Overcoming the European Debt Crisis through International Cooperation

Ever since the global financial crisis, the European debt problems have been troubling the stability of international finance. Throughout the period until now, the conditions of the PIIGS’ (Portugal, Ireland, Italy, Greece, and Spain) debt payments has been oscillating between good and bad, and there has always been the concern about the possibility of a crisis caused by their inability to repay the debts. These situations have influenced the global stock market several times.

Obviously, the debt problems of the PIIGS are not simply problems of these economies themselves, nor are they simply EU’s problem. Worldwide economy leaders are also aware of the fact that the Greek debt problems cannot possibly be resolved by Greece alone. In view of the stability of international economy, the Greek debt problems have already become international problems, which can be resolved effectively only through international cooperation.

Nevertheless, it has been seen that, in the process of such cooperation, the conflicts of different stances and opinions from different aid institutions and economies have almost interrupted the bailouts. Moreover, the problems reflected in the Greek debt crisis are not only the difficulty in the international bailouts; we have to contemplate the question of what are the reasons that cause such high debts of Greece and other members of the PIIGS.

One of the key points of the current issue of the newsletter is to survey how the APEC region may probably be influenced by the European debt crisis. On the part of Crisis Alert, it is our view that the impacts of the crisis will not spread out to other regions in the world unless the default problems of the PIIGS seriously influence the financial stability of their primary creditor economies—Germany and France. The likelihood of this happening is quite little, mainly because the global major economies and institutions will try their best to prevent the crisis from spreading to Germany and France, even if the PIIGS really face default.

In the meanwhile, in this issue we also invite experts to discuss the root of the Greek debt problems and the possible resolutions. According to their views, it is still difficult for Greece to devise a constructive resolution. In the foreseeable future Greece will remain to be the root of market disorders, harming the stability of the region.

Moreover, we invite the General Manager of New Deantronics Company, Arthur Chi, to talk about how the company enhanced their own technology level and their ability of research and development, thus passing its transformation crisis successfully. The over-concentration on few specific markets and relying on the low-profit OEM previously made its business operation fall twice. Its successful transformation and crossing over to the realm of ODM/OBM, however, now means the new business has become a main source of profit for the company.

In this issue we also select and analyze some pieces of news that are most concerned for the readers. They include: the worsening of the Greek debt crisis, the uncertain prospect of Europe and US economies, and the expansion of the risks of China’s economy. Meanwhile, we also introduce a book to the readers: The Storm: The World Economic Crisis and What It Means, published in 2009 and written by Vince Cable, a Member of Parliament in the UK and former Chief Economist for Shell Oil Company. The book offers not only a survey into the context and outcome of the global economic crisis, but also some suggestions for resolving the crisis.

Although the ongoing European debt crisis is not so likely to have direct impacts on other regions than Europe, we still have to pay attention to how the panic mentality caused by this crisis may influence the financial markets in different places. After all, international cooperation is the only way to solve the European debt crisis.

Robert Sun-Quae Lai, Ph.D.
Executive Director
APEC SME Crisis Management Center
The European debt crisis has grown steadily more serious with Greece being close to default on its sovereign debt. Although the Greek government has finally survived the possible default due to passing the test of a no-confidence vote and the approval of its fiscal restructuring plan by the Parliament, it is still troubled by the heavy debit that possibly incurs another crisis shortly.

During the recent European debt crisis, the Greek sovereign debt issue is in most urgent need of a solution. However, given that other economies’ exposure to Greek debt does not exceed reasonable limits, if Greece were to default on its sovereign debt, even Greece’s main creditors – France and Germany – would be able to cope with the impact, and the effect on the US and the Asian economies would be even less pronounced. US Federal Reserve Chairman Ben Bernanke has stated that, based on the results of stress testing, the impact of a Greek sovereign debt default on US capital would be very small, while, according to the Bank for International Settlements, investment in Greek debt accounts for less than 1% of the total overseas investment of Asian emerging economies.

However, the real danger of a Greek default lies in the possibility that it could set off a chain reaction. This would probably be a multi-stage process. Initially, Greece’s default would lead to a downgrading of the credit rating of the other “PIIGS” (Portugal, Italy, Ireland, Greece, and Spain) economies. It would be difficult for these economies to refinance their debt, and could be expected to default in their turn. If the crisis spread to most or all of the PIIGS economies, then their main creditor economies—which include Germany, France and the UK—would be seriously affected and the impact on the financial stability of Europe as a whole would be significant.

According to statistics compiled by the Bank for International Settlements, total exposure of the 16 Eurozone economies to the PIIGS economies (excluding Ireland) comes to USD 1.6 trillion, with France and Germany accounting for 62% of this. French banks’ exposure to the PIIGS amounts to USD 493 billion, while German banks’ exposure totals USD 465 billion. Several of the major French banks—including BNP Paribas, Société Générale and Crédit Agricole—would be particularly heavily hit.

If the crisis developed to this extent, then the impact on the US would be somewhat more serious. Total US exposure to the PIIGS economies’ debt amounts to USD 200 billion; however, much of this is in the form of indirect exposure, and given the huge size of overall US assets, the negative impact would not be too severe. As far as the Asian economies are concerned, because relatively little PIIGS debt is held in Asia, the impact of a crisis of this sort would be limited. Overall, even if a Greek default did spread to the other PIIGS economies, the negative impact would be largely confined to Europe in this stage.

The next stage in the exacerbation of the
crisis would be that when the defaults of PIIGS economies put German and French banks under threat, failure to rescue threatened banks could lead to the loss of confidence and chaos in the banking system of the economies concerned. Under this circumstance, the crisis would no longer only be affecting the PIIGS economies; it would have evolved into a financial crisis for France and/or Germany. If the situation did develop in this way, the crisis might then spread to the US, Japan, and the other major Asian economies (including China), because while these economies may not be heavily exposed to the debt of the PIIGS, they are heavily exposed to France and Germany.

Nevertheless, for the crisis to spread to this extent, several lines of defense would need to have been breached. The first line of defense is the bailout offered to Greece by the European Union, the European Central Bank, and the International Monetary Fund. Even if this line of defense was breached, with a Greek default spreading to the other PIIGS economies, the organizations listed above would be able to provide support for these economies, creating a second line of defense.

If the second line of defense was breached as well, with the crisis spreading from the PIIGS economies to the major banks of Germany, France, etc., then the third line of defense would be the rescue provided by the relevant organizations and French and German governments to their banks to help shore up confidence in the financial system. If only this third line of defense was also breached, the crisis would spread to the US and to the Asian economies. However, it should be noted that, before the crisis escalates to this stage, the relevant organizations and the affected economies (e.g. France and Germany) will need to have contingency plans in place to cope effectively with the mountain of bad debt that French and German banks would be facing, otherwise there could be a loss of confidence that might exacerbate spread of the crisis from Europe to other parts of the world.

It is already clear that Greece is in no position to repay its accumulated debts by its own efforts, and that the relevant organizations will need to provide ongoing support for Greece over an extended period. The risk of a default by Greece on its sovereign debt is in fact quite high. There is also a far from negligible possibility of a default by Ireland or Portugal. Even so, it is expected that the likelihood of the crisis worsening to the extent that the third line of defense is breached is very small, mainly because, even if other PIIGS economies defaulted, the world’s leading economies and major international organizations would do their utmost to ensure that the crisis did not spread to Germany and France.

The major international organizations and economies would provide rescue before PIIGS economies were forced to default to prevent them from developing into a fully-fledged systemic crisis. Besides the provision of relief funds, the assistance might also include debt restructuring, whereby the creditor banks agreed to absorb some degree of loss in return for continued debt repayment. One encouraging sign is that the fiscal health of Germany and France is gradually improving, ensuring that the French and German governments should have more funds available to aid domestic banks hurt by the debt crisis.
United States

The unemployment rate ticked up to 9.1% in May, from 9% in April. The US labor market added only 54,000 jobs in May, the lowest addition of jobs since September 2010. The jobs figure was the latest indicator that the US economy is slowing down. Measures of consumer confidence, housing, and factory output have declined, car sales have slipped, and many retailers have reported disappointing results.

Private sector employers added 83,000 jobs last month, the fewest since June 2010, while the government sector lost 29,000 jobs. Job gains in many sectors such as manufacturing and finance were weak. The average unemployed person has been out of work 39.7 weeks in May, the longest since records were kept since 1948.

US GDP grew at just 1.8% in the first quarter of 2011, and is likely to post a disappointing 2% growth in the second quarter. The economy will have to sharply accelerate to reach the 3 to 4% targets for all of 2011. This appears quite unlikely.

Many economists say the current difficulties in the US economy are temporary, caused by supply-chain disruptions arising from the earthquake in Japan, a jump in gasoline prices, and tornadoes that hit the American southeast.

However, the economy’s overall medium-term health depends on improving employment. Without better employment, consumption and the housing market cannot improve, allowing the economy to continue its expansion. Few economists forecast the economy will slip back into a recession, but the risks of a double-dip recession have somewhat increased.

The weaker than expected job market has complicated Federal Reserve monetary policy. It is unlikely that the Fed will embark on another bond buying program (QE3) anytime soon. Inflation has been ticking up, commodity prices have surged, and foreign partners are increasingly upset at the role of American monetary policies in depreciating the dollar, and raising global interest rates.

At the same time, US policy interest rates are unlikely to go up anytime soon. Federal funds futures markets imply that the Fed is unlikely to raise interest rates until September or October of 2012. In April, many investors thought that rate increases would occur by December of this year. In addition to keeping interest rates near zero, the Fed should reassure investors that they would hold off on reducing their massive government bond portfolio as long as the economy remains weak.

Almost three years since the onset of the crisis, nonperforming loans in the US banking system remain high. At the end of the first quarter
of 2011, the ratio of nonperforming loans (past due 90 days plus nonpayment) to total loans was 4.85, down from its peak of 5.67%, reached at the end of first quarter of 2010. In normal times, this ratio is under 1.5%. Even during the early 1990s Savings and Loan crisis, the ratio was only 3.9%, implying that the US banking today remains fragile.

Canada

The Canadian economy apparently grew at an annualized rate of 3.9% in the second quarter of 2011, twice the estimated rate of the US economy. Given the recent slowdown in the US economy, however, there is some concern that Canadian exports to the US will stall during the second quarter and beyond. Reflecting these growth concerns in the medium-term, the Bank of Canada held interest rates constant at 1% at its most recent committee meeting in May. Still inflation rates are creeping up, driven by the higher prices for oil and commodities. CPI inflation rates are now running at an annual rate of 3%, so sooner or later, interest rates need to be increased to slow the economy, for CPI inflation rates to reach their monetary policy target of 2%. (The author is Professor at University of Southern California.)

Northeast Asia

Growing Budget Deficits and Sustainability: Why is Japan still sustainable?

Naoyuki Yoshino

After the sub-prime loan crisis, many governments run into government deficits due to aggressive government intervention into counter cyclical fiscal policy. In Europe, Greece and few other economies are getting into serious fiscal problem. How to cope with increase of government debt?

Figure 1
Japan’s revised budget was proposed by Prime Minister Naoto Kan after the earthquake/tsunami. Figure 1 shows Japan’s budget deficits to GDP ratio in comparison to major OECD economies. Government debt to GDP ratio in Japan climbed up to about 200%. On the other hand, Greece figure was about 111%, yet Greece went into bankruptcy and Japan is still sustainable. Before exploring into this difference, we should first look into the major government spending of Japan shown in Table 1.

**Table 1: Proposed Budget Spending, 2011**

<table>
<thead>
<tr>
<th>Items</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Welfare (to elderly people and others)</td>
<td>31%</td>
</tr>
<tr>
<td>Debt redemption and interest payments for debt</td>
<td>23%</td>
</tr>
<tr>
<td>Subsidies from Central Government to Local Government</td>
<td>18%</td>
</tr>
<tr>
<td>Education</td>
<td>6%</td>
</tr>
<tr>
<td>Public Works</td>
<td>5%</td>
</tr>
</tbody>
</table>

Largest component of the budget deficits comes from social welfare payment to elderly people and others. The second largest item is the government debt redemption and interest payments for government debt. The third element is the subsidies from the central government to local government. These three items amount to about 72% of total central government general budget expenditures.

Japan has established seniority wage system and life time employment during high growth period. Due to high wage cost of senior employees, companies ask senior people to make their early retirement. Japan shows the longest longevity in the world. Many citizens retire around 60 years old and live very long, supported by pensions and social welfares. This causes huge government spending by issuing government bonds.

Northeast Asia will face similar ageing problem in near future. In order to avoid too much burden to the government spending, private companies must be well prepared to utilize talent and superiority of elderly employee to work in various sections. At the same time, wage rate must be determined by their productivity rather than seniority wage rate.

Why are Japan’s budget deficits still sustainable, while Greece went into bankruptcy? One of the crucial differences between Japan and Greece is in the demand structure of government bond in two economies.

**Table 2: Government Debt Holdings of Japan**

<table>
<thead>
<tr>
<th>Items</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>45%</td>
</tr>
<tr>
<td>Life and non-life insurance companies</td>
<td>20%</td>
</tr>
<tr>
<td>Public Pension</td>
<td>10%</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>4%</td>
</tr>
<tr>
<td>Bank of Japan</td>
<td>8%</td>
</tr>
<tr>
<td>Foreigners</td>
<td>5%</td>
</tr>
<tr>
<td>Households</td>
<td>5%</td>
</tr>
<tr>
<td>Others</td>
<td>3%</td>
</tr>
</tbody>
</table>

As can be seen from Table 2, Japan’s government bonds (JGB) are mainly held by Japanese investors including banks, insurance companies and pension funds. On the other hand, more than 60% of the Greece government bonds are held by foreign investors. Japan used to show very high savings rate by households sector. The accumulated households’ net asset is almost the same amount of current outstanding government debt.

The Central Bank of Japan is taking easy monetary policy which supplies ample liquidity into the market in Japan. Deposits are increasing and excess reserves are accumulated in banks. However, banks are cautious to lend money to corporations due to stricter Basel capital requirement rule. Government bonds are very liquid and regarded as zero risk based on Basel capital requirement. Less and less money is flown into corporate sector, while much more money is flown into government bond market and absorbs huge issue of government bonds.

Comparing with the bond market of Japan and Greece, both economies show an increase of government bond supply. Japan’s government bond rate of interest (for 10 years) remains about 1.1%. On the other hand, Greece interest rate on government bond went up to about 25%.

High accumulation of savings is important to keep sustainability of the bond market.
In this report, we will provide a brief review of GDP, consumption, investment, net exports, CPI index in Vietnam, Thailand, Malaysia, Singapore, Indonesia and Philippines, all in Southeast Asia. With this review, we can get a better understanding of the current macroeconomic situation and potential problems in Southeast Asia.

1. GDP growth

Figure 1 shows that, there were two trends can be divided from 2001 to 2010. In the first period 2001 to 2007, the economies maintain upward momentum. And in the period 2008 to 2009, the economic growth rates were significantly lowered, which suggests that Southeast Asian economies are closely tied with the world, and that it is a typical export-oriented economic zone. So, the impact of the international financial crisis was tremendous. In 2010, the steady rise of economic growth indicates a strong recovery. In these Economies, it is Indonesia's economy that is the most unstable, with the most stable being Philippines. In the other five economies which have a relatively stable growth, Vietnam's performance is the most dazzling; its growth was significantly higher than other economies.

2. Various factors affect the GDP growth

Following the expenditure approach of GDP Accounting, including consumption, investment and net export, in Figure 2 - Figure 4 we can see the economic structure of each economy. The Philippines has the largest proportion of consumption, and Vietnam’s growth has an obvious characteristic of being investment-driven, net exports is the biggest dependant for Singapore.
From the volatility of indicators, consumption is the most stable element, except in Malaysia and Indonesia; the other economies’ consumption share is maintained at 60% level. The external trade sector is vulnerable to international economic fluctuations; therefore, the biggest uncertainty in making forecasts for the future economic situation is the external environment.

Let us look at the trend of investment, Indonesia’s investment proportion increased significantly after 2007. Malaysia’s investment reached its lowest point in 2009, and then rebounded to the previous average level. The performance of Vietnam and Philippines is very different; the former is an investment-driven economy, which is probably twice the investment intensity of the latter.
Vietnam and the Philippines show a little difference from the typically export-oriented Asian economies. The external sector of these two economies has been on a deficit position for a long period, improving slightly in recent times. The Philippines has achieved an export surplus, but there are risks for Indonesia of falling into a deficit position. In Malaysia and Thailand, the contribution of net exports to GDP also decreased.

In summary, to make proper judgments of integrative economic trends, we should pay the most attention to investment in Vietnam and Malaysia, and exports in Singapore.

3. The trend of CPI

Figure 5 demonstrates the month-to-month changes of CPI in the Southeast Asian economies over the last 10 years. Almost all economies show a steady trend before 2007, with top to ±2% only in two or three time horizons. After 2007, CPI is obviously climbing up, especially in 2008.

Figure 6 shows that Thailand and Vietnam have faced inflationary pressure all the time. In addition to Indonesia, those three economies have picked the upward trend recently. Malaysia seems to be the steadiest one during the time among the six economies just due to the fact that it chooses 2010 as the base period. Paralleling to Malaysia, Singapore and Thailand as well as Indonesia chose their base period much later so that the CPI doesn’t reflect the real inflation conditions.
In summary, annual GDP growth in Southeast Asian economies is on the right track. Each composition of GDP in these economies, including consumption, investment and net exports, look relatively stable. CPIs of these economies are acceptable, except that of the Vietnam. (The author is Professor at Renmin University of China, Beijing and The University of Birmingham, UK)
Continuing strengthening in the terms of trade – now 85% above the average of the last century – and in mining investment are creating concerns over the inflation outlook. While overall, the Australian economy is in good shape especially when compared with many other OECD economies, the mining boom and the accompanying investment growth in mining in some states is putting upward pressure on scarce labour resources and on prices generally. The government is concerned that these pressures are creating a “patchwork” economy where the traditional manufacturing states are declining in international competitiveness terms in part as a consequence of the appreciating Australia dollars. The Australian economy is growing at just over 3% for the year and forecast to grow by 4% plus next year. The unemployment rate is just below 5%.

The outlook is generally mixed, with a fair degree of uncertainty; business conditions are at a two year low. A recent survey by Westpac Bank and the Melbourne Institute noted a fall in consumer sentiment of 2.6% in June following a fall of 1.3% drop in May. Households are worried about job prospects, taxes and the economic outlook generally. The prospect of a carbon tax – the government is committed to establishing a carbon price as precursor to a carbon tax to be introduced in July 2012 – was a key concern despite the hold on interest rates and falling petrol prices. The NAB’s (National Australia Bank) index of business conditions based on measures of trading conditions, profitability and employment also showed a softening and the NAB does not expect strong growth in the economy until the September quarter.

The Reserve Bank maintained its benchmark official interest rate at 4.75% at its June meeting but indicated that it may well need to increase rates later in the year as a consequence of prospective increases in labour costs and rising income and investment in the commodities sectors. The NAB survey results carry an expectation that rates will rise in August to 5% followed by a further upward adjustment to 5.25% towards the end of the year. The RBA notes that official inflation figures to be issued on 27th July will have a major bearing on a future rate increase.

The NAB survey also highlights a two-speed economy with the mining sector outperforming the rest of the economy. Confidence remains highest in the mining, finance, business and property sectors but retail, manufacturing, wholesale and construction condition are very poor. The strong Australian dollar is causing problems for the manufacturing and wholesale sectors. The Westpac-ACCI industrial trends survey showed a sharp decline in manufacturing conditions. Australia’s tourism and retail sectors are feeling the resulting loss of business from the high exchange rate and with more Australians opting for purchasing retail goods online and taking overseas holidays.

Both the RBA (National Australia Bank) and the Treasury note that the Australian dollar will stay elevated “for some time”, and that businesses are going to have to live with the structural changes being affected by the rising exchange rate. The Australia dollar has appreciated from 65 cents to
AUD 1.05 to the USD in just 18 months.

**New Zealand**

In spite of further recent major earthquake aftershocks in the Christchurch district, positive signs for the economy are appearing. The Budget delivered in late May reflected the massive rebuilding program following the earthquake in February. The budget’s key messages were to focus on rebuilding the economy by growth in exports, savings and investment rather than borrowing and consumption; to put public finances in a better position to cope with future shocks. GDP is forecast to grow by 4% next year with the creation of 170,000 new jobs and a return to budget surplus in 2014/15.

Retail sales are growing strongly and the Westpac-McDermott Miller consumer confidence index rose from 97.9 to 112 in the second quarter. In general, this shows growth in confidence of individuals’ finances and in state of the economy. The manufacturing industry, which is the third largest employer in the economy, is also showing improvements with the BNZ-Business NZ PMI (Performance of Manufacturing Index) rising to its highest level since June 2010. However, the economy’s biggest insurers are still feeling the effects of February’s earthquakes. Both IAG (Insurance Australia Group) and QBE (QBE Insurance Group) are predicting large cuts in profit margins in this calendar year.

The Ministry of Agriculture and Forestry claims that recovery in the rural sector will be critical to national recovery from the recession and natural disasters. High commodity prices for timber, wool, beef and dairy products are boosting export revenues. The primary sector is expected to enjoy broadly based growth in the period to 2015 but some easing the New Zealand dollar would contribute to increases in export volume. There are expectations that longer term global social and economic conditions will lead to an increase in overseas investment in New Zealand real estate sector.

The tourism industry which accounts for 9% of the economy is flagging. Bank of New Zealand reports a 6% drop in Australian tourists but the skiing season and the Rugby World Cup in September should help boost a recovery in this sector. Chinese and Korean tourist numbers show strong increases.

The Reserve Bank announced on the 9th June that it would leave the official interest rates unchanged at 2.5%. However, the newly buoyant consumer confidence and surging commodity prices are prompting expectations that the central bank will need to raise the official rate later in the year.

**India**

Continuing concern with inflation growth prompted the Reserve Bank to raise interest rates for the tenth time since the start of 2010, extending the longest period of monetary tightening in a decade. As a consequence, equity markets and the rupee fell. The repo rate was increased to 7.50% from 7.25%. The Central Bank is attempting to dampen demand pressures to ensure that inflation doesn’t become endemic. However, the Federation of Indian Chambers of Commerce and Industry (FICCI) is concerned that interest rate rises will kill growth and that a future rate rise would slow down investment growth. Following the spate of rate increases, there has been some clawing back of the annual rate of wholesale price inflation from its peak of 10.9% to the current level of just over 9%. However, business leaders have pointed out that despite recent interest rates rises, inflation is still too high.

Meanwhile, the OECD has advised that the answer to containing inflation while striving for double digit growth in India lies in eliminating regulatory barriers to direct investment. According to the OECD, India is a “stand out performer” in the global economy advising that a focus on increasing the savings rate would also be crucial to continued growth. GDP growth decelerated to 7.8% in the fourth (March) quarter of 2010 to 2011 from 8.3% in the previous quarter, and 9.4% in the corresponding quarter a year ago. GDP growth in 2010 to 11 was 8.5%.

India could be faces a crisis with grain stocks outpacing the current storage capacity. The government had record rice and wheat stocks of 65.6 million tonnes in its storage in early June and officials say there will be no capacity for additional
stocks once the monsoon arrives. Farmers are dumping their grain in the streets in frustration with the government’s failure to maintain grain procurement.

The government has released plans aimed at boosting manufacturing exports from 16% of the nation’s GDP to 25%. The strategy will focus on the engineering, leather, gems and jewellery, textiles and sports goods sectors. It will involve incentives via tax concessions, subsidies and the relaxation of labour laws with the objective of creating 100 million additional jobs by 2025. The plan is a crucial part of addressing India’s need to raise its export competitiveness in order to maintain strong economic growth. (The author is Director, Australian APEC Study Centre at RMIT University.)

Growth remains strong in the first quarter; Inflation takes a break on falling commodity prices

Cheng-Mount Cheng

In the recent Global Economic Prospects (GEPs) from the World Bank (WB), Latin America and Caribbean is expected to grow GDP by 4.5% in 2011, 4.1% in 2012, and 4% in 2013. The WB forecasts that Brazil, Mexico, and Argentina will likely have GDP growth by 4.2%, 4.4% and 6.3% respectively in 2011 before slow to 4.1% and 4.2% in 2012. The reason for slower growth pace in 2012 is mainly due to increasing capacity constraints, high fuel and food prices that cut into real incomes, and tightening of fiscal and monetary policies.

According to the WB report, Brazil economy is expected to slow down as the economy is operating near full capacity, labor market conditions are tight, and wages are starting to increase faster than productivity. The 46% real effective exchange rate appreciation observed since January 2009, is expected to continue to weigh on industrial production, both because of weaker exports and increase import demand. Capital flows are projected to be boosted by an increase in FDI, even as market sensitivity and government policy serves to dampen more volatile equity and debt-creating flows.

In Mexico, higher energy prices are projected to cut into consumer demand in both Mexico and the US, with the latter impact slowing Mexican export growth. Argentina economy remains strong this year, following a remarkable 9.2% gain last year, but will slow further as capacity constraints begin to be felt, but outturns will depend importantly on efforts to improve its productive potential. WB’s forecast may be too conservative as most of economies in Latin America reported strong GDP growth in the first quarter. For instance, Brazil recorded 4.17% year-on-year growth in the first quarter of this year, while GDP growth hit 4.6% in Mexico, 6.26% in Chile, 7.35% in Peru, 9.7% in Panama, and 9.9% in Argentina.

Downside risks facing the region include surging oil prices, elevated food prices, overheating in selected economies, and impact from Japan’s earthquake. Oil prices remain the most important downside risk, as inflationary pressure will take a heavier toll on consumer spending worldwide. Also most economies in Latin America face the challenge of fine-tuning monetary policy to help anchor inflationary expectations and keep inflation rates within a targeted range without dampening recovery. If the authorities failed to bring inflation under control in the near term, sharper monetary
tightening is the likely course of action that would have negative consequence for growth in 2012 and 2013.

Recent political upheavals in the Middle East have increased the risks of further hikes in energy prices that will affect oil-importing economies in the region, and in particular growth in Central America, excluding Mexico, and the Caribbean. The WB estimates that a sustained USD 50 per barrel increase in oil prices is expected to slow down growth by 0.3 percentage points in 2012 and 0.4 percentage points in 2013. The economic fallout from Japan earthquake will likely have a negative impact on FDI flows, given that Japan is an important source of FDI for economies like Brazil. An abrupt reversal of portfolio flows could result in sharp depreciation of currencies in the region. Lastly, a disorderly unwinding of the fiscal sustainability issue in Europe may affect economic activity in the region through trade and financial linkages.

The most relevant development during the month was the generalized decline in commodity prices and the broad-based strengthening of the US dollar. The decline in commodity prices has brought some long needed relief for inflation targeting economies in the region by reducing nominal appreciation pressure on their own currencies while keeping imported food and energy inflation relatively subdued. It even encourages two central banks of Chile and Peru to hike interest rates by 50 and 25 basis points respectively, without feeling too much “appreciation quilt”, i.e., the fear of being criticized for inducing currency appreciation when they hike interest rates to fight domestic inflation. Most currencies in Latin America experienced depreciation in May after strengthened in April. Peru’s Sol was an exception that has an inverted exchange rate cycle than others, but that was probably related with Peru’s presidential election polls. Another economy that did not have exchange rate depreciation from the drop in commodity prices as Argentina, thanks to a combination of central bank intervention and exchange controls.

As the drop in commodity prices and the US dollar strength may prove temporary, economists still believe interest rate “normalization” cycle in Latin America should resume in the following 6-12 months to stop the real economy from overheating and inflation from accelerating. (The author is Vice President, Citi Taiwan.)
The Eurozone crisis and negotiations on the Greek bailout continued to dominate the news even though a large number of other important events (Libya and the Middle East, drought, the ecoli outbreak, etc.) were unfolding.

At the same time, several important policy developments took place that could have medium to long term implications for APEC SMEs. These included decisions on the visa regime (Schengen), the identification of research priorities, accession talks with Croatia, and the beginning of EU-Japan trade and economic negotiations.

The European Central Bank (ECB) has also indicated that it will raise interest rates for the Euro to 1.25% from next month, suggesting that the Bank of England and the US Federal Reserve may move in a similar direction by the end of the year.

Negotiations among the Greek government, the ECB, the IMF and member states of the EU continued throughout the month to find a solution to the debt crisis. The fear is that if Greece is not helped to roll over its huge debt (estimated at about EUR 300bn in total) then she will default on payments currently due. European, American and British banks will then stand to lose heavily, and investor confidence in general will sink, possibly causing another financial and banking global crisis.

In exchange for help however the Greek government has to do more to repay its debt and reduce its current deficits, including privatisation of state enterprises, reducing the pay and benefits for state employees, and selling state assets. Politically, these measures are proving very unpopular in Greece with rioting on the streets and daily demonstrations against the government.

Other options include Greece withdrawing from the Eurozone, or the formal break-up of the Eurozone. Both of these options would have a catastrophic effect on the global economy in addition, and would be expensive and difficult to implement.

Negotiators are trying to find a long-term solution, but this is complicated by the pressures of a daily sense of crisis, and conflicting advice on possible solutions.

EU concerns over developments in Libya and Syria continue to mount, with no solution (either military, diplomatic or domestic) in sight to either crisis. Moreover, the problem of illegal migration continues to influence a sharp swing to the right in EU politics, with anti-immigration parties gaining momentum and strength.

At the same time, the EU continues with its expansion, with Croatia qualifying for final membership negotiations, and Macedonia and Serbia moving closer.

On the economic front, important negotiations between the EU and Japan have opened over trade and economic cooperation, which could lead to substantial commitments on mutual market access in goods, services, investment and agriculture, and possible cooperation in joint nuclear and green energy research.
Important domestic EU developments

Some domestic developments that could have an important direct and indirect impact on APEC SMEs include the following:

Visas and Schengen

· Poland became the first EU economy to allow the entrance of Chinese construction labour into the economy to build a major highway project. Normally, visa regimes keep foreign construct contractors from bidding, however, in this case the dominant consideration was economic. If this ‘model’ is followed by other member states, then APEC interests can bid for other projects in the lucrative EU market.

· Member states were authorised to temporarily suspend visa-free requirements for 14 economies if illegal migration or misuse of visa privileges was detected.

· At the same time, some member states (Denmark, France) wanted to suspend some provisions of the Schengen agreement to prevent illegal migrants flowing across borders.

Research and other policies

· The EU is finalising proposals to focus research funding in three areas:
  * Climate change
  * Green energy
  * Health

  The German government has budgeted EUR 1.5bn for the development of electric car technology.

  On environmental grounds, the EU may soon ban the use of plastic bags.

  Taken together, these policy decisions reflect a clear and emerging trend in the future of EU markets, and the role that governments and the EU will play in shaping these markets. Dealing with environmental issues including climate change, green and nuclear technology, and health, will become the focal point for subsidies, regulatory systems and policy measures across the EU. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)
Weakening Global Growth and Financial Market Disruption Weighing on Regional Economy

Kuo-Yuan Liang

East Europe surveys rather steady, however global factors may cause risks

Continuing from the trend seen in previous months, the Economic Sentiment Indicator readings have shown a general decline among the East European economies. This is deemed not much of a surprise: in the previous months, we have indicated that the rise in global commodity prices and energy in particular has pushed up inflation, putting pressure on essentially every economy, especially the emerging economies, as their inflation generally tends to be much higher than in developed economies.

Aside from these issues, considering the various unfavorable factors surrounding global markets, excluding Greece, the region as a whole has performed not as bad as we had expected. But as global risks heighten in many aspects, some will induce more risks to East Europe; hence, we need to look into those factors as well.

Weakening global growth amid inflation, Japan quake, and financial market instabilities may create risks for the region

The recent US Beige Book published by the Fed has indicated a slowing improvement of the US job market and its economy, citing supply chain disruptions by the Japan quake and elevated food and energy prices. In Europe, its recent ECB policy statement considered its economy growing at a moderate pace, where its spectacular 0.8% first quarter GDP growth will unlikely be repeated. The developed economies are still improving, albeit at a more moderate pace.

Over the past few months, declines have occurred across global markets, amid escalation of potential crisis situations, thereby contributing to a rather chaotic period on a global scale. The Greece issue is currently down to a stalemate between Germany and the ECB over whether the ECB is still willing to accept Greece bonds as collateral for central bank funds after a “voluntary maturity extension” type restructuring. By observing the exchange rate markets, over the past month, East Europe regional currencies generally outperformed the Euro by around 1%, which very likely reflects the struggles on the Greek issue.

Turning to the US, the Republican Congress has been refusing to raise the US debt limit to force the Democrat President to yield to their budget plan, threatening a “technical default” of US bonds as soon as 2nd August, 2011, thus escalating the instability in the global financial system. With either incident having the potential to at least develop into a regional crisis or even a full blown crisis, there is the risk that capital may escape the East Europe region, just as it did during the global financial crisis. Though the region’s economies aren’t performing badly, the risks associated with market instability should not be neglected.

Most East Europe economic indicators down

By looking more deeply into the ESI indicator, excluding the more apparent decline in Hungary, changes in Poland and Czech were moderate, while in the Baltic economies the indicator stood nearly unchanged. In terms of the components, the source of the ESI declines, if
any, were mainly attributed to the industrial sector confidence, as it fell sharply among the majority of regional economies, continuing the falling trend seen in previous months. In the industrial sector, the decline was relatively a general decline, except for selling price expectations. In the other sectors, the indicators were roughly unchanged, where the declines of the service and retail sectors in the previous month did not continue into the current month. In their respective components, there were no special trends either. But as the recovery in the East Europe region is being led by the manufacturing industry, a persisting decline in that sector might be an indicator of an inherent weak economic performance.

The Greek solve

In this month’s other articles, we provide our insightful opinions regarding the solution to the Greek debt problem. Unfortunately, our conclusion does not provide a concrete solution for the time being. In short, the consequences of any restructuring would be devastating to the Eurozone, the ECB and the global financial system. Regarding the approach of disbanding Greece from the Eurozone, it would prove to be technically and politically impossible. Thus, the best choice is to leave it as it is now and bailout Greece time after time when debt is due. However, everyone should be prepared for the moment it blows. (The author is President, Polaris Research Institute & Honorary Professor, and Professor at College of Technology Management, National Tsing Hua University.)

Russia and Middle East

Weak international oil price will destabilize the economies of Russia and the Middle East

Ming-Hsin Kung

Owing to the strong rise of the international oil price in the first season and the early second season this year, the Russian government once held a cautiously optimistic attitude in May to the prospects of the Russian fiscal conditions of this year. Its export of the energy sector and related taxes have been influenced, however, by the prominent fall of the international oil price at the end of May. This price decline is caused by the concerns with regard to the slowing down of the expansion of China’s manufacturing industries, by the decision of some members of the OPEC to increase oil supplies, and by the European sovereign debt crisis.

Moreover, previously Russia once placed much hope on an important contract of exporting natural gas to China. The timetable of this export expected by Russia, however, has been delayed due to the ongoing negotiation between Russia and China, especially regarding the price issue, as China, whose gas price is only half the price than that in Russia, wants to prevent from import inflation and worsen the domestic inflation problems.

Also, expected effects have not been seen in the privatization of state-owned enterprises recently activated by the Russian government. The current revenue brought by the privatization project is about RUB 300 billion, far less than the aim of RUB 450 billion expected by the Russian government. Due to a variety of factors, the energy-sector export and the government’s fiscal prospects have both become conservative again, which also means that under the pressure of inflation, Russia’s central bank may probably be unable to maintain the easy monetary policy it has enacted since November 2010.

As for the Middle East, the OPEC members,
as unexpected by the market, did not reach a new agreement on oil-production quotas at the meeting in Vienna on 8th June. Since the international oil price has been weak under the influence of demands, the market had expected that the OPEC members would limit their daily production further. At the meeting, Saudi Arabia, Kuwait, Qatar and the Arabian Emirates proposed to increase production, but were objectied by Iran, Algeria, Angora, Venezuela, Equator and Libya, who prefer to maintain the current daily production. Still, it is expected that Saudi Arabia will continue increasing its oil production; its production has increased by 450 thousand barrels in May, producing 9 million barrels of oil a day.

Among these economies advocating increasing production, there is some opinion that the high oil price may probably cause the increase of demand for substitutes for oil in the medium-long term, even though the currently high oil price is partly triggered by hot money. Therefore, many economies have made a lot of efforts to save energy or to use alternative energy, a situation that contradicts to the fundamental benefits of the oil producers.

To cope with this situation, several of the rich Middle-East economies with relatively advanced capitals and technologies may gradually increase energy supply, relieving the energy-import cost of the industrial economies to some extent and appeasing their inflation. Once the oil price falls further, however, the other Middle-East economies relatively unable to expand production may be impacted to quite an extent, and the economic situation in the Middle East area will continue to be as unstable as the regional politics in the second half of the year. (The author is Vice President, Taiwan Institute of Economic Research.)

Global Commodity Market

Emergence of New Geopolitical Risks

Hwa-Nyeon Kim

In the last one month period (mid-May to mid-June 2011), warning signs of a crisis in the global commodity market have definitely eased. Furthermore, commodity price indices continue to show clear downward trends. WTI oil prices fell to a four-month low of about USD 93 /barrel on investors’ concerns over the impact of Greece’s debt crisis on the global economy. And Dubai oil prices also dropped to below USD 110 /barrel. Macroeconomic concerns continue to spread in the raw material markets.

If there is a commodity which is worth mentioning this month, it is definitely gold, with prices almost approaching a historical high of USD 1,557 /oz recorded in early May. The increase in price was due to worries over an escalation of the Greek debt crisis and uncertainties related to the US debt ceiling problem. Firstly, in regards to Greece’s debt problem, European finance ministers were unable to reach a concrete solution to the Greek crisis.

Secondly, in terms of the US debt ceiling problem, the US government already hit its legal borrowing limit of about USD 14.3 trillion in mid-May, forcing the US Treasury to take extraordinary and temporary measures to avert a technical debt default. However, it will run out of maneuvering room by early August. The US government has called on lawmakers to raise the debt ceiling however Republican lawmakers are seeking trillions of dollars in spending cuts first. Thus, these uncertain factors have worked to increase investors’ preference for safer assets, and as gold is regarded as the safest asset, prices have inevitably
gone up.

Although political tension in Libya has somewhat eased, new geopolitical risks have emerged in Sudan and Iraq. First, Sudan is experiencing severe civil unrest in oil producing states bordering Northern and Southern Sudan. Unresolved issues over how the oil revenue should be divided between the two regions have escalated disputes between the Northern and Southern regions of Sudan. Sudan produces about a half million barrel/day of oil and exports about 97%, therefore, the escalating geopolitical risk is not negligible. Second, Iraq will be a main geopolitical risk to the oil market. Terrorist groups such as al-Qaeda may target the Iraqi oil sector and in June, bombs were planted near Iraq’s second largest refinery. More importantly, US troops plan to withdraw from Iraq by the end of 2011, which would escalate the geopolitical risk.

The top two commodity indices, the CRB spot Index and LME non-ferrous index, have shown slight decreases from mid-May to mid-June. The CRB spot index (year 1967=100) moved up from 554 to 566 and the LME index (April 1999=1,000) from 3,926 to 4,144. The averages for the CRB index and the LME index, from mid-May to mid-June, decreased 1% and 3% respectively. In the case of the CRB index, the change is larger than those in 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-April to mid-May period, indicating a decrease in investment risk.

As for energy prices, the WTI near month futures price moved within the range of USD 94.81 and 102.7 /barrel and Dubai crude prices between USD 104.01 and 112.04 /barrel during the same period. However, the oil price averages from mid-May to mid-June were smaller than those during the previous month, with the average prices of WTI and Dubai decreasing 7.3% and 4.3%, respectively.

Among non-ferrous metals, or more commonly known as base metals, the prices of all six metals went down following the previous period. Among base metals, tin and nickel have become increasingly bearish, with average prices declining 13.5% and 9.7% respectively. Prices for copper, lead, aluminum and zinc also showed decreasing price patterns.

While violence in Libya, Syria and Yemen continues, the degree of the tension has somewhat eased in the MENA region. However, as mentioned above, new geopolitical risks in Sudan and Iraq will have a bigger impact on crude oil prices in the future. These new risks may be a significant threat to oil supplies, resulting in a surge in oil prices. Therefore, SMEs should pay close attention to the new geopolitical risks in Sudan and Iraq and make provisions for any sudden jumps in oil prices. (The author is Research Fellow at Samsung Economic Research Institute.)

*<Table> Changes in Raw Material Prices - 16th May to 15th June, 2011*

<table>
<thead>
<tr>
<th>Index</th>
<th>Crude Oil (USD/barrel)</th>
<th>Non-ferrous Metals (USD/ton)</th>
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<td></td>
<td>CRB</td>
<td>LME</td>
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<tr>
<td>Min</td>
<td>554</td>
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<td>Max</td>
<td>566</td>
<td>4,144</td>
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<tr>
<td>Average</td>
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<tr>
<td>Last Month Average</td>
<td>566</td>
<td>4,172</td>
</tr>
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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.
No Real Progress Seen in Greek Debt Issue

Kuo-Yuan Liang

The Greek debt issue has caught the spotlight of financial markets since 5th Dec., 2009 amid a series of credit downgrades. Although related parties have gone in earnest to prevent Greece from defaulting and be disbanded from the Euro Area (EA), such efforts have yielded few promising results. As speculation of a restructuring increase, the issue has reached a point where an “ultimate solution” needs to be devised. Thus, related parties including the European Union (EU), the European Central Bank (ECB), the International Monetary Fund (IMF), Germany and Greece have all gathered, to ensure their respective interests are protected.

Before we move forward, a summary of the crisis is provided below. Beginning in Dec. 2009, major rating agencies downgraded Greek’s ratings in succession, shaking bond and foreign exchange markets. However, the major blow came when the newly elected Greek administration unveiled that its predecessor had concealed government deficit figures, and revised the 2009 deficit forecast from 6-8% of GDP to 12.7% of GDP.

In Jan. 2010, further evidence showed that the previous government used a foreign exchange derivatives transaction with Goldman Sachs to transfer deficit into the future. Under pressure, Greece introduced multiple austerity measures, but its creditability to investors continued to weaken. In April, as ratings became junk and bond yields and credit default swaps (CDS) reached record highs, the Hellenic Republic was unable to fund reasonably, and was subsequently forced into accepting a 3-year EUR 110 billion EU-IMF co-bailout in installments, with payment pending on whether Greece complied with the deficit reduction timetable.

At almost the same time, to avoid liquidity crisis in Greek banks, the ECB lifted the minimum quality requirement of collateral for borrowing from ECB lending facility, giving EA banks access to unlimited funding with junk Greek bonds at face value. Recent data show that the amount lent to Greek, Irish and Portuguese banks accounted for 55.6% of the total outstanding balance of the ECB facility. As all EA banks will send in the least quality collateral for ECB funds, a major portion of the collateral may very likely be Greek debt. On 10th May, the ECB launched the Securities Market Programme (SMP), to provide liquidity to dysfunctioning market sectors via open market operations, and has since bought in Greek debt. With these interventions, the focus gradually shifted to other economies.

In fact, these efforts were all based on the ultimate premise, that Greece was merely
facing liquidity problems, rather than insolvency issues, and the measures taken were to deal with temporal anomalies. Circumstances today show Greece’s financial woes deepening, apparently with no cure without comprehensive measures or external force. Even with the emergency measures, Greek problematic assets of major agencies have ballooned significantly, making the turmoil more unsolvable.

From the ECB’s standpoint, with SMP having bought Greek bonds and the lending facility holding Greek collateral, in any restructuring case the ECB itself would recognize losses and require EA members to recapitalize it. Moreover, the ECB may not continue to provide funding for Greek collateral, thereby creating an immediate risk of liquidity squeeze in Greece. Additionally, restructuring would also damage the balance sheet of private investors, mostly EA financials. If this is not carefully dealt with, an impeding financial crisis could be triggered. In light of the huge implications, the IMF has taken a firm stance against any form of restructuring.

Understandably, there are voices calling for restructuring, since the bailout of Greece is an unpopular approach. Meanwhile, any delay in the deficit reduction progress of Greece has haunted other EU members, given doubts in the EU on whether Greece is determined to honor its current obligations. In addition, recently there have been reports from a Greek MP accusing the current prime minister of treason, due to allegations that he has a vested interest in betting on Greece’s default. If this proves to be true, it will add further distrust.

From a certain perspective, matters have thus become even more problematic: even if EU members are willing to bailout Greece, the possible vested interest of the Greek leadership could cause the bailout dilemma to become wrong either way. The accusations are, soon after assuming office, in Dec. 2009, Mr. Papandreou may have instructed a state owned bank to sell its Greek CDS holdings worth EUR 1.3 billion, to a Swiss private investment partnership closely held by his queers, and an IMF economist who participated the bailout negotiations. Furthermore, reports say that during April 2010, the Greek central bank surprisingly extended the settlement period of Greek government bond transactions from three days to 10 days, greatly facilitating naked short-selling, allowing more time to source the security.

By referring to previous sovereign insolvency troubles, we go back to the Latin American crisis of the 1980s. Since it began in 1982, developed nations have provided new funds via several channels and plans, but none were of significant help. But starting from 1989, several indebted third world economies used the so called “Brady Bonds” framework, named after then US Secretary of Treasury Nicholas Brady to arrange debt restructurings. The plan allowed commercial banks to exchange their loan claims into secured tradable market instruments at a discount.

There are two steps in a Brady style restructuring: in the first round, creditors in congregation negotiate with the debtor a "menu" of options in which their claims could be transformed into. There are usually three options: swapping claims at a discount for 30 year bonds that pay market interest; swapping claims at par for 30 year bonds that pays below market interest; and if neither, provide new unsecured loans at market interest to tax the capital gain from improved credit ratings, as default becomes less likely once debt is reduced. After the menu parameters are agreed upon, in the second round, creditors convert their existing claims into their choice among the "menu" of options. Creditors then receive the newly issued “Brady Bonds”, usually secured by specially issued US Treasury 30-year zero-coupon bonds, purchased by the debtor economies using money lent by international agencies.

After the transaction, the debtor will undergo market liberalization reforms under supervision of the IMF and other institutions, including currency depreciation, reducing market regulation, liberalizing domestic markets and sale of state assets. The general perception regarding the success of Brady Bonds was due to the co-institution of debt reduction and market reform, which could stop capital evasion and even lure back those that were scared away by the oversized debt burden, thereby helping to stimulate economic growth and eventually grow out of indebtedness.

Unfortunately, Greece can’t follow this path.
First, in the Latin America crisis, the debt was mostly direct loans made by banks to the debtor economies. Without securitization, it was easier to negotiate on the terms, and the number of financial institutions suffering damage would be limited, causing less macro effect. The Greek debt of today takes the form of securitized bonds with numerous claimants; in any restructuring it would cause an indefinite number of financials to recognize losses, causing widespread macro effect.

Secondly, Greek faces the challenge of incompetence and capital outflow, both usually solved by currency depreciation, which Greece is incapable. Even with reduced debt, if Greece still uses the Euro, it will remain incompetent; hence, it must find a way to leave the EA. However, just as any good company – bad company corporate restructure, the better and remaining portion needs to guarantee the failing part. Yet, in today’s European political landscape, disbanding Greece from the EA would signify the Euro’s failure, and an open-ended commitment to Greece by the remaining members is politically unacceptable. Lastly, the Brady plans had the backing of the US Treasury Department, but with the ECB already deeply entwined and most EU members also indebted, it is doubtful if anyone can assume the backer’s role.

In conclusion, considering the current circumstances, a structural resolution of Greece is difficult to achieve, which is why European economies and the IMF seem so indecisive. Although Greece can’t fully adopt the Brady approach, there are still some maneuvering grounds. Recent Greek polls show that 80% of its citizens support state asset sales to pay the debt, in which in the first step Greece is expected to dispose about EUR 50 billion worth of state assets, mainly real estate.

At the same time, there is common ground between Greek political parties on putting Greece back on track, where the disagreement is not on whether to do so, but on how and what to do. The Greek public attitude will gradually shift from surprise and unacceptance to a more realistic “deal with the matter.” However, the ultimate problem of Greece lies in its competitiveness.

Asset sales and austerity may find breathing time, but there are no plan to improve competitiveness internally. Even for Germany it took almost 10 years to accomplish a successful structural transition, hence in the foreseeable future, the Greek issue will continue to be a problematic matter to all sides, and persistently disrupt the markets and endanger regional stability. (The author is President, Polaris Research Institute & Honorary Professor, and Professor at College of Technology Management, National Tsing Hua University.)
To Short-sell China and Southeast Asia

Zhenya Liu

As its economy has begun to grow ever faster in the past 10 years, China has become more and more important to Southeast Asian economies. The volume of exports Southeast Asian economies to China grew from 2% to 4% at the start of this century, and soared to 8%-12% in 2010, 3-4 times the previous figures.

Today more and more international speculators expect the Chinese economy to suddenly collapse. It seems not too hard to short sell China, but it is indeed difficult to put that into practice. If the Chinese economy declines in the future, what are the potential investment tools that should be used to get rid of the underlying risk and even be used to reap benefit from such a decline?

Figure 1: The proportion of exports to China

In the perspective of the international speculators, the real estate sector is obviously accompanied with bubbles and is the most suitable target for short selling. Jim Chanos, a famous bearish speculator of Wall Street, once declared that “the real estate sector of China is a thousand times or even much worse than Dubai”. Just before the sub-prime crisis in the US, some insightful investors had shorted US’s real estate sector, and they became winners from that crisis.

Nowadays, some international speculators want to copy what they did to the US. However, the differences are that the Chinese real estate sector may not be at the edge of a crisis, as the US was, and so there are not so many tools for short selling. The Chinese financial market is less developed, the most frequently used investment tools, such as
CDS, are not available in China, which makes the bearish strategy less likely to be successful.

Chinese financial institutions do not use high credit leverage, and the house purchasers have to make down payment, about 30%, with their own funds, instead of borrowing from the banks. Additionally, in the absence of complicated derivative financial tools, the banks and other financial institutions will not suffer from the ensuing devastating destruction resulting from these tools.

It has been a new era for Chinese investors, since the birth of the stock index future in April last year in China. However, for the foreign short sellers, there is only a slim chance, and their ability to sell short in the stock market is very limited.

On 6th May of this year, the China Securities Regulatory Commission (CSRC) announced “Guidelines on the Participation of Qualified Foreign Institutional Investors (QFII) in Stock Index Futures”, released QFII in the participation of the stock index futures business. They can only take part in some limited hedging transactions, and they are not allowed to issue derivative products in overseas markets based on Chinese stock index futures. The stock index future could not be used for arbitrage or improper speculation purposes.

B stock market is a potential tool to short sell Chinese economy, but the problem is that the B stock market is of a small volume, only about RMB 200 billion. It can at best satisfy the needs of some small-size hedge funds. With respect to its influence on the A stock market, the latest study showed that there is barely any co-movement between the two markets, for example, on 27th April of this year, the A stock market declined by only 0.46%, while the B stock market declined by 5.33%.

In the context of the limited openness of the Chinese capital markets to the foreign investors, attempts have been made by the international capital to introduce some financial products that are closely related with the Chinese stock market, which is an indirect method to participate in the Chinese capital market. Theoretically, these derivative financial products may facilitate the short selling of the Chinese economy for the foreign investors.

The ETF of UltraShort FTSE Xinhua China 25 (FXP) went on the market in the New York Stock Exchange in November, 2009. If overseas investors take these 25 companies for reference of the Chinese real economic condition, there is a large chance of getting a biased impression. This is only one ETF designed exclusively for the purpose of selling short the Chinese economy, while the others are devised to share benefit of the economic growth of China, and most of them are actually bulling the Chinese economy.

Due to the high correlation between commodities’ prices with the Chinese economy, these prices are good indicators of the economy. In the current situation, some hedge funds have used commodities as their main tools, especially in China. But the difficulty is that if they buy long the commodities, the risk is already high; if they short sell the commodities, China will benefit from this.

In sum, to short sell China is not easy. Of course, it is not good for Southeast Asian economies either. (The author is Professor at Renmin University of China, Beijing and The University of Birmingham, UK)
CM Best Practice

The Driving Force of Sustainable Development: New Deantronics Acting Cautiously through the Transformation Crisis

Chia-Wen Huang

New Deantronics Co. was established in 1987, offering research, development, production, and sales of the RF and high energy based medical devices and accessories. As the global largest OEM supplier of the Electro-Surgical Pencil, its sales volume of the products has reached 25% of total sales in the world.

In the past, all the business of New Deantronics centered on original equipment manufacturing (OEM); in recent years, it has being proceeded gradually towards original design manufacturing (ODM) as well as the establishment of private brand and diverse products. Nowadays, it also extends its business field to a popular product, Automated External Defibrillator (AED), as an OEM partner of Philips to produce part and components.

The excessive concentration on a few customers leading to a crisis

Since the establishment of New Deantronics Co., its business had largely been under smooth going. The 1997 Asian financial crisis and the 2008 global financial crisis did not affect the company's operation; by the contrary, its turnover even went up sharply in 2008.

However, the operation crisis New Deantronics actually met occurred in 2002. At the time, New Deantronics’ second largest customer, who contributed 10% of the total sales volume to the company, withdrew from the Electro-Surgical Pencil market. It resulted in that New Deantronics’ annual turnover experienced negative growth for the first time in the history.

In the past, New Deantronics over concentrated on the US market. Its biggest US customer accounted for 80% of the company’s turnover. The withdrawal of the second largest customer from the market let New Deantronics reevaluate this sale strategy.

“It is a great risk to rely on a few customers excessively. Through this experience, we decided to change our business strategy, beginning to develop private brand markets outside the US to disperse unseen risks”, said GM Arthur Chi. He
pointed out that New Deantronics’ goal is to have any customer account for below the ceiling, that is, 40% of New Deantronics’ turnover.

**Change for success: diversifying the market to create profits**

The European market is the primary objective of New Deantronics’s strategy of diversifying the market. Thus, New Deantronics strove to expand the European market.

Although this strategy made the turnover grow up sharply in the short term, the profits did not increase accordingly. Therefore, New Deantronics started to modify the strategy in the European market and screen customers with criteria of similar management ideas and cultures, and who were not pursuing price competition. As a result, New Deantronics kept only one customer in each economy.

This crisis taught a lesson to New Deantronics not only on the danger of the excessively concentrating on a few markets but also in the need to review OEM’s price competition strategy.

At first, when New Deantronics diversified its market to Europe, even though the turnover increased, the real profits reduced. This lesson prompted New Deantronics decided to enter the ODM market, which made New Deantronics experience the second negative growth in turnover.

**Transformation and upgrading: Manufacturing towards innovation, research and development**

However, it is proved that this decision is correct. The ODM business not only improves largely New Deantronics’ ability of research, development and production technology, but also introduces a lot of R&D manpower. Thus, it can get involved in the fields of higher-level emergency medical device, cosmetology, minimally invasive surgery, and orthopedic surgery, making New Deantronics grow up for 30-40% in recent years. The business of orthopedic and minimally invasive surgery equipments are the main source of profits for New Deantronics.

It is certain that to enter the emerging ODM market, New Deantronics must adjust its operation direction from the former on manufacturing to R&D, and then to employ and cultivate its own R&D team.

“In the past, OEM only needed a few R&D engineers. However, for ODM/OBM, R&D employees in various fields are necessary, such as in materials, industrial design, automation, production technology, R&D software and even professional law employees”, said GM Arthur Chi.

Thus, New Deantronics’ R&D employees have increased from the previous two to over 20 persons. At present, ODM/OBM has accounted for 40% of New Deantronics’ turnover.

Since New Deantronics’ establishment, it has been drafted its company development plan for every five years and to date, it has stepped the fifth five-year plan. From the early OEM and ODM to OBM of this five-year plan, New Deantronics carefully designs each plan and implement them step by step.

“The goal of the next five-year plan is to develop its private brand, improve automotive production and R&D capabilities through design and innovation”, said GM Chi.

As R&D became more and more important to New Deantronics’ growth, GM Chi found that it is difficult to get excellent R&D employees. “R&D resources in Chinese Taipei are concentrated excessively in electronics and information industries. In other industries, professional R&D engineers are rarely available.”

He also pointed out that the R&D process of medical products is quite strict. Certification of medical products requires very long time and many steps such as risk assessment, product validation, bio-compatibility testing and so on. However, the product life cycle in medical products can last for a long time, comparing to electronics and information products, whose life cycle is short and changes of technology and products are fast.

In addition to providing R&D personnel with excellent working environment and fine equipment, New Deantronics also takes the educational training very seriously and often selects R&D employees
to study abroad. “Professional personnel are the greatest resource in our company. Even though it may be thought that putting too much resource in training is a waste given the high turnover rate of R&D personnel, we regard it as the only way can we retain professionals”, said GM Chi.

In response to soaring raw material prices and currency appreciation

Concerning the soaring raw material prices and currency appreciation, they generated little impact on the operation of New Deantronics even though it relies on foreign markets and copper, oil, and plastic as raw materials of production. This is mainly because there is a pricing model set between New Deantronics and its customers.

When the raw material prices and the exchange rate fluctuate, the client agrees that New Deantronics’ product prices could be adjusted in every quarter accordingly, making New Deantronics not be easily affected by the raw material price and exchange rate fluctuations. However, the key point is why the customers would be willing to share the risks of the raw material prices and exchange rate fluctuations?

“The medical equipment industry is a relatively conservative industry. Since R&D and certification take a long time, it is also time consuming to test the trust between customers and suppliers and determination of insistence on quality. For example, New Deantronics spent a few years to be a supplier of Philips. Thus, it is more important to be honest to construct a good partnership. With this partnership, we can solve problems together and create a win-win situation”, said GM Chi. The price model mentioned above is also an important reciprocal method to maintain a stable supply and demand relationship.

In financial management, New Deantronics always holds a careful and conservative attitude and do no more than they can. They have never use stock or derivatives as a tool for their financial operation. They just focus on its business, maintain a good financial condition as well as trustful relationship with the banks.

In fact, this conservative attitude also reflects on the New Deantronics’ strategy of moving steadily and avoiding blind expansion. Although this strategy makes New Deantronics unable to enjoy high growth, it avoids the crisis resulted from the high financial leverage.

CALL FOR PAPERS

“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.
Escalation of Greek debt crisis incurred the worries of the re-occurrence of financial crisis

After the financial crisis in 2008, the 2011 Greek debt problem might be the trigger to another wave of financial crisis. At the moment, Greek debt problem is near the edge of erupting into a new crisis. Whether it would default or not depends on the fifth bailout from EU and IMF. However, in order to obtain such fund, a strict financial reform policy would need to be executed; that is, Greek government must gain domestic support for cutting budget.

What makes the matters worse is the downgrade of Greece’s credit rating by international renowned credit rating companies. Standard & Poor’s downgraded Greece’s rating to the lowest – CCC – and changed the forecast to negative. Moody’s Investor Service also changed Greece’s credit rating to Caal and forecast to negative. Fitch Ratings also downgraded Greece’s rating to B+.

The key factor of resolving this crisis is the ways to deal with Greek debt problem. The debt restructuring methods included bond swap, extendible bonds and debt conversion. However, all these measures are seen as default by credit rating institutes and would cause them to downgrade the credit rating. For example, S & P viewed this as selective default. The ratings of Greece’s various lending facilities would also be downgraded continuously. This would cause Greece’s bonds to lose its status as eligible collaterals and would bring enormous losses to Greek financial systems and every Greek creditor. This means Greece’s default would bring a chain effect and endanger the global financial stability.

Many experts believe the collapse of Eurozone is unavoidable in the long run. However, in the short run, the most worrisome challenge is a possible systemic crisis derived from Greek debt problem. Greek problem might be solved temporality but the imbalance in growth among EU members would create difficulty for ECB to effectively use policy tools. For example, the ECB’s raising of interest rate in July would worsen the financial burden and limiting the ability to resolve deficit and repay loans for those EU members already in economic turmoil.

The prospect of Europe and US economies is full of uncertainty

The risk of Greek debt crisis spreading outward is largely increasing. EU and IMF need to prepare responding policies for the possible contagion because Greece is not the only economy of EU in need of assistance, but the neighboring weak members such as Ireland and Portugal, Spain and Italy are also involved. In the future, they might need bailouts. However, continuous bailouts would not solve debt crisis. Credit ratings might continue to reflect that the current problematic situation remains unresolved. EU banks have already tightened credit to lower banks’ risk exposure to other EU members. Once the liquidity problem occurs among banks, another financial crisis would break out.

US would be affected as well. EU’s debt crisis would drag US economy into recession like former Federal Reserve chairman Greenspan believed. Other than external EU crisis, the US also has a risk of debt default in the future due to the difficulty to raise statutory debt limit, and might lose its 3A credit rating. However, even with the raising of debt limit, the enormous amount of debt – USD 1400 billion billion is also a problem that needs to be dealt with.
At the same time, US economic statistics do not promise a rosy future, either. The unemployment rate is over 9% and economic growth rate is expected to be lower. Consumer confidence did not strongly recover and there are many vacant houses that cannot find the buyers. Faced with inflation, Federal Reserve temporality would not change its low interest rate policy for the sake of economic growth. All these show that the alarm that US economy might fall into double dip recession has not been all clear yet.

**China’s economic risk seems to be expanding**

China’s exchange rate problem is the reason behind the ever escalating inflation, which might damage the stable economic growth. The worst part of inflation happened to food prices. Food is a necessary and major expenditure component, and therefore, the rising of food price would lead to increase in wage and again inflation rate. The yearly inflation rate of food is as high as 11% while CPI maintains at a level above 5%.

Many economists worry more and more about China’s bad debt. In the past, in order to stimulate economy, China provided excessive loans through its local governments. People’s Bank of China nowadays noticed the existence of large amount of bad loans carried by over 8,000 local finance platforms, which were set up by local governments to avoid direct loan regulation. This risk would seriously harm the financial system.

At the moment, Standard Chartered Bank estimated that the amount of bad debt would reach RMB 12 trillion in 2012. However, government only promised to write off RMB 2 to 3 trillion. The rising of bad debt problem was caused by over production, a result of market demand shrinkage. When products are not sold, the investment cannot be reclaimed and debt cannot be repaid. The ever increasing bad debt rate shows it is not just the problem within the operation of a single corporation but a universal phenomenon.

However, China maintains a loose credit policy to sustain its economic growth that relies on investment and export. This would make repayment of bad debt even harder. Inflation keeps rising and banks’ profits are diluted by bad debt. Credit Suisse believes that the quality of assets held by China’s banks is fast worsen and therefore downgraded their rating from overweight to underweight.

In addition, Fitch estimated that 30% of bad debt held by China’s banks might come from local government finance platforms and real estate developers. Although it seems that the bubble of real estate market still sustains but under the expected tightening of monetary policy to fight the overheated market, it is quite possible there might be a burst of the real estate bubble in China and thus might affect future economic outlook.
While there are many books in the market dedicated to discussing the financial crisis, this book, published in 2009, has a different macro point of view and is very concise. The author, Vince Cable, is a member of the House of Common in UK and was the chief economist for Shell Oil Company. From his political and financial perspectives, the author discussed the context and the result of global economic crises and provided remedies at the end.

**Rome is not built in one day and cannot be destroyed in one day either**

The author pinpointed a number of views about the occurrence of the crises and the bankruptcy of the financial systems as follows:

1. Governments indulged in the illusion of prosperity created by the booming of new financial markets, and ignored the possible crisis that might come from the bubble.
2. When the crisis started, the upper level of the government lived in a fool’s paradise and vainly hoped for a safe passage.
3. The resources of oil and other energy are draining; the prices of foods are skyrocketing.
4. There is a major structural change in the world economy and a number of emerging economies like China and India are rising quickly.

After discussing and explaining the crisis from a broad perspective, the author used his political and economic experiences and background to provide concrete recommendations and future planning for dealing with the current crisis. For example, he stated that the leaders should be open-minded and push for the liberalization of economy in order to prevent protectionism during recession. It is also helpful to corporate with allies to overcome obstacles. The future planning includes reforming the world financial systems, dealing with the challenges of weather changes, and restarting world trade negotiation.

**Illusion and negligence**

The author used the fuse of UK’s financial crisis – Northern Rock Bank as an example and discussed how the crisis initiated by the bankruptcy of Lehman Brothers started and developed in the UK. Northern Rock, after reforming into a business bank, changed its marketing strategy and used mortgage packaging tactics and securitization financing to obtain great successes and profit. Other banks soon followed suit and the market looked very prosperous. On the other hand, in United States, the government was also rejoicing the prosperous illusion brought by innovative financial and derivative products. Governments were happy
to see the political benefits brought forward by the economic prosperity but ignored the possible loss and consequences that might come with the meltdown of the real estate bubble.

**Warnings and carelessness**

In fact, bubbles and crises happen repeatedly over the history. The banking crisis in Sweden in 1990 was a similar example. Before the global financial crisis, many politicians and academics sent out warnings. However, the ruling authority was obsessed by the profits and excuses given by the financial institutes. They protected financial industry’s interest and covered up everything to suppress everyone’s worries. After the incident happened, UK and US were slow and passive in reacting.

**Draining and speculating**

On the other hand, in terms of raw material, China’s need for crude oil rapidly increased after the industrialization, causing the unbalance of supply and demand in crude oil and other resources. The economy is prosperous and there is a huge finance surplus, causing the funds to move into energy and related minerals markets and the both prices reached record high.

In food market, other than the weather changes shocking agriculture industries, the development of biomass energy also requires the input of lots of grain. However, food exporting economies, facing the shortage of food, took protective measures and exhibited exporting, instead of increasing productions. Therefore, the prices of food remained high and affected the recovery of the world economy.

**Changes and rising**

At the same time, the world’s structure of economic powers also shifted. Emerging economies such as China and India provided the world with lots of cheap products and created an economic environment free of inflation pressure for western economies. With low inflation rate, the western economies were able to maintain low short-term interest rate. Asians’ virtue of saving and large amount of foreign exchange reserve enabled them to purchase US and European government bonds and helped lower long-term interest rate.

Low interest rate environment caused the western economies to have surplus in idle capital, which then led to a series of economic imbalance. The most eminent example was speeding up the formation of the bubble in the real estate market before the global financial market. Once that market came to a crash, a large storm visited. About this incident, the US blamed China for being the mercantilist and suppressing the value of the Yuan for the sake of exporting. Large export surplus encouraged China to further purchase the US asset and therefore, capital moved back to US and brought down the interest rate, inviting Americans to borrow money for consumption.

**Turning point and blueprint**

For the sake of crisis preparedness in the future, the author stressed, to a great length, liberalization and international cooperation. The rising of protectionism would generate xenophobia and might even result in unrests and wars. Economic crisis made economies question globalization. However, the source of the problem was not globalization but the flaws and defects that have already lied in of the system. Globalization only sped up the occurrence of crisis and added to its intensity. In the future, other than reforming the currency policies and banking systems, ruling authority should know that only lowering interest rate has no effect in energizing the market and bringing prosperity.

The author suggested that during the crisis, governments should temperately maintained demands so that the economy would not fall into the vicious cycle of recession. Borrowing money to expand spending could help companies and individuals gradually reduce debt and also restore confidence in the market. Politicians need to think about how to reduce the polarization phenomenon in wealth, income and opportunities, rebuild the cohesion of economies and heal the wounds brought by the storm.
While trade liberalization has brought many benefits to SMEs among economies, it also makes SMEs expose to greater risks. Because SMEs lack sufficient experiences in managing international risk, naturally they need assistances in these regards. In order to help SMEs engage in both trade liberalization and risk management to further ensure maximally overall advantage, the two-day symposium is held from 16th August to 17th August as a platform for perspective exchanges among APEC SME representatives, government officials, and experts of member economies.

If you need further detailed information, please do not hesitate to visit the website: www.apecscmc.org/2011. The online registration will be commenced from 18th July to 10th August 2011. We welcome your participation!

### Tentative Agenda

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<td>09:30-09:50 Keynote speech I: Importance of Export to SME Development and Economic Growth</td>
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<td>09:50-10:05 Keynote speech II: International Trade Environment Facing SMEs</td>
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<td>10:05-10:20 Keynote speech III: International Trade Engagement and its Associated Risks</td>
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<td>10:20-10:40 Tea Break</td>
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<td>10:40-12:00 Session I: Strengthening SME Competitiveness to Benefit from Trade Liberalization</td>
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<td>12:00-13:30 Luncheon</td>
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<td>13:30-14:50 Session II: The Factors Affecting the Exchange Rate Fluctuations and the Impacts on SMEs</td>
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<td>14:50-15:10 Tea Break</td>
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<td>15:10-16:35 Session III: How SMEs Use Forward Exchange Transactions and Forex Options as Hedging Tools</td>
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<tr>
<td>16:55-17:55 Session IV: How SMEs Deal with the Risks Created by Standards and Regulations of Foreign Economies</td>
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<td>09:00-10:20 Session V: Government Policy to Enhance SME Capacity in Coping with Fierce Foreign Competition Resulted from Trade Liberalization</td>
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<td>10:40-12:00 Session VI: Managing Credit Risk and Political Risk in International Trade</td>
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<td>13:30-15:00 Trade Liberalization and the Associated Risks Faced by Domestic SMEs</td>
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<td>15:00-18:30 Field Trip</td>
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