinion within Greece is however against further austerity, and to resist these pressures, thus making the situation even more intractable.

At the same time, the prospects of a second recession have also begun to grow. US and EU growth and employment figures for the month were poor, and a similar image was emerging for the UK. This led to much discussion about another round of Quantitative Easing in the EU, US, and the UK. The hope is that it will stimulate growth through higher demand.

The EU’s economic prospects thus seem to be uncertain. A possible banking crisis, combined with continued low growth and high unemployment, means that Europe will have to depend on global demand, particularly in Asia and the US to revive. With the US in an equally unenviable situation, the hope is that Asian demand will play a role in helping recovery.

But Asia itself is finding that growth is slowing down, and also have their own policy concerns relating to inflation; hence the danger of a global slowdown on a significant scale.

For the small and medium enterprise (SME) sector in the APEC region, this slowdown may make export conditions more difficult. For larger SMEs there could however be significant business opportunities in acquiring new assets in the EU region. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)

East Europe

Euro Damages Regional Economy

Kuo-Yuan Liang

Recurring Greek Debt Woes Ascending as Risks Concentrate at the Euro System

The European debt crisis was taken to next level, as Greece announced that its 5% of GDP annual government deficit target in 2011 would be off by 1%. The deficit target was one of the pre-conditions Greece must meet in order to remain eligible to receive further funding installments from the EU-IMF co-bailout that has been in place since May 2010. Unlike the previous situation where a Greek default was only short of one installment, this time the ECB (European Central Bank) had already significantly increased its possession of Italian and Spanish bonds by the Securities Market Programme (SMP) since early August, which makes worries exacerbated.

With EUR 22 billion of Italian and Spanish bonds purchased in the first week of reintroduction, and roughly 14 billion Euros being added to the portfolio each week after that, the ECB now holds more than EUR 150 billion of government bonds under the SMP. More than half were bought in recent weeks, meaning that a significant portion of the systematic risks at the national level have been transferred and concentrated on the Euro system, thus putting the common currency at elevated risk.

However, despite the ECB’s SMP has signaled a commitment and encouraged EU member
capitals to speed up the quest for a single Europe, to the market’s disappointment, subsegment developments in August did not build on that momentum. In addition, doubts about Germany’s stance in the handling of Greece were repeatedly discussed, as German political figures frequently commented on Greece and if it should default.

**Liquidity Crunch This Time as Core Europe and ECB Already at Their Limits**

Hence, with the Euro system in a much more vulnerable position than in the past, France and Germany are seemingly reluctant and perhaps unable to commit much more in the short term. The admission made by Greece on 1st September not only pushed up bond yields, bond spreads against German bunds, and CDS (credit default swap) of peripheral economies, as Greek default concerns have always did, but also caused liquidity tightness in the European financial sector, as well as a dropping Euro.

Liquidity conditions further tightened in the Euro wholesale funding market, with the Euro Libor versus Overnight Interest Swap (OIS) spread shooting up to alarming levels on already elevated grounds. There were also market rumors since late August that money market funds were unwilling to lend to European banks, which caused a liquidity squeeze that eventually prompted five major central banks, the ECB, the Fed (The Federal Reserve), the Bank of England, Bank of Japan, and the Swiss National Bank, to jointly offer to provide European banks unlimited short term US dollar funding for three months.

**Liquidity Squeeze in Europe Triggers Capital Outflow in East Europe**

Among the aforementioned developments, the liquidity squeeze has the most significance to the East Europe region. As the Euro, at the epicenter, was plunging from above 1.45 (29th August) to south of 1.35 (12th September intraday low) against the US dollar, or around 7%, major regional currencies performed even worse, falling 3%~5% against the Euro, signaling a possible capital withdrawal from the region by Euro Area financials in order to alleviate their increasingly tightening funding conditions. This is made clearer by the fact that the Koruna was merely flat, and the Zloty and the Forint were still falling against the Euro, when the Euro rebounded and reached north of 1.39 against the USD at 15th September amid liquidity provisions by global central banks.

It is more likely that capital is moving out of non-Euro Area economies of East Europe, regardless of fundamentals, which may eventually impose the kind of risk we have been mentioning in this column for the past several months. More specifically, due to the high foreign capital(Euro Area) participation in the region’s local economies, the region’s economies are generally small, their lack of abundant foreign reserves, and exceptional free mobility of capital compared to their emerging market peers (a result of being an EU member), have put the region’s economies at the risk of balance of payment difficulties, as experienced by Poland during the 2008 global financial crisis.

**Plans to Help SMEs Stay Afloat Needed Amid Dragging Debt and Liquidity Woes**

Sadly, based on recent developments, I believe the European debt crisis has actually taken several steps backward. Recent Merkel comments in having the Greece problem be solved by the European Stability Mechanism (ESM) are signaling that Germany intends to leave the problem afloat for at least one more year. Even as global central banks provide funding, it is not something banks can permanently count on, and they still need to search for funds and sources while the lifeline is still there. Hence, I believe they will continue to draw cash from East Europe for some time.

Amid such a liquidity crunch, small and medium enterprises (SMEs) will inevitably get hit the most, in view that they mostly rely on the banks for needed funding, but banks tend to tighten daring such circumstances. Given that the East Europe region is not the center of the debt woes, I truly believe the difficulties are temporal in nature, but nonetheless, as there is a chance the liquidity difficulties may last for some time, SMEs should prepare plans to stay afloat immediately. For the same reason, regional capitals should also establish formidable funding and credit lines to prevent a temporal banking sector contraction spreading too much into the real economy, and make sure emerging and promising small businesses can have a better chance to survive, thereby leading the national economy to the next rise. (The author is President at Polaris Research Institute & Honorary Professor, College of Technology Management, National Tsing Hua University.)
Economic Fluctuations Slowing Down, with Political Risks Still Rising in Russia, Middle East and North Africa

Ming-Hsin Kung

Recently, the economic fluctuations have been slowing down in Russia, bringing the monetary policies of the economy to a steady state. The Central Bank of Russia announced in mid-September to keep their base rates at 8.25%, based on their assessments of this year’s inflation and various risks regarding the possibilities of economic growth, including considerations over such factors as the economic uncertainties in the US and Europe and the current environment of monetary market. However, they also said they would attempt to reduce the risks of fluidity shortage by means of adjusting the interest margin between overnight interbank rates.

The domestic economic situation has been stable in Russia so far, with an inflation rate of 8.0% as of early September, lower than the rates of 9.0% and 8.2% in the previous two months. This improvement owes primarily to the fact that Russia’s agricultural sector has produced more than expected, causing the food price to fall back from a high point. Besides, the industrial production and fixed capital investment in Russia have both kept growing since July. It is only the Economic Confidence Index (ECI)—a leading indicator—that has had a relatively weaker performance, reflecting the possible risks that Russia may face concerning the unclear prospectus of its economic growth in the following seasons. As to the performance of Russia’s export sector, its trade to China has been growing and is expected to reach USD 70 billion by the end of this year; regardless of the previous disputes between Russia and China about price in their energy contract, their bilateral trade is expected to keep growing. When it comes to Russia’s export by sector, the export of agricultural products has been growing in recovery, while the export of the energy sector is still slow.

Although Russia’s economic performance can be considered as quite stable recently, there are still some geopolitical risks worthy of our attention. First of all, there is the long running territorial dispute between Russian and Japan over Southern Kuril Islands (named as Northern Islands or Territories in Japan); in early September Russia held military trainings with its strategic bombers and naval ships in that region, and Prime Minister Vladimir Putin also said that Russia would invest additional RUB 1.2 billion in developing that area. Also, later in mid-September the Russian National Security Council Secretary Nikolai Patrushev made a working visit to Kunashiri Island and Habomai Island of this region, triggering a strong protest and concern from the Japan government. In addition to the dispute between Russia and Japan, Russia’s Ministry of Energy expressed in mid-September their intention to assist Iran building more nuclear power plant; this move will trigger serious concerns from trans-Atlantic economies, enhancing Russia’s international political risks.

In the Middle East and North Africa, we see situations similar to Russia’s. As far as economic performance is concerned, economies in the Middle East actually work well on improving the economic growth and unemployment rate in 2010. There is a trade surplus in Israel’s export, an economy that has also attracted foreign investment in high-tech industries in recent years. An even remarkable performance can be seen in Turkey: its economic growth rate was not only adjusted from 11.0% to 11.6% in the first season, but also reached 8.8% in the second season; moreover, its absolute amount has also kept increasing since the first season. Consequently, the Central Bank of Turkey is expected to change its monetary policies from the previous lowering of base interest rates to a
kind of policy more inclined to retrenchment, so as to prevent inflation.

In spite of the generally good economic performance of the Middle East and North Africa, there are constant conflicts among economies as well as within a single economy. Above all, there are conflicts between Israel and its neighbors. Israeli forces may take military action against Iran, which allegedly intends to develop nuclear arms. Also, Turkey announced in early September to totally suspend all trade, military and defense ties with Israel and to impose further sanctions against Israel, as relations between the two economies continued to worsen after Israel refused to apologize for its raid on a Turkish ship.

When it comes to Syria’s suppression of its people, Russia and China have kept resisting the import bans and other sanctions supported by EU and US in the UN Security Council. Various foreign relations of the EU and the US reveal how the two have been bogged in economic troubles, with gradually weaker sway over the Middle East and North Africa region. Diplomatic and political risks will remain high in this region because of the counterbalance powers from economies such as Russia, China and Turkey. (The author is Vice President, Taiwan Institute of Economic Research.)

Global Commodity Market

Libya’s Geopolitical Risks Dissipate while Recovery in Oil Production Remains Uncertain

Hwa-Nyeon Kim

There was a modest increase in warning signs of a crisis in the global commodity market in the last one month period (mid-August to mid-September 2011) as well as a downward turn in prices. Weak macroeconomic data and sovereign debt risks from the US and Europe continued to weigh down on the commodity markets. And commodity prices fell on investors’ concerns over the impact of the US’ and Europe’s debt crisis on the global economy. The biggest issue in September was the increasing possibility of a default by Greece. European leaders postponed their decision on the execution of a bailout for Greece until October as there were insufficient efforts from Greece to reduce its fiscal deficit.

EU ministers have also been unable to decide on how to implement a second bailout plan for Greece which was agreed on in July. With the increasing possibility of an economic slowdown, US President Barack Obama recently unveiled his USD 447 billion American Jobs Act 2011 in an attempt to boost both consumption and employment. However, it is uncertain whether the act will pass smoothly through congress as it will lead to an increase in national debt and fiscal deficit. Thus, worries over the growth of the world’s top two economies continue to spread into the raw material markets.

If there is a big event worth mentioning in September, it is the Federal Open Market Committee (FOMC) meeting at which investors anticipate Fed Chairman Ben Bernanke to announce some form of financial stimulus measure for the US economy. Possible measures that investors expect include ‘Operation Twist,’ which sells short-term bonds to buy long-term debt and although low in possibility, a third round of quantitative easing (QE3). Both measures will reduce long-term interest rates to allow for cheaper borrowing as well as increase business and household spending. Therefore, if these financial stimulus measures are decided upon and announced at the FOMC meeting, they will act to further increase commodity prices.

The top two commodity indices, the CRB (Commodity Research Bureau) spot Index and LME (London Metal Exchange) non-ferrous
index, have shown slight decreases from mid-August to mid-September. The CRB spot index (year 1967=100) moved up from 553 to 544 and the LME index (April 1999=1,000) from 3,795 to 4,044. The averages for the CRB index and the LME index, from mid-August to mid-June, decreased 1.9% and 5.7% respectively. In the case of the CRB index, the change is larger than that during the previous month. This implies that downward trends within the commodity indices have become more apparent. In terms of price variations, the daily price changes of these two indices were smaller than those seen during the mid-July to mid-August period, indicating a decrease in investment risk.

As for energy prices, the WTI (West Texas Intermediate) near month futures price moved within the range of USD 82.26 and 90.21/barrel and Dubai crude prices between USD 100.98 and 110.08/barrel during the same period. The WTI oil price average from mid-August to mid-September was smaller than that for the previous month, with the average price of WTI decreasing 5.7%. The average price of Dubai crude oil also decreased 2.1%.

Among non-ferrous metals, or more commonly known as base metals, there were no price increases in the last one month period. Tin and nickel prices fell the most following the previous period, with the average price of both metals dropping 10.6% and 8.7%, respectively. Prices for the remaining metals such as zinc, aluminum, copper and lead also showed decreasing price patterns.

August welcomed an end to the Libyan civil war as rebel forces seized Libya’s capital Tripoli from the Gaddafi regime, and established the National Transitional Council. However, oil production in Libyan oilfields will remain uncertain. Many experts expect Libya’s oil production to be back at possibly 500 to 600 thousand barrels per day by the end of 2012 but not the pre-war level of 1.6 million barrels per day in the coming two years. Estimations of a delay in the recovery of Libya’s oil production are mainly based on security concerns. Libya will face extreme difficulties in rehabilitating its infrastructure and several production facilities that were damaged during the six-month conflict right after the war.

In addition, bringing back oil production will need a certain amount of investment from foreign oil companies, which in turn will require security before sending workers back into the oilfields. For example, most oilfields in the Sirte basin, which account for about two-thirds of Libya’s pre-war production, were damaged due to discontinued pumping. Consequently, these fields will take several months to restore. Therefore, as oil supply will be limited, SMEs (Small and Medium Enterprises) should not expect too much of a decrease in oil prices and make provisions for continuous high production costs. (The author is Research Fellow at Samsung Economic Research Institute)

<Table> Changes in Raw Material Prices - 16th August to 15th September, 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>535</td>
<td>3,795</td>
</tr>
<tr>
<td>Max</td>
<td>544</td>
<td>4,044</td>
</tr>
<tr>
<td>Average</td>
<td>540</td>
<td>3,893</td>
</tr>
<tr>
<td>Last Month Average</td>
<td>551</td>
<td>4,130</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.
Why Global Imbalances Matter for SMEs

Kenneth Waller

The size of global imbalances is seen as central causes of unstable economic relationships now existing in the global economy and financial system volatility. The chart reproduced below published by the IMF (International Monetary Fund) in *Global Prospects and Policies, April 2011* provides a perspective on the size of global imbalances and the major economies involved in their creation.

Importantly it shows how the imbalances widened significantly in the period leading to and through the recent global financial crisis, and perhaps more importantly it points to the prospect of substantial imbalances continuing through the period (of the chart) over the medium term to 2016.

The chart shows the major economies with current account surpluses – China and some Asian economies – (excluding Japan) (CHN+EMA), Germany and Japan (DEU+JPN) and the oil exporting economies – above the equilibrium line, and major current account deficit economies, the US, some eastern European economies and the UK (OCADC) and the rest of the world below the line. The discrepancy line points to a sizeable “surplus” gap as representing the global imbalance.

The key reason why imbalances are expected to remain over the medium term is because growth in domestic demand in economies with large surpluses is unlikely to be higher than that existed before the global financial crisis - and demand...
growth in deficit economies is not expected to be much lower.

Other factors are reflected in the compilation of the chart, but the main message arising from it is that the needed rebalancing of the global economy is not yet occurring. Net exports of surplus economies are not in the aggregate seriously reducing, and net exports of deficit economies are not growing at a rate sufficient to restore a more balanced global economy. The major deficit economy, the US is not yet seeing a growth in demand for its exports sufficient to improve its imbalance and to offset slow domestic growth. The major surplus economies in Asia, including importantly China, are not yet switching in a substantial way from export growth to growth in domestic consumption.

While many economies did introduce stimulus packages to maintain domestic activity immediately following the onset of the crisis in 2007/08, the impact of those measures on global imbalances was modest and short-lived.

One underlying factor in the continuation of the imbalance is the limited adjustments in currencies of some major emerging economies. Some emerging markets with flexible exchange rates and open capital accounts have seen exchange rate appreciation, in part as a consequence of large capital inflows. This has resulted in monetary policy challenges for some economies.

A number of Asian emerging economies are reluctant to allow their exchange rates to appreciate so long as economies with major surpluses maintain undervalued exchange rates against the USD. This is of course one of a number of causes of tensions in the economic and political relationship between the US and China.

Uncertainty caused by the European debt crisis and the sovereign indebtedness of Greece and the seeming inability of the Europeans to solve these issues further clouds the medium term outlook. These factors have caused a lowering by the IMF forecasts of global growth for 2011 and 2012 by around 0.5%, with growth expected at around 4.0% respectively for each year. The IMF however warns that the risks to these forecasts are on the downside; the world is entering a “danger zone”. While emerging markets are forecast to grow just over 6% for both 2011 and 2012, advanced economies are forecast to grow by only 1.6% and 1.9% respectively. World trade volume is forecast to fall by 0.7% from earlier forecast in 2011 and by 0.9% in 2012.

There are major concerns for SMEs (Small and Medium Enterprises) as a consequence of continuing global imbalances – and their causes – and the current deteriorating financial uncertainty in Europe and in the US.

Efforts by the global financial system, including the proposal for the Framework for Strong, Sustainable and Balanced Growth and a Mutual Assessment Process are intended to promote better global outcomes (global balance). This is to be achieved by economies working cooperatively in framing their respective policies rather than making policies that do not take into account their impact on other economies.

Most recent analysis by the IMF suggests that economies are seeing benefits in cooperative policy approaches. However, resolution of the European debt crisis and misaligned exchange rates between major economies are far from settled. So long as those matters remain unresolved the imbalances shown in the chart above could extend beyond the period covered by the chart. These circumstances suggest complex conditions for investment decision-making by large and small enterprises for some time into the future.

The expectation that China and India and other Asia economies will maintain strong growth strategies over the period ahead will be a crucial aspect of government and business decision making in the Asia Pacific region.

Public policy by major regional economies will need to reflect the obligations as being part of a globally integrated economy. Some major Asian economies, particularly China and Japan, will have to make a significant contribution to a Mutual Assessment Process along with the Europeans and the US. Precisely what that means is an unknown at this stage, but at the very least it does carry an obligation to pursue policies that are conducive to improving the global imbalance. Failure to do that by the major economies in the west and in Asia would be likely to lead to a serious breakdown in international relationships as well as in rising nationalism and protectionism. The stakes are very high, and there will be a requirement for regional
solidarity in support of continuing the path of global economic and financial integration.

But there are strong arguments for the Asian region to do much more to promote and strengthen economic and financial systems within the region. For example, serious consequences could occur if the European and western banking system relapses into a liquidity crisis and thereby reduces sources of liquidity to the Asian banking system.

To avoid this, regional economies and financial institutions should have in place mutual support agreements to maintain credit growth and promote investment and trade finance. The failure to have such mechanisms in place in 2007 contributed to the sharp fall in intra-regional trade and to series shortages of credit to SMEs in particular.

Regional governments, policy makers, regional multilateral institutions such as the ADB (Asian Development Bank) and businesses in particular, have to take measures to minimize risk to the region.

While this would involve the region’s governments in supporting global economic and financial rebalancing it would also require them to engage as a matter of urgency in the development of mechanisms to strengthen regional financial frameworks. The ADB should be encouraged to play an important role in such processes.

And since banks will continue as the dominant financing institutions throughout the region for years ahead (until capital markets develop and integrate), they should play a catalytic role. There is a major onus on private banks to proactively develop mutual support policies in the economies in which they work and across the region. The private sector has a critical role to play in supporting the interests of SMEs and indeed for businesses and households generally.

Banks in the region are generally well capitalized; in most cases they are prudentially well managed and carry relatively modest non-performing loans. As a group, they are well placed to develop precautionary measures to support economic and trade growth and guard against liquidity pressures should they arise again because of failures in Europe and the US in resolving current financial system instability.

This is not a call for reckless lending by banks in the region. It is a call for prudent lending to support SMEs and businesses generally by organizing mutual support and guarantee programs that embrace the idea that financial institutions could take cooperative measures in concert with their competitors to strengthen their own domestic financial systems and those of their neighbors. Governments and policy makers should encourage such measures, but those measures could equally be driven by private financial institutions and by banks in particular.

In summary, global imbalances are likely to continue to impact on global economic activity through lower growth and financial instability for a lengthy period ahead. Businesses globally and regionally are likely to be adversely impacted, importantly SMEs which as a group in any economy have little influence on the big picture – other than that, they supply the momentum to employment growth as well as the development of services and they are often the most innovative.

While Asian economies must support global mutual cooperation policies to rebalance the world economy, it is urgent that efforts are mobilized in the region to implement regional self-help measures to maintain growth, market opening and financial system stability. This is a major challenge but it is not one just for governments alone. There are strong self-preservation reasons why private sector banks should take a leadership role. (The author is Director, Australian APEC Centre at RMIT University.)
Beware of Purchasers who Offer Favours

John R. Rush

Background

In recent years in New Zealand (NZ), one of my banking colleagues had an SME client that was a fruit grower enjoying considerable commercial success and profitable growth in the domestic NZ market. That SME (Small and Medium Enterprise) had decided the time had come to enter into international trade and had commenced exporting its fruit to the US west coast.

The SME owners were extremely nervous about having to deal for the first time with foreign currency receivables denominated in United States dollars (USD) as they had no experience dealing in international foreign exchange markets. Moreover, there had been significant weakening in the USD at the time, which weakening was expected to persist over time.

However, the exchange rate fears of the NZ SME were alleviated when their US purchaser surprisingly suggested that they would be prepared to accept invoicing in NZ dollars (NZD) provided that they be given a discount of 3% over the invoicing period of one month as compensation for accepting the exchange rate risk in these international trade transactions. Naturally, this was good news to the NZ exporter as they were then able to completely avoid all exchange rate risk at what they regarded as a relatively small cost!

My banking colleague, being a past attendee at an Oakbridge foreign exchange workshop, sensed that the NZ exporter had adopted a financially detrimental choice and suggested that the NZ exporter invite me to write and present a customised in-house foreign exchange workshop explaining an invoicing alternative that was in their best financial interests.

Relevant Contemporary Financial Markets Data

At the time this matter was brought to my attention, respective US and NZ one month interest rates were, broadly speaking, 1.50% pa (per annum) and 5.50% pa.

Optimal Choice of Invoicing Currency for the NZ SME Exporter

The use and pricing of forward foreign exchange contracts were not well understood by the NZ exporter. I explained that a forward contract was a financial markets contract undertaken with a banking counterparty whereby the bank would agree at the future forward contract settlement date to purchase (in this instance) the exporter’s future USD receivable in exchange for an NZD sum guaranteed at the time the forward contract was opened. The implication is that the bank is offering a certain exchange rate that is good for settlement at a future time – regardless of where the spot exchange rate has moved over the forward contract period. By invoicing in USD and then entering
into a forward contract, the NZ exporter had thereby attained future exchange rate certainty in an uncertain world.

The NZ exporter now realised that their nervousness about incurring foreign exchange exposures as the result of invoicing in USD was misplaced. However, they then expected that this forward contract, being an instrument that insulated them from potentially volatile spot exchange rate movements, must come at a prohibitive cost.

The case study written specifically for the NZ exporter clearly demonstrated the principles by which forward foreign exchange contracts are priced. That pricing is simply a function of relative interest rates as between the two subject currencies of the forward contract. Because NZ interest rates were higher than US interest rates for the subject maturity (i.e. one month) of the forward contract, the NZ exporter would obtain a benefit of \((5.50 - 1.50)\%\) pa = 4.00\% pa from the forward contract. (The guaranteed one month forward rate would be significantly better than the spot rate at the time the forward contract was instituted).

The benefit embodied in the forward contract pricing astounded the NZ exporter’s directors, as they previously had an unshakable belief that taking forward cover was necessarily a costly alternative! However, the case study to which they were exposed in the workshop clearly revealed the pricing of forward contracts in such a way that the conclusion they had “discovered”, while counter-intuitive, was indeed unequivocally correct.

Equipped with their new insights into international foreign exchange markets pricing, the directors decided at their workshop to amend their previous invoicing practice and thereafter invoice in USD. Remember that the NZ exporter had agreed to give their US purchaser a discount of 3% as compensation for the purchaser accepting NZD invoicing. The NZ company’s directors now realised that invoicing in NZD was effectively costing them an annualised 36\% (≈ 12 x 3\%). They could, if they so chose, adopt an alternative method of invoicing in USD and completely covering their currency risk by taking a forward contract at a certain benefit of 4.00\% pa, being a turnaround in their favour of 40 annualised percentage points.

It was now clear that the US purchaser’s “favour” was extremely costly to the NZ SME exporter!

**Generalised Implications of This Case Study for All SMEs**

The directors of the NZ SME exporter were shown for the first time some fundamental, unchanging principles of pricing forward foreign exchange contracts. In doing so, the totally unwarranted mystique attaching to this area of financial markets practice was revealed. The NZ SME directors “discovered” that:

1. Forward contract pricing is based on interest rate differentials;
2. Exporters in a high interest rate economy will necessarily get a forward contract benefit when exporting to a low interest rate economy (and the converse is true);
3. Purchasing a forward foreign exchange contract does not necessarily incur a cost;
4. The widely believed notion that when a bank prices a forward contract it is somehow passing on its expectation of the future spot rate level is simply not true;
5. It is possible to attain certainty in an uncertain world of exchange rate volatility – and even get a benefit at the same time.

A corollary of the forward contract pricing principles illuminated in the NZ SME’s workshop is that:

6. Importers in a low interest rate economy will necessarily get a forward contract benefit when importing from a high interest rate economy (and the converse is true). (In the NZ SME case study noted above, if the US purchaser did indeed have an NZD payable by virtue of accepting NZD invoicing and covered that payable with a forward contract, then the US purchaser would attain a benefit of 4.00\% pa – to which would be added the invoicing benefit of 36\% pa for a total benefit of 40\% pa!)

Note the symmetry between the above respective principles (2) and (6). This symmetry is not an accident. It is a consequence of the well-defined, analytical means by which a forward contract is priced. This pricing is well known to
banks that operate in foreign exchange markets. Those banks are generally not noted for carefully explaining forward pricing to their SME clients.

**Conclusion**

What became of the NZ SME?

The directors established a thriving export business to the US and always invoiced in USD and completely covered their currency risk using forward contracts. They never again rendered international invoices in their domestic currency and granted a discount to the overseas purchaser.

The directors took the view that they would rather “sleep easy” than be constantly attempting to forecast future exchange rate movements. The NZ SME exporter was eventually sold for an attractive price to an international corporation. The directors retired on the sale proceeds but remain my good friends and are always happy to buy me drinks when I pass through Auckland. They continue to maintain that whatever their foreign exchange workshop cost them, it was definitely not expensive. (The author is Principal Consultant, Oakbridge Limited Financial Consulting Group, Australia)
Eurozone Debt Crisis

Hui-Ping Lee

According to an announcement made by the European Commission in September, the Economic Sentiment Indicator (ESI) in the Eurozone declined from last month’s 98.4 to 95.0, which is lower than economists’ expectations and less than its long term average. The EU ESI index has declined in seven successive months to a 21-month low. In Germany, IFO index hit its lowest since July 2009 and Investor Confidence Index has fallen to a record low in two and a half years.

The continuous downtrend of industry and consumer confidence in Eurozone indicates that the area will remain unceasing recession in the coming months. The situation also means that the crisis is definitely going to damage economic growth of the area and those member states not directly under the shock are not immune to the harm either.

Germany’s lower house has voted 523-85 to back the reform of European Financial Stability Facility (EFSF). However, the EFSF reform bill cannot be valid until being approved by 17 EU member states. As for the final installment of Greece’s first bailout package schedule, Eurozone leaders won’t come to a decision before a summit held on 13th October.

Famous international investor, George Soros, believes that EU bailout fund, EFSF, is in its infancy stage, and its function is not fully defined. Chief economist at JPMorgan Chase & Co pointed out that, “Greece is insolvent and the European Union needs to deal with that. It hasn’t yet come to terms with that.”, according to Bloomberg.

Aggravation of EU debt crisis and depressed business and consumer confidences double confirmed that the crisis is going to haul economic growth in EU.

The US Operation Twists Invites No Positive Reactions

Creeping economic growth and gloomy labor market in the US have built up risks of recession. In order to stabilize the market and boost economy, The Federal Reserve decided to sell USD 400 billion of treasury maturing in three years or less in exchange for six-year to 30-year bonds. The Fed (The Federal Reserve) is expected to ease money by lowering long term exchange rates while avoiding debt increases. After the announcement of the news, the US stock market plunged heavily, and Asia stock and exchange markets suffered from overall devaluation, which reflected that investors still doubt about the feasibility of Fed’s movement.

Nevertheless, Bernanke, chairman of Federal Reserve, indicated in a speech on 28th September in Cleveland that the Fed is prepared to take more unconventional policy steps if the weak US economy worsens too much and implied possibilities of the third quantitative easing, or QE3.

Hedge Funds Pushes up Yen, Japan Says No to Intervention

The world chaotic economy, for example, the woes in EU, the lack of market confidence
in Fed’s operation twists, gloomy atmosphere of global stock markets, all enlarges investors’ consideration of avoiding investment risks. Differ from the previous Naoto Kan government, the new Yoshihiko Noda government makes no clear comment on whether Tokyo will take action to stem the Yen’s surge so that the USD/Yen pair keeps a narrow range of 76-78 in September.

However, Japan’s Finance Minister, Jun Azumi, said in a press conference after a cabinet meeting that over rising yen might drag Japan’s economy and the government will cramp the exchange market when necessary. In addition, Japan will boost its war chest for currency intervention by 15 trillion yen to give itself more leeway in case it needs step into the market again to balance the soaring yen. It also represents that Japan can loaded itself with total 165 trillion yen to intervene the exchange rates by borrowing from outside markets. However, there might not be big differences whether Tokyo decides to intervene the Yen to USD exchange rates because currently Japanese Yen is the only option of money hedging with high fluidity and commutability of USD.
Billion Dollar Green: Profit from ECO Revolution

—Authored by Tobin Smith and Jim Woods; Published by John Wiley & Sons Inc. in 2008

Chia-Yu Shen

In the previous Crisis Monitor, we have introduced the book *Whoops! Why Everyone Owes Everyone and No One Can Pay* by John Lanchester, mentioning that the global economy is in danger due to piles and piles of debt, which is not only the responsibility of financial professionals but all of us. There are unlimited desires and demands from human beings but extremely limited resources. Our desires have made the global financial system fragile, and the resources have become more scarce with some have been wasted.

In this monitor, we are going to introduce a book bringing the world understand further about green energy industry—“*Billion Dollar Green: Profit from ECO Revolution*”, written by Tobin Smith and Jim Woods. This book conveys how we can change adversity into possibilities and helps us to understand the development and trends of green energy industry, allowing us to follow these trends to invest in a new and clean market.

The US Investment guru, Tobin Smith, and financial analyst, Jim Woods, have discussed the reasons why the green energy industry has become investors’ main focus, and they also give the readers hints about how to invest and make profits by following the global green transformation trends, understanding the trends and revolution of green energy, and entering the green energy market that worth billions of dollars. A wide range of different green energy industry aspects have been carefully analyzed, including transportation, solar energy, water, electricity systems, information technology, biomass technology, new battery technologies, and so on, which will help you understand further how to deal with and make profit from green energy industry in the “green capitalism” era.

Why Has the Green Energy Industry Become the Main Trends?

The reasons why the green energy industry has become the main trends for future development are identified at the beginning of the book. The green energy industry is becoming more and more crucial because of some economic factors:

1. The rise of global energy demand,
2. The shortage and the rising exploitation cost and price of oil energy,
3. The rising cost of clean resources such as clean water and air.

When people start to realize that the energy we are currently using has become gradually scarcer and more expensive and devastating the earth, the clean energy, on the other hand, has...
become more and more important. With the support and maturation of new technology, clean energy is coming to be the relatively cheap substitute that best serves the world. In addition, the deteriorating greenhouse effect and the becoming-to-be-expensive needed resources (such as clean water, air and earth) have also facilitated the formation of environmental protection concepts. This also makes governments, businesses, and people begin to pay attention to relevant laws, policies, developments, investments, strategies, lifestyles, and some more aspects for a greener world.

Energy Crisis—the Rise of China and India, and “the New Cold War”

According to the International Energy Outlook 2007, the global energy demands will grow tremendously from 447,000 trillion British thermal units (Btu) in 2004 to 702,000 trillion Btu in 2030 (which indicates 57% growth). The economical transformation of China and India does not only mean the explosion of population and the demands for water and food, but it also means the demands for energy and tremendous impacts to the whole world. What is more, the price of the oil energy we are currently using is unavoidably rising. Meanwhile, the oil energy that can be obtained relatively easier and less costly is running out, due to more difficulties and higher cost involved to acquire crude oil, or oil energy. These factors indicate just one fact: that the energy crisis could be happening and further deteriorating.

Other than this fact, the well-known richest natural resources (especially the oil energy) are controlled by areas such as Iran, Iraq, Saudi Arabia, Russia, China, Venezuela, and Nigeria, which are not friendly to the western economies. As a matter of fact, the authors have named the possible fight for the oil energy as “the New Cold War”, and have also indicated that oil energy will become one of the important factors of world’s major conflicts. This fact also leads to the conclusion that the instability of oil supply and energy security issues is one of the main reasons why we need to pursue green energy.

The Impacts of CO₂ to the Global Economy and Policy

The US Vice President, Al Gore, and his book An Inconvenient Truth have shown the impacts of CO₂ emission and global warming effects on climate change. The rapidly development of China and India is also forcing themselves becoming the main economy of CO₂ emission. In tackling this issue, the whole world is currently looking for new energy, new technology, new products, new investments, and new research in order to mitigate the worries for such climate change; and many economies begin to use fiscal and legal measures to facilitate relevant investments, research and developments for environmental protection. As the authors indicated, this shows capital inflow to the green energy industry and a great future potential of green energy market.

Greener Lifestyle and Greener Investment Portfolio

The green energy market could presents only a small part of global market at the moment, but it shows a great potential for developing and substituting some parts of global market in the future. This book has not only pointed out the reasons for and the importance of greener lifestyle and greener investment portfolio, but it has also made efforts to analyze most of the aspects of green energy industry including transportation, solar energy, water, electricity distributing systems, biotechnology, biomass and biofuels, fuel cells, advanced batteries, green lifestyles (green buildings, food, and products, etc.), old energy industry’s new green solutions, and so forth. There are independent chapters talking about these ideas especially aiming at its problems, possibilities, profitability, key players and a number of green investment portfolio suggestions, which are very worth reading.
Correction Announcement

It has come to the attention of APEC SME Economic Crisis Monitor that a misleading description should be corrected in the APEC SME Economic Crisis Monitor No. 14, page 25, Column 5 CM Event: APEC Symposium on Enhancing SME Capacity of Managing the Risks Associated with Trade Liberalization- “Hedging Strategy for Currency Risk”.

We sincerely apologize and would like to re-adjust the description from “However, John Rush, Principal Consultant of Oakbridge Limited Financial Consulting Group, Australia, on the other hand, recommend that foreign exchange hedging is not the core business of SMEs and should be dealt with by experts” to “However, John Rush, Principal Consultant of Oakbridge Limited Financial Consulting Group, Australia, on the other hand, noted that exchange rate forecasting is probably not the core business of SMEs. Consequently, SMEs should adopt a risk averse position on currency exposures and acquire currency risk management skills from independent experts”, thanks to Mr. Rush’s kindly clarification and revision.