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Rich Achievements in Exploring the Risks Associated with Trade Liberalization

Under the recent crises of European and US debts, fluctuations in exchange rates and commodity prices may probably cause operational impacts for the export-led small and medium enterprises (SMEs). Responding to the issues derived from trade liberalization, the APEC SME Crisis Management Center (SCMC) held a symposium on this topic on 16th to 17th August 2011, and invited many distinguished experts to discuss the crisis and opportunities under trade liberalization, so as to help the SMEs understand more about the risks of export trade. More than six hundred people from the industrial, governmental, and academia fields and from different economies were attracted to attend this symposium.

Trade liberalization has forced SMEs to face severe international competitions, and therefore they have to strengthen their own competency from five strategies. The first way is to digitalize, applying ICT (Information and Communication Technology) into the core of business so as to make better decision and operation; and the second is to nurture the quality fundamentally, deepening the product technology through quality management and thus creating the uniqueness of the enterprise.

The third strategy is to implement cluster innovation, assisting SMEs in achieving synergy through clustering. The fourth one is to cooperate, encouraging the SMEs to enlarge not only intra-company but also intra-industry exchanges, which will enable them to create new business opportunities together. And the last method is to finance, assisting the SMEs with a financial guidance platform for accomplishing the accounting system, improving the financial structure, and accessing to funds for operation and development.

As essentially concluded in the symposium, SMEs will not be enabled to be engaged in foreign trades solely with the help of trade liberalization. They still need to overcome many risks and obstacles, and therefore they should be equipped with more comprehensive professional abilities in order to have a position in the severely competitive international markets.

The emphasis of this issue is to examine the prospects of global economic development, analyzing primarily the possibility of a double dip recession. The Crisis Alert section has indicated that although the doubt dip recession is not quite likely to happen, the advanced economies are very possible to keep weakening. We encourage SMEs in the advanced economies to expand to overseas markets, so as to get rid of the economic vicious cycle.

At the same time, in this issue we invite experts to discuss how the economies in Latin America can find out solutions to their financial problems under the shadows of the European and US debts as well as the possible economic recession. According to our expert, these economies take different counter-measures to respond to the economic slowdown. Based on the current circumstances, it is common that the central banks of these economies are unlikely to lower interest rate immediately because they are staying calm to see how the future will develop.

We also look into one of the Philippine case about how they assist their SMEs in exporting. F. T. Escalon, news editor in chief of Philexport Cebu News, has introduced the measures that the Philippines take to help SME exports, including teaching them the basic knowledge of currency hedging, offering them trainings about exportation, arranging business matchmaking, and providing services about market information.

In addition, there is a section particularly arranged in this issue, presenting the achievements of the APEC Symposium on Enhancing SME Capacity of Managing the Risks Associated with Trade Liberalization. Furthermore, “APEC Principles on Enhancing SME Capacity of Managing the Risks Associated with Trade Liberalization” will be formulated afterwards. Meanwhile in this issue, we introduce our readers a recently published book — Whoops!! Why Everyone Owes Everyone and No One Can Pay. This book examines how a crisis takes shape step by step in this “fake golden age” when everyone is in debts.

Based on the analyses offered in this issue, SMEs should find out ways to break through the current market situation with risks of recession, which certainly menaces their business operation.

Robert Sun-Quae Lai, Ph.D.
Executive Director
APEC SME Crisis Management Center
Right at the moment when the market has been overshadowed by pessimism because the credit rating of the US was downgraded by Standard and Poor’s, the US government revised the GDP (Gross Domestic Product) growth rate of the second quarter downward. Some research institutes also adjusted downward the expected GDP growth rate of both the US and the world. Under the circumstances, whole world has been overcast by the gloom of a double-dip recession. Since the global financial crisis, economies around the world have implemented rescue packages with attempt to restore the economic growth. After three years since the enforcement of those packages, however, the current outcome shows not only that they have not been too effective, but also that some side-effects have been generated.

**Post-crisis policies aiming to stimulate growth weakened the economy instead**

There are two kinds of stimulus measures that economies have taken: fiscal policies, and monetary policies, and they have generated different outcomes in advanced economies and in emerging economies. Under the direct impacts of financial crisis, the advanced economies have used all kinds of fiscal and monetary policies, but no prominent effect was brought about. On the part of fiscal policies, these economies spent a large amount of government budget rescuing banks and supporting social welfare, with an attempt to stabilize financial systems and stimulate consumption. As a result of this practice, the government budget deficits of these advanced economies have soared dramatically high and their debts accumulating rapidly. Consequently, the European and US debt crises—both very hard to tackle with—burst out; the governments, then, are forced by their overly high debts to adopt a certain policies unfavorable to economic growth.

As to the monetary policies, the advanced economies, one after another, enforced radical monetary policies with zero interest rate to inject huge liquidity into the market to stimulate economic growth. Indeed, these policies have greatly increased liquidity, but the excessive liquidity did not enter the real economy to invest or consume; on the contrary, they became hot money, searching everywhere for targets of speculation. Trading in the commodity markets has become active and resulted in the increase of oil prices, which has not only retarded economic growth instead, but also worsened the inflation. To speak fundamentally, therefore, the post-crisis monetary policies of the advanced economies have little contribution to economic growth. On the contrary, they have increased commodity prices and thus hindered economic growth.

Because the fiscal and monetary policies that advanced economies have implemented in the post-crisis era are actually one of the main causes of the slow recovery and weak economic growth at the present time, situations will not be improved if these policies continue. Now the advanced economies’ fiscal policies have come across
a bottleneck. Their government finances have become a burden that drags economic growth and restricts the space of maneuver of fiscal policies. Comparingly, the monetary policies may probably still have some space. However, post-crisis experiences show that it did not generate too much effect from these policies. Theses policies, on the contrary, will cause inflation and an increase in the prices of raw materials, and even trigger various kinds of crises.

The current weak recovery of the advanced economies comes from two sources: stagnation of consumption and shortage in investment, which are both related with the policies held by banks now. Banks have become conservative about their loaning after the financial crisis. Lack of access to loans from banks makes many small and medium enterprises (SMEs) unable to raise funds for expanding business and increasing employment. Since the SMEs are the primary source of employment in each economy, their inability to increase employment will prevent the economy from improving its unemployment rate, thus making it difficult to increase consumption. Without taking this problem seriously and finding solutions, it is highly possible that the economic recovery will continue to be feeble.

Banks’ policies are merely one of the factors, of course, and the overall international economic environment must be taken into account. As a matter of fact, the emerging economies are the real beneficiaries of the advanced economies’ easy monetary policies. These policies have led a large amount of liquidity to enter the emerging economies, not only stimulating consumption and investment there but also triggering a domestic-led growth. In the environment flooded with money, the emerging economies can support part of their growth by their own domestic consumption. If the advanced economies further strengthen their easy monetary policies, it would only lead to an overheated growth of the emerging economies, making the imbalanced growth between the advanced and the emerging economies worsen. Under this circumstance, For the advance economies to boost their growth, the only way is to increase their export to the emerging economies.

Although the likelihood of a double dip recession is quite little, that of a constantly weak economy in the advanced economies is rather large. The SMEs in the advanced economies still have to face weak demands and markets, and therefore we encourage them to reach to overseas markets, so as to get rid of the economic vicious cycle.
United States

The unemployment rate ticked down to 9.1% in July, down from 9.2% in June. The economy added 117,000 jobs, which is higher than what was expected. The July employment figures paint a picture of an economy that is growing very slowly. Averaged over the last three months, employment grew by 72,000 jobs, which is far lower than the 200,000 required bringing the unemployment rate down. If people who are working part-time because they cannot find full time jobs are added to the unemployment rate, the unemployment rate will be 16.3%. On a positive note, private sector employment rose sharply, while government sector employment continued to decline.

Another disappointing number was the GDP data. GDP climbed at a 1.3% annual rate in the second quarter, following a 0.4% (revised) gain in the first quarter. Consumer spending in the second quarter showed the smallest gain since the second quarter of 2009, when the economy was in a recession. The weak GDP data reflected a 4.4% fall in consumer purchase of durables such as washing machines. Economic growth in the first quarter was also revised down to 0.4%, from the 1.9% estimated earlier, reflecting smaller inventories and higher imports.

During the third quarter, a decline in government spending suppressed aggregate demand. Outlays by state and local governments dropped at a 3.4% annual rate, while non-military spending by the Federal government declined by 7.3%. This recent revision to the GDP data also showed that the 2007 to 2009 recession damaged the economy more than what was previously estimated. Output in the US economy has declined by 5.1% during those two years. Reflecting the recent weak employment and GDP data, many analysts now put the chances of a recession occurring soon to be between 33 and 50%.

In early August, the US Congress passed a law to raise the debt ceiling of the US government. The passing of the law followed tense negotiations in Congress that greatly raised uncertainty in global financial markets. The new law cuts spending by USD 917 billion over the next ten years, and sets up a congressional panel to aim for an additional USD 1.5 billion in cuts. If the panel is unable to come to an agreement, there will be USD 1.2 billion in additional cuts. However, some analysts and ratings agencies believe that the cuts do not go far enough to save the US from long-run fiscal insolvency.

The first round of spending cuts will hit the US economy in 2012, lowering government spending by USD 25 billion or 2.1% from the projected baseline growth. Analysts say such cuts will shave 0.1% to 0.2% points from the rate of US real GDP growth in 2012. Perhaps more
importantly, the recent debt agreement removes the flexibility of the US government to pursue expansionary fiscal policy should there be another negative shock to the economy. Given the general weak state of the US economy today, this loss of flexibility raises the risk of a recession, since it makes unlikely, a large countercyclical fiscal response.

In response to the weakening economy, the Federal Reserve in early August committed to keeping short-term interest rates near zero until at least mid-2013. This commitment means that many dollar-denominated risk-free interest rates will be hovering around zero for the next two years, suggesting a flattening of the entire yield curve.

This move is expected to weaken the dollar over the medium-term in foreign exchange markets.

**Canada**

Canadian GDP rose 1.5% in the second quarter (revised). Growth is expected to rise in the third quarter. CPI inflation is anticipated to rise to 2.8% in the third quarter and 2.6% in the fourth quarter. However, given the recent risk of recession in the US, if that happens, it is anticipated that the Canadian economy will slow down considerably. (The author is Professor at University of Southern California.)

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**Northeast Asia**

**Downgrading of US Government Securities: Impact on Northeast Asia and the Creation of Fiscal Discipline**

*Naoyuki Yoshino*

Downgrading of US treasury securities had various impacts on Northeast Asian region, and it showed that each economy should follow the fiscal discipline to cope with the burden of the deficits for future generation. The downgrading generated impacts on China and Japan, ones of the largest foreign owners of the US government securities. Some US government officials questioned the transparency and accountability of the rating and believed the downgrading lacks a legitimate reason.

After the sub-prime loan crisis, the doubt about the credit rating agency had been raised in various occasions. Their credit ratings of housing loans to low income group were rated very high. However, after the crisis, it had been downgraded all of a sudden.

**Debate for the credit rating methods**

After the sub-prime loan crisis, there are various criticisms toward credit rating. Issues to be discussed about the credit rating in general can be summarized as follows:

1. Credit rating is a prediction of the future state under normal economic conditions, and its effectiveness is very limited when an unexpected event occurs. The same thing can be said about credit examination and investment decisions.

2. If we attempted to reflect potential impacts of unexpected events in credit ratings, we would be unable to make such credit ratings that fit in the normal economic conditions.

3. There are two opposite ideas about what credit rating ought to be: ratings flexibly responding to changing conditions and stable ratings.

4. Corporate finance credit ratings are likely to vary according to various factors (changes in business results or external environments, etc.).

5. There is a gap between simplicity represented by a rating symbol and complexity actually arising
in the rating process.

6. If a credit rating depends on publicly available information alone, the slow-acting effect of the rating cannot be avoided.

7. Rapid and drastic downgrading of a credit rating could make the situation even worse.

As for the ratings of sovereign bonds, further issues have to be taken into account besides the credit rating for corporations:

1. Estimate of the government long term hidden debt such as medical care, medicaid, and estimated required pension reserve, etc.;

2. Government commitment to cope with the budget deficits;

3. Flexibility of the tax system and flexibility of the government spending to cope with the budget deficits both politically and institutionally.

The US government bonds

Table 1 shows the ownership of US Treasury securities. Besides FRB (Federal Reserve Board) & intra government ownership, it is largely held by foreign investors. Downgrading of the US Treasury securities will have large impacts on foreign owners.

Table 1 shows the share of foreign ownership excluding the holding of FRB & intra government amounts to 55.09%. Figure 1 summarized the major foreign investors of US Treasury securities. China owns 27.32% and Japan holds 19.65% of all foreign investors followed by oil producing economies (5.16%). The current account surpluses of China and Japan made their economy accumulate its foreign reserves by US dollars. It is natural to invest their accumulated US dollars into dollar denominated assets. Downgrading of US treasury securities shift away from US securities to other currency denominated securities such as Japanese Yen, Swiss Franc etc., which push up their values.

Not only United States but also some of European economies and Japan are facing huge budget deficits. What is needed in many economies is to establish the fiscal policy rule and set it up as a commitment of the government. In monetary policy, there is Taylor rule which ask the central banks pay attention to the inflation rate and economic growth to pursue their monetary policy.

Each government has to make commitments to its fiscal policy so that the expansion of the budget deficits could be avoided. Otherwise the downgrading of government bond would be seen in various places in the market which would create financial turmoil. (The author is Professor of Economics, Keio University.)

<table>
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<tr>
<th>Ownership of US Treasury Securities</th>
<th>%</th>
<th>Ownership excluding FRB &amp; Intra government</th>
<th>%</th>
</tr>
</thead>
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<tr>
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<td></td>
<td></td>
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<td>Depository Institutions</td>
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<td>8.43</td>
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<Table 1> Ownership of US Treasury Securities

<Figure 1>
Since Thailand’s army took over power in September 2006, the political situation in Thailand has become continuously unstable. This unstable political situation has created a big problem with regard to international investor confidence, and money soon flew out the economy.

According to Wikipedia, the political situation in Thailand in this period was described by the following: “Since 2008, there has been an ongoing political crisis in Thailand in the form of a conflict between the People’s Alliance for Democracy (PAD) and the People’s Power Party (PPP) governments of Prime Ministers Somchai Wongsawat and Samak Sundaravej, respectively, and later between the Democrat Party government of Prime Minister Abhisit Vejjajiva and the National United Front of Democracy Against Dictatorship (UDD). It is a continuation of the 2005–2006 political crisis, wherein the PAD protested against the Thai Rak Thai (TRT) party government of Prime Minister Thaksin Shinawatra. The PAD’s followers usually dress in yellow, called 'the yellow shirts', the royal color of King Bhumibol Adulyadej. The UDD’s followers dress in red, widely called 'the red shirts', known as the supporters of the deposed Prime Minister Thaksin Shinawatra.”

But more recently, this changed as Yingluck Shinawatra, sister of former Prime Minister Thaksin Shinawatra, won the election. In the latest World Bank report on Thailand, the economy was upgraded from lower middle income to upper middle income, which is defined by average incomes of USD 3,976 to USD 12,275.

Actually in the past ten years, Thailand’s economy has grown strongly; poverty has reduced; political awareness of the rural population has increased. Even in the face of political chaos, Thailand still kept a business-friendly tax regime, hospitality and services beloved by foreigners, a low-wage platform for manufacturing, and generally pro-investment governments. All these helped Thailand’s economy through even the worst of its political problem seen in history.

Despite the political meltdown of the past five years, and the bloody standoff in Bangkok last spring, Thailand has maintained its economic momentum. Thailand’s economy grew by over 7% in 2010. According to the National Economic and Social Development Board (NESDB), in the first three months of 2011, Thailand’s gross domestic product (GDP) increased by 2% from the previous quarter. That would translate into an annualised figure of 8%. In common with other economies in Asia, rising prices of food and fuel are pushing up inflation in Thailand.

After Yingluck Shinawatra was elected in June, the political situation in Thailand seems much more stable. Many analysts believe the Thai economy will improve in the second half of 2011. However the newly elected Thai government should pay more attention to food prices, avoid hard economic decisions and think more about how to upgrade the economy’s workforce.

Food prices in Bangkok have been seen to jump in recent weeks. All fresh food market prices—coconuts, vegetables, fish—are all higher in the markets, which most households rely on. For Bangkok’s external sector, the biggest issue is the currency. The baht is stronger now than it had been for years—about THB 30 to USD 1—which is damaging to Thailand’s popular exports of rice, especially when neighboring Vietnam undercut their rice prices.

Thailand’s educational system is a big
problem, and this low quality education is preventing the economy from rising up to value-added. Eventually, even low wages and a business-friendly environment will not be enough of a competitive edge. In the past, neither Thaksin nor successive Democratic governments took serious steps to improve Thailand’s education system. New Prime Minister Yingluck Shinawatra also does not seem to understand the importance of Thailand’s educational deficit. Yingluck needs to set up her education reform plan and appoint a more experienced person as the Education Minister in her new cabinet to improve Thailand’s education system. (The author is professor at Renmin University of China, Beijing and The University of Birmingham, UK.)

Falling Global Demand Clouding the Region’s Growth Outlook

Kenneth Waller

The Reserve Bank of Australia (RBA) adjusted its 2011 growth forecast down from 4.25% to 3.25% and the National Australia Bank business survey of 9th August noted that growth was losing momentum and that the economy is now “travelling below trend levels”. The drop was largely observed in finance, business services, manufacturing and in the service sectors and the impact of rising global uncertainty. Notwithstanding a softening in the economy, Australia continues to benefit from strong terms of trade, that is, the prospect of a resumption of full coal production (by late 2011)—following losses arising from the floods in Queensland earlier in the year—and strong mining investment generally.

The unemployment rate rose to an eight-month high of 5.1% in July from 4.9% of the previous month; employers are growing more cautious about hiring full-time staff reflecting the uncertain economic outlook. Goldman Sachs & Partners Australia Pty predicts a further unemployment rise above 5.25% in the coming months. Notwithstanding an increase in the jobless rate, the government notes that the labour market remains resilient and is still the envy of the world.

The Westpac-Melbourne Institute Consumer Sentiment Index for August dropped 3.5% from July to 89.6, its lowest level since the depths of the global financial crisis. The services and retail sectors have been particularly affected in the last two quarters; employers have reduced pay roll expenditures and households are cutting back on consumption. While inflation remains at the high end of the RBA’s target, the central bank refrained from an official rate rise at its last meeting and some analysts predict that the next move in the official rate will be downwards. Much will depend on the outlook for international growth. Given the uncertainties in the US and Europe and the likely impact of a serious global slowdown in activity, the RBA is likely to become increasingly hesitant about a rate rise in coming months.

Exporters are raising concerns over strong Australian dollar which has risen by over 14% in the past year. Mining exports to Asia have seen Australia’s terms of trade soar to a 160-year high and underpinned a sustained surge in the AUD. The declines in consumer confidence, rising unemployment and a strong dollar based on the mining sector have created a two-track economy.

The RBA Governor has noted that Australia’s stronger currency, the decline in consumption and higher savings may be the “new economic reality” and that industry should respond to these challenges by improving productivity.
The head of Australia’s mining giant BHP Billiton noted in a recent interview that the Australia is well placed to weather and any new economic crisis, but expressed concern on over-reliance on mining exports (Australia earns more than AUD 8 billion from iron ore and coal exports monthly). “Taking a bet on one sector is not the answer. A better long-term strategy is to have a balance of manufacturing, resources and services.”

India

The Planning Commission is contemplating on adjusting downward the economy’s growth target for the 2012-17 period to about 8.5-8.7% from an earlier 9-9.5% as a consequence of the bleak global growth outlook. Compounding economic management problems are the relatively high fiscal deficit of around 8% of GDP, and a current accounts deficit of over 2.5%. On sectoral basis, projections are for agriculture to grow by 3.5% but for a slowdown in industry and services growth by 7.4% and 9.0 % respectively.

Despite 11 rises in the policy interest rate since March 2010, from 3.25% to 8%, India continues to struggle to contain inflation; the headline inflation was at nearly 9.5% in June, and in July, food inflation had risen by nearly 10.0% over the last 12 months. The central bank noted that inflation is far above the threshold level of 5%.

Managing inflation over the period ahead will involve further interest rate rises, and this combination of rising rates and prices is impacting on investor perceptions. India’s equity market is down by nearly 14% in the year to date. Concerns are growing that inward portfolio investment and foreign direct investment will be adversely impacted by the current international outlook and domestic management problems.

The Prime Minister’s Economic Advisory Council (PMEAC) noted that the RBI (Reserve Bank of India) “will have to continue to maintain a tight monetary policy for quite some time, given the combination of domestic inflationary situation, the international backdrop and the fairly strong growth that the domestic economy is experiencing”.

In the April-July period, exports reached USD 108.3 billion, and imports were USD 151 billion, making a trade deficit of USD 42.7 billion. Robust exports included engineering products at USD 32 billion, gems and jewellery at USD 13 billion, petroleum and oil products at USD 19 billion, man-made yarn and made-ups at USD 2 billion, electronics at nearly USD 4 billion, and readymade garments at USD 5 billion.

There is some apprehension on the sustainability of export performance due to economic uncertainties in the economy’s main markets—the United States and Europe. These two markets account for about 35% of India’s total exports, and there are fears of a sharp export deceleration in the remaining months of 2011. Full-year export growth could be between 20% and 25%.

New Zealand

The Finance Minister noted that the economy is in good shape to face global economic uncertainties “because it’s got its debt under control”. He believes that the Reserve Bank knows how to manage the current uncertain outlook because it "learned a lot from 2008 and that most households have got the messages from the world that they need to borrow a bit less and save a bit more."

Confirming a somewhat improving sentiment, the survey of consumer confidence for the period 25th July to 7th August recorded an increase by 3.9 points to 113.3 points, its highest level since January. Analysts suggest that consumers feel more positive about the prospects of the domestic economy amidst the unstable conditions overseas. The survey showed a rise in the number of respondents who consider that this is a good time to spend on household appliances to levels seen before the financial crisis.

Adding to positive short-term prospects, it is estimated that the 2011 Rugby World Cup, the largest sporting event ever to be held in New Zealand, will attract some 95,000 visitors. The cup will be played over seven weekends starting 10th September until 23rd October. The central bank estimates that tourist spending will reach NZD 700 million, equivalent to about 1.4% of quarterly gross GDP.

This is a welcome development as the tourism industry had been battered by both the strong NZ dollar—around 20% above its long term rate with
the US dollar—and the prevailing global financial crisis, resulting in lower visitor numbers from Asia, the United States and Europe.

In contrast, the investor confidence index has fallen. The Confidence Survey reported that the overall index declined in the second quarter levelling out after falling in March following the February earthquake. A strengthening local economy is needed to generate positive investor perceptions that New Zealand is a safe international investor option.

Manufacturing contributed 12.5% of GDP in the quarter to end March. The sector grew by 1.9% (in terms of volume) and 2.9% (in terms of value) in the first quarter of 2011. Machinery and equipment manufacturers are the fastest expanding sub-sector, followed by food, beverage and tobacco. Output in the petroleum, coal, chemical and associated product sectors declined. The services sector grew over the six months ending July. However, the BNZ-Business NZ Performance of Services Index dipped slightly to 54.5 in July, but there were welcome gains in new orders and in supplier deliveries. (The author is Director, Australian APEC Centre at RMIT University.)

**Latin America**

Rate hike cycle likely comes to an end—rating downgrade risk increases

*Cheng-Mount Cheng*

Financial markets tumbled in August to bring a new round of uncertainty to the global economic outlook. In particular, S&P’s downgrading the US long term sovereign rating to “AA+” from “AAA” with negative outlook has ignited new rating review on other AAA economies. As a result of those developments, we think Latin America (Latam) central banks will likely stop rate hikes in their monetary policy except for few economies whose inflation pressure remain stubbornly high. Here are some of recent developments for the Latam economies during the past month.

**Brazil Copom raised policy rate to 12.5% but signaled for a pause**

On 20th July the Brazil Copom decided to hike the Selic rate by 25 basis points to 12.5%, in a unanimous decision. In the statement, Copom thought there was no bias regarding to the balance of risks between growth outlook and inflation. Compared with previous statements in which the monetary authority highlighted the risks for inflation that would need adjustments in monetary conditions for a sufficiently prolonged period, this time Copom statement appeared more laconic that could open the door for a pause. In 28th July, the Copom minutes made it clear that the inflation risk has become more favorable, on moderation in recovery of developed economies, softer pace in domestic demand growth, and recent accommodation in commodity prices. Nevertheless, Copom’s inflation forecast remained about the target, suggesting further Selic rate hikes may be required if the monetary authority aims to bring inflation back to mid-point target of 4.5% in 2012. On balance, future rate decision should be data dependent but with recent financial market turmoil, it’s likely that monetary tightening cycle may have ended with Selic rate at 12.5%.

On 27th July the Brazil government amplified the incidence of IOF tax to exchange rate derivatives contracts. According to official decree, the IOF tax of 1% (calculated over the notional value) will apply over any derivative operation (above USD 10 million) that is affected by exchange rate variation. Before this action, the government had increased IOF tax several times, although derivatives operations were always...
exempted. In this sense, the new measure was aiming to curb further the appreciation trend for the Real.

**Colombia Banrep increased policy rate to 4.5% with hawkish statement**

On 29th July the Banrep decided to raise its policy rate by 25 basis points to 4.5% that was in line with market expectation. According to the communiqué, inflation increased for the second consecutive month and some pressure on core inflation indicators has begun. The central bank considered that economic activity indicators for the second half of 2011 were displaying positive results, leading it to change its GDP growth forecast range from 4.5%-5.5% to 4.5%-6.5%. In the press conference, central bank director Jose Dario Uribe mentioned that the rate hike decision was not unanimous. Also, no additional measures regarding foreign exchange rate were mentioned. Despite that the meeting took longer than usual, the communiqué was not much different from those published in previous months and still considered hawkish. This implied that the intensity of the discussion among board members was high and that some strategy for further intervention in the foreign exchange markets could be implemented if a specific threshold is breached.

**S&P downgraded Venezuelan long-term foreign and local currency ratings**

On 19th August Standard & Poor’s rating services downgraded the Venezuelan government’s long-term foreign and local sovereign credit ratings to from “BB-“ to “B+“. The new rating carries a neutral outlook. The communiqué mentioned the downgrade comes after S&P’s adoption of the revised methodology and assumptions for sovereign ratings, which assigns a higher weight to political risks. In the rating agency’s view, changing and arbitrary laws, price and exchange rate controls, and other distorting and unpredictable economic measures have undermined private sector investment and hurt productivity, which have been weakening growth. S&P also states that the recent deterioration of President Chavez health could contribute to the uncertainty. Nevertheless, the oil and gas reserves offset the policy uncertainty up to some extent and therefore justify the “B+” rating. The agency highlights that ratings could go further down if the price of oil stays low for a significant period of time and the political situation deteriorates; or, alternatively, ratings could go up if fiscal and external indicators improve and policies aimed at supporting investment and growth are adopted. With this downgrade, two of the major credit rating agencies have a similar assessment of Venezuela’s credit, while Moody’s view is one notch lower. (The author is Vice President, Citi Taiwan.)
Economic growth is unable to support the debt burden

Julius Sen

Overview

Although many people in EU governments and institutions were on holiday during the period of this report, a number of very important policy developments took place:

- A new stress test for EU banks identified only eight banks that failed the new and more rigorous tests.
- The EU summit on the debt crisis took surprisingly ambitious measures to resolve short, medium and long term challenges, without actually committing to the formal integration of fiscal policies.
- The European Central Bank (ECB) intervened heavily by buying Greek and Portuguese bonds, and then Spanish and Italian bonds, to bring borrowing costs down and stabilise markets.
- It is now assumed that the European Financial Stability Facility (EFSF) will gradually evolve into an IMF (International Monetary Fund) type organisation over time.
- The Italian government and parliament approved an accelerated programme to bring down government spending and debt by 2013.

Market reactions to these measures indicated a continuing crisis of confidence:

- After initial positive indications, the remaining part of the reporting period demonstrated wild swings in investor opinion.
- Stock markets have finally recovered (as of 15th July), following ECB intervention in the bond market, but broader concerns about growth remain.

The Eurozone crisis

The period under review was dominated by this issue, and the associated debate on problems in the US, UK, and Japanese economies.

While the Eurozone continued to move hesitantly towards finding a permanent solution to the crisis, together with the appropriate institutional reform and organisational backing, key elements of the process remain to be sorted out, and may require a change to the treaties and the approval of all governments.

On the one hand, economies like Germany, Holland, and France wanted highly indebted economies (mainly Greece, Ireland, Portugal, and Spain) to continue with governmental measures to rapidly reduce their deficits and debt levels, and so refused to agree to any substantive write-off or reduction in debt levels.

On the other hand, these same economies agreed to do just enough to prevent the crisis spinning out of control. Thus, they intervened to support the buying of bonds by the ECB (now estimated to have reached EUR 96 billion); offered reductions in interest payments on bail-out loans (for Ireland, Portugal and Greece); created new and larger funding facilities to provide further loans (through the ECFC – the fund to be augmented from EUR 440 billion to about EUR 1.2 trillion), and encouraged the roll-over of existing loans by banks to avoid default.

Taken together, these measures had contradictory effects. One group of investors was reassured and responded accordingly, while another group of investors saw the continuing risks of this
incomplete set of measures, particularly with the US, UK and Japanese economies so weak, and leadership so uncertain.

The essence of the problem is fairly simple: economies with high levels of debt need to maintain high levels of growth to pay down these debts. However, deficit reduction measures of economies will cause growth to slow down, making any reduction in the debt stock almost impossible. To investors, this dangerous mix is driving them to look for safe havens for their funds. More than EUR 50 billion was withdrawn during the month under review from bonds and equity markets in the EU, and invested in money markets (gold, cash, etc.).

**Impact on APEC SMEs**

Largely indirect, but depending on the area of activity, any slowdown in EU, US, UK or Japanese economies could have a severe effect on Asian and emerging market suppliers (big and small). At the same time, opportunities to buy companies and other assets in the EU (or elsewhere) are likely to grow significantly.

**Other developments in the EU**

There are two pieces of news from the EU that could have interesting consequences for APEC SMEs.

The first is that the EU reports that 85% of all counterfeit goods circulating in the EU (representing a value of about EUR 1 billion) are thought to originate in China. This suggests that imports from China may be subject to more intense scrutiny, raising costs and delaying deliveries.

And the second is that the EU is planning to meet 50% of its energy needs from wind power by 2050, suggesting a major policy and regulatory commitment to this sector. Details are still awaited. (The author is Associate Director & Senior Programme Advisor, International Policy Unit, London School of Economics and Political Science.)

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**East Europe**

**Region stood relatively firm amid extraordinary market conditions**

*Kuo-Yuan Liang*

The past month was a rather busy and eventful period, in terms of international finance and politics. On 21st July, the second bailout program for Greece was agreed among the Euro group. The flexibility of the current bailout fund for distressed governments of the Euro Area, and the EFSF (European Financial Stability Facility) was extended without any expansion in scale. This package rendered a significant reduction in Euro Area peripheral sovereign yields and CDS (Credit Default Swap). However, this came at the cost of rising Spain and Italy yields and CDS, as the market considered the EUR 440 billion EFSF insufficient to contain the troubles in Spain and maybe Italy. This trend worsened until the second week of August, as the ECB (European Central Bank) launched another round of Securities Market Programme that could purchase Spanish and Italian bonds from secondary markets.

As later announced, in that week the ECB spent a whopping EUR 22 billion to keep Spanish and Italian bond yields around 5%, buying time for parliaments to resume congregations in mid-September and affirm the changes to the functioning rules of the EFSF that was agreed in
the second Greece bailout. These series of actions shows the Euro agency’s determination to stop the European debt crisis, but simultaneously at the expense of transferring member economies’ systematic risks to the Euro system. This is a huge commitment to a fiscal union, and will effectively force European leaders to proceed with that path at a faster pace.

In America, amid all the debt ceiling debate and drama, the sovereign ratings of Uncle Sam was eventually down a notch. At roughly the same time, timely economic data raised concerns that the US and global economy was slowing down. Together these factors induced violent global market selloffs and a rush to find a safe haven.

In previous articles, we have constantly warned that the international destabilizing factors might weigh on the rather small East Europe economies. This market turbulence may inflict payment difficulties similar to those experienced during the international financial crisis of 2008, as capital seeks for safe havens. But as it turned out, from 14th July to 15th August, the major currencies of the East Europe regions were rather stable, considering the extreme market circumstances.

The Zloty and Koruna fluctuated at roughly 4-5% against the US Dollar, while the Forint had a wider 6% range. During this period, the Zloty and Forint each depreciated roughly 2% against the US Dollar, while the Koruna appreciated by 1% and the Euro rose 2%. In other words, the Zloty and Forint fell about 4% against the Euro. While this somehow shows capital heading to the developed world amid global growth concerns, the magnitude remains very manageable. This signals that the market is not very pessimistic about the economy’s future, but perhaps a slight dampening in expectations. Still, for the sake of a worst case scenario where a full blown crisis occurs, whether Europe or the US, regional states still need to be vigilant toward situations that may cause massive capital retreat.

ESI survey data shows most economies unchanged, except Hungary

By looking at the July ESI (Economic Sentiment Indicator) survey data, major economies in the East Europe region have seen little changes from June, which have mostly been small increases. The fall in sentiment was more apparent in Hungary. In terms of regions which saw declines, in Hungary, the drop was quite broad based, in which confidence briefly rose in retail trade but declined in the other four indicators. In industries which saw falling confidence, their components fell with few outliers, except for the slightly rising demand and employment expectations under the service industry confidence. In retail trade, the advance had wide support from most components, with a slightly falling business situation. For the other economies where sentiment declined, their fall was much less significant than Hungary. The fall in Estonia was much less pronounced than Hungary, where the decline was mainly attributed to the industry and retail trade sector at a lesser extent. In terms of the industry, most components fell except for employment expectations, while retail components fell, excluding the rising present business situation.

In the other economies, the ESI rose only marginally in Poland, Greece, Latvia and Lithuania, while marginally declined in the Czech Republic. Among these economies, the trend is not clear among the sectors, but the industry and retail trade seems to be slightly weaker than other sectors, such as service and consumer confidence. In sum, the July ESI indicates the regions’ major economies are generally on a standstill, where there are still some positive expectations for the future.

We consider July’s ESI a continuation in the adjustment from the peak in the first quarter of 2011, in line with global business trends of moderation in global manufacturing industry activities, as indicated by US ISM manufacturing, Markit PMI (Purchasing Managers’ Index) in Eurozone, and the China manufacturing PMI. Meanwhile, services moderated less significantly. We believe the world economy is currently in a correction phase of an inventory cycle. Looking forward, August indicators will soon reveal how much the economic sentiment is affected by the US downgrade and subsequent financial market selloff. (The author is President at Polaris Research Institute & Honorary Professor, College of Technology Management, National Tsing Hua University.)
According to the data provided by the Central Bank of Russia, the Russian Ruble has been appreciating against US Dollar, thanks to the continuous rising of the oil price. During the first seven months of this year, Russian Ruble’s actual exchange rate to US dollar increased by 12.8%, with the nominal exchange rate increasing by 10.6%. Its actual exchange rate to Euro increased by 5.5%, with the nominal exchange rate increasing by 2.1%.

However, due to the sharp falling of the global stock market for days and the dramatic decline of the international oil price, the exchange rate of Russian Ruble to US Dollar and Euro depreciated largely in early August. As shown by the official price announced by Russian Central Bank, Russian Ruble’s exchange rate against US Dollar depreciated by 3% on the single day of 10th August, and its exchange rate against Euro also depreciated by 2.3% on the same day. The market saw Russian Ruble’s depreciation as caused by the recent sharp fall in the oil prices and investors’ selling hedge in the stock market. However, the Russian Central Bank now says that it will not change its current Ruble exchange-rate policy, nor will it implement any massive intervention in the forex market (foreign exchange market).

The Russian Rubles’ depreciation may help the export sector to earn foreign exchange with higher value of domestic currency to pay for salary and other production costs, but it may cause imported inflation at the same time. However, it seems hard for Russia’s export sector to perform better on the basis of Ruble’s depreciation.

Regarding the oil exportation, one of the events that may lead to more tension in August is the possible cease of the oil supply contract between Russia and China, who can hardly reach an agreement so far concerning the price issue. Russia may be thinking about the worst-case scenario: to pay back the loan of more than USD 10 billion to China earlier than it planned. Also, it may have to stop its original plan to supply oil to China through the Eastern Siberia–Pacific Ocean oil pipeline (ESPO pipeline), and to export the oil to the west instead.

This scenario would not only deprive Russia an important potential market of its oil export trade, but also bring it quite some pressures to pay US Dollar loans earlier at the moment of Ruble depreciation. Consequently, it is expected that the Ruble depreciation may not contribute too much to Russian exports in the second half of the year. As to the question of whether there will be an imported inflation, we still need to keep an eye on the trend of the recent prices of international bulk commodities. There are indeed higher risks now.

As to the situations in the Middle East, since the Organization of the Petroleum Exporting Countries (OPEC) is the fourth largest foreign creditor of the US (only less than China, Japan, and the UK), there are undoubtedly great impacts on the capital market and investors’ confidence in the Middle East stock markets. In Israel, Saudi Arabia, and Egypt have fallen sharply, and a remarkable correction can be seen in the international oil price. Fortunately, banks in the Middle East have performed steadily well during this year, and the problem of investors’ lack of confidence in the capital market—a problem caused by the US debt crisis—will not impact the liquidity of the financial industry in Middle East. Therefore there is little likelihood for systematic risks to appear in the financial system in Middle East.
As to the risks of individual economies, the recent increase in Israel’s risks is more prominent. The Israeli public has been protesting peacefully for weeks, demanding the government to reduce the continuously increasing living costs, especially such costs as housing and daily life. Israel may become another focus among the recent democratic demonstrations in the Middle East because of the current protest.

If the government actively responds to its people’s appeal for tax reform, public housing, and minimum wage adjustment, the economy will face a greater fiscal pressure in the future. So far the debts of the Israeli government have been 77.3% of its GDP (Gross Domestic Product) with considerable portion of foreign debts in its debt structure. Based on the fact that at present Israel is highly connected with the US in economy, if the public protest impacts on the foreign investors’ confidence in the stability of the Israeli government’s policy becomes impacted by the public protest, the fiscal and overall risks will increase prominently in the near future. (The author is Vice President, Taiwan Institute of Economic Research.)

No Sharp Declines in Commodity Prices

Hwa-Nyeon Kim

In the last one month period (mid-July to mid-August 2011), warning signs of a crisis in the global commodity market have increased somewhat with a downward trajectory in prices. In terms of demand, commodity markets face strong headwinds from continuously weak macroeconomic data and sovereign debt risks from both the US and Europe. WTI oil prices fell to a six-month low of below USD 80/barrel on investors’ concerns over the impact of both the US and Europe’s debt crisis on the global economy. And Dubai oil prices also dropped to nearly USD 100/barrel. Due to uncertainties over a possible double-dip in the US or global economy and a concrete solution to Europe’s debt crisis, gold prices hit a historical high of nearly USD 1,800/oz. Accordingly, the majority of investors made buying safe haven assets such as gold a top priority in addition to US treasury bonds. Thus, worries over global debt risk continue to spread in the raw material markets.

If there is a commodity which is worth mentioning this month, it is Dubai crude oil, with prices staying above the USD 100/barrel level since assets prices in the financial market tumbled after early August. The main reason for the strong performance is the unsolved geopolitical risk in the MENA (Middle East and North Africa) region. Libya produced less than 200 thousand barrels a day from the normal level of 1,600 thousand barrels a day. Some oilfields and pipelines in Libya were recently damaged. In addition, many sources have reported that oil production and export in Syria are on the decline. The rising violence in Iraq is also threatening stable oil production. And as there are no signs of the geopolitical turmoil subsiding, the price of Dubai crude will not go down as much as those of other commodities including WTI (West Texas Intermediate) even if there were another significant shock in the global financial markets.

Crude oil price will remain volatile, but a repeat of the sharp decline seen in the second half of 2008 is not expected. The reasons are as follows: first, on the demand side, the scale and speed of the increases in demand from emerging economies continue to support world demand, considerably tightening the supply-demand balance. Although advanced economies are suffering from a slowdown in economic growth, demand from emerging economies continues to
show an upward trajectory. For example, India’s oil demand in May was the second highest ever, with a 5% increase compared to the previous year while demand in China continues to rise substantially. With China’s demand in May increasing by 9% year on year, global demand increased by above one million barrels a day compared to the previous year. Second, in addition to the turmoil in the MENA region where most OPEC nations are located, supply growth in the non-OPEC region is continuing to slow down. Therefore, the relatively tight demand-supply conditions will result in a moderate decline of crude oil prices.

The top two commodity indices, the CRB (Commodity Research Bureau) spot Index and LME (London Metal Exchange) non-ferrous index, have shown slightly different performances from mid-July to mid-August. The CRB spot index (year 1967=100) moved from 539 to 558 and the LME index (April 1999=1,000) from 3,776 to 4,339. The average for the CRB index from mid-July to mid-August decreased 0.2% for four consecutive months, while that for the LME index increased 0.4%. However, after early August both indices dropped. In addition to the decrease in the CRB index, such changes were smaller than those for the previous month. In terms of price variations, the daily price changes in both indices were greater than those seen during the mid-June to mid-July period, indicating an increase in investment risk in commodities.

As for energy prices, the WTI near month futures price moved within the range of USD 79.3 and 98.87 /barrel and Dubai crude prices between USD 100.03 and 113.21 /barrel during the same period. However, the WTI oil price average from mid-July to mid-August was smaller than that for the previous month, with the average price of WTI decreasing 2.8%. However the average price of Dubai crude oil increased 1.5%.

Among non-ferrous metals, or more commonly known as base metals, zinc and tin prices rose the most following the previous period, with the average price of both metals rising 2.5%. Nickel and copper prices also showed rising price patterns. However, the minimum prices for nickel and copper during the last one month period were USD 21,225 /ton and USD 8,802 /ton, respectively which are less than those for the previous month. Among base metals, lead prices revealed decreasing variations.

There are too many uncertainties in the global financial markets including commodities. One thing that is almost certain is that in the short-run, commodity prices will go down due to the possibility of a recession. However, from a long-term perspective, the direction will reverse upward due to a weakening US dollar and global money liquidity supported by ultra low interest rates in the US. Therefore, SMEs should not expect too much of a decrease in commodity prices and make provisions for any sudden jumps in the near future.

<Table> Changes in Raw Material Prices - 18th July to 15th August, 2011

<table>
<thead>
<tr>
<th></th>
<th>CRB</th>
<th>LME</th>
<th>WTI</th>
<th>Dubai</th>
<th>Copper</th>
<th>Lead</th>
<th>Nickel</th>
<th>Zinc</th>
<th>Tin</th>
<th>Aluminum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min</td>
<td>539</td>
<td>3,776</td>
<td>79.30</td>
<td>100.03</td>
<td>8,802</td>
<td>2,278</td>
<td>21,225</td>
<td>2,096</td>
<td>23,125</td>
<td>2,346</td>
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<tr>
<td>Max</td>
<td>558</td>
<td>4,339</td>
<td>99.87</td>
<td>113.21</td>
<td>9,827</td>
<td>2,742</td>
<td>25,080</td>
<td>2,495</td>
<td>28,800</td>
<td>2,623</td>
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<tr>
<td>Average</td>
<td>551</td>
<td>4,130</td>
<td>92.21</td>
<td>108.42</td>
<td>9,428</td>
<td>2,549</td>
<td>23,370</td>
<td>2,341</td>
<td>26,556</td>
<td>2,492</td>
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<tr>
<td>Last Month</td>
<td>552</td>
<td>4,114</td>
<td>94.90</td>
<td>106.84</td>
<td>9,312</td>
<td>2,597</td>
<td>22,826</td>
<td>2,284</td>
<td>25,920</td>
<td>2,486</td>
</tr>
<tr>
<td>Average</td>
<td>552</td>
<td>4,114</td>
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<td>2,486</td>
</tr>
</tbody>
</table>

Note:
1. The CRB index recorded 100 in 1967 and LME non-ferrous index recorded 1,000 in April 1999.
2. The WTI price is based on the near month futures price traded in NYMEX and non-ferrous metal prices are based on the spot prices traded in LME.
Over the last couple of weeks, markets have realized that there is no easy solution to the current situations in the developed world. In the US, the unpleasant combination of disappointing data and a less than perfect resolution to the debt ceiling crisis have reignited concerns about the economy’s ability to boost growth. Standard & Poor’s historical downgrade of the US sovereign could be just a tip of the iceberg that reflects a deep structural issue in the fiscal situation that under the polarized environment of US politics could become a drag on growth for many years. Growth outlook in Europe is also grim, with debt crisis in the peripheral economies intensifying and becoming contagious. Spain and Italy have recently come under the attack as liquidity concerns are rapidly starting to turn into solvency ones.

The size of funds in the European Financial Stability Facility (EFSF) seems inadequate to handle current situation. As in the previous stages of the European debt crisis, politics look to be one of the main roadblocks to an orderly solution. As a result, investors have reacted by shunning risky assets across the board (equities, commodities and emerging market assets) and jumping into whatever looks like a safe heaven (which ironically includes US treasuries) amid thinly traded markets. The only assets that have rallied are gold and rates, not because they look safer, but rather to reflect that growth is going down.

In this piece we showed the results of some researchers who try to address the effects of the current international scenario on Latin America (Latam). They find that external shocks can explain a large share of variance in some economic fundamentals in Latam. In turn, those researchers start by focusing on each economy’s vulnerability to external shocks and the main transmission channels through which the crisis can affect the region. Then they analyze how the region policymakers would be able to reach, either through monetary or fiscal policy.

Channel 1: Trade and Commodities

Latam is a net exporter of commodities, and this is its main vulnerability. The share of commodity in total exports (excluding Mexico) ranges from 96% in Venezuela to 58% in Brazil. Thus recent falling in commodities, assuming no double dip scenario, will have some negative impacts on Latam economies and in particular on those economies depending on commodities the most. The research result concludes that Venezuela and Argentina are particularly sensitive to a downturn in commodity prices. Venezuela needs

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1 This article is a summary from Latin America Macro View—Here We Go Again, by Joaquin A Cottani, Jorge A Pastrana, Camilo and Gonzalez, 11th August 2011, Citigroup
high prices to keep its fiscal accounts and balance of payments under a sustainable path. In Argentina, low commodities could put the brakes on an already overheated economy. Regarding trade, Mexico is by far the most exposed to a downturn in the US economy, followed in a distant second by Colombia. In 2010, 73.5% of Mexico’s exports were headed to the US thanks to the tight links in the manufacturing sector. In Colombia, the share of total exports to the US in 2010 stood at 37.4%. But note that Colombia also has one of the lowest exposures to the world’s main growth engine, namely Asia and China in particular, with exports to developing Asian only amounted to 6.9% of total sales abroad. Brazil and Peru have the highest exposure to Europe due to their relatively higher share of exports to Europe around 18% and 17% respectively in 2010.

Channel 2: Capital Flows, Asset Prices and Volatility

Most Latam assets have weakened, but investors do not seem to be rushing for the door yet. Even though stock markets across the region have taken a beating, the weakening of local currencies has been much milder and most government bonds have even risen in value. This situation suggests that for the moment, investors are rebalancing their portfolio toward less riskier assets but not exiting the region entirely. Furthermore, the role of exchange rates could become an important shock absorber in inflation targeting economies. In a highly dollarized economy such as Peru, the central bank is more reticent toward exchange rate flexibility because large changes in the local currency have large effects on inflation and financial stability. Nevertheless Peru central bank has strong enough of foreign reserves (USD 47.7 billion as of July 2011) to face the situation.

In Argentina, the balance of payment is highly sensitive to external financing conditions. During the first half of 2011, capital flight in Argentina amounted to USD 9.8 billion, and if the current situation were to worsen, external credit for provincial governments and corporations would likely become scarcer, and the economy would likely march inexorably towards stagflation. In Venezuela, the government has to continue issuing external debt in order to continue providing hard currency through SITME\(^2\) (Transaction System for Foreign-Currency Denominated Securities).

FDI (Foreign Direct Investment) flows are a sensitive subject in Colombia and Peru. In both economies, FDI flows are heavily skewed toward the oil and mining sectors and therefore commodity prices are important determinants of future investment projects in these economies. Even though lower equity prices in Latam do not have the same effect on consumption decision as they do in the US. However, the selloff in asset prices, and the accompanying volatility would still undermine confidence.

Overall, both channels point to weakening of economic performance in Latam. The overall effect on the Latam economy, let alone on the US and European ones, is still far from certain. Nevertheless, the current financial turmoil points slower growth in Latam and with it, lower inflation and the possibility of lower policy rates.

Policy Response

The possible ways to respond to a deeper-than-expected slowdown are not homogeneous across the region. What seems to be common denominator right now is that all central banks are in a wait-and-see mode hoping for more clarity on where the world is headed. Thus central banks are unlikely to undertake rate cuts right away. Regarding fiscal policy, Chile and Peru have more room than other Latam economies to respond to a crisis, where Brazil and Colombia have less room than what they had before 2008. In Chile, the gross debt-to-GDP ratio is expected to remain in single digit and Peru, albeit far from Chile’s situation, has one of the lowest debt-to-GDP ratios in Latam at 23.6% in 2010. Finally, the usual suspect such as Argentina and Venezuela would have little ammunition to enact countercyclical fiscal policy. (The author is Vice President, Citi Taiwan.)

\(^2\)Under this scheme, companies buy bonds in foreign currency at the central bank and subsequently sell them abroad to get dollars at an exchange rate of VEB 5.30.)
New Basel Capital Requirement and SME Financing

Naoyuki Yoshino

Sony, Honda, Panasonic, Seven Eleven Holdings etc. all grew from small businesses. How to raise money from banks is quite important for the growth of SMEs (small and medium enterprises). For example, Honda has an interesting story about its initial financing. Mr. Soichiro Honda who became the President of Honda Corporation went to a local bank to borrow money when it was a very small business. Honda started its business from manufacturing motorcycle. A local bank denied lending money to Honda since its future was not certain, and Mr. Honda had hard time to look for lenders to his company. Finally, he was allowed to borrow money from one big bank.

Sub-prime loan crisis brought various reforms in financial rules and regulations. Basel capital requirement is one of them. New Basel III will be implemented in near future. Deposit-taking banks have to keep their adequate capital to cope with various risks. Banks will become much more cautious for riskier loans and investment. SMEs will be affected by stricter credit analysis of banks. Asian economies are dominated by their very thin banks and venture capital markets. How to finance SMEs in the new environment? There exists an information asymmetry between SMEs and banks.

Financing for SMEs

At the ASEAN+3 Finance Ministers’ Meeting in May 2009, the Ministers agreed to establish the Credit Guarantee and Investment Facility (CGIF). Financing for SMEs and the infrastructure development are vulnerable to a credit crunch since it largely depends on indirect funding sources, such as bank loans.

Yet, considering SMEs’ large share in many dimensions of Asian economic activities, further efforts should be made for SME financing. SMEs are often believed to be difficult to examine in terms of their financial and non-financial accounts.

However, the Credit Risk database of Japan is an example of how SMEs can be rated based on financial and non-financial data. CRD (Credit Risk Database) made it possible to collect a huge amount of database from SMEs and rated SMEs based on its statistical analysis.

Database Provided by Credit Risk Database (CRD)

The CRD Association was established in 2001, at the initiative of the Ministry of Economy, Trade and Industry (METI) and the Small and Medium Enterprise Agency (SMEA) by 52 credit guarantee corporations as well as financial and non-financial institutions. Its aim was to facilitate fund-raising of SMEs and improve their operational efficiency. With the increasing importance of the fund-raising of SMEs, the membership increased from 73 institutions at the end of March 2002 to 200 institutions at the end of 2010.

The CRD database provided by the CRD Association covers SMEs exclusively. It covered 14.37 million corporations and 1.737 million sole proprietors as of March 2010, which was more than 50% of all SMEs in Japan. The database for default covered 3,289,000 corporations and sole proprietors, and it is so far the largest database for SMEs in Japan.

Member financial institutions use scoring models to enhance the efficiency of credit evaluation, check the validity of internal based rating systems, and make loan pricing in line with credit risk. In addition, the CRD Association provides the consulting services for SME management support. These services have been developed based on the thought that the improvement of SME management will contribute to the reduction of credit risk for member financial institutions and to the strengthening of the business

— Column 3 CM Knowledge
The provision of credit information helps lenders understand better the risk profile of their borrower clients and enables them to expand their credit services. Recent availability of new technologies such as credit scoring has facilitated the ability of banks to service SMEs better. The information-capturing platform of a credit bureau makes it possible to measure SME borrowers in a number of ways. What gets measured gets managed, and the metrics provided by credit bureaus serve the needs of both banks and SMEs.

Better credit granting and risk management are based on better information provided by a credit information system. By disseminating captured information about SMEs and its suppliers, SMEs could build up their track records. Even though these SMEs have no banking relationships, if their credit bureau record indicates a good credit standing among their suppliers, such information may be used to their favor to support necessary financing applications. SMEs with good track records may also be able to access credit in more favorable terms, and obtain faster decisions on their financing applications.

The negative and positive data (especially positive one) from credit bureau will benefit SME loan applicants by providing a more balanced view of SME credit ratings. By knowing how the credit bureau presents information about them, SMEs (which were rejected by banks) will also gain a better understanding of their financial deficiencies through the credit bureau reports and ratings. These reports would also serve as a convenient tool for SMEs to carry out a self-evaluation to identify areas that need improvement and initiate adequate remedial actions to increase their competitiveness. SMEs are thereby empowered to improve their own profile, with correspondingly enhanced prospects for the SME sector as a whole. (The author is Professor of Economics, Keio University.)
Can the Philippines survive a “double dip” US recession?

F. T. Escalona

Japan has just announced a negative growth rate of 1.3% for the 2nd quarter of 2011. Although the actual figure is lower than the anticipated 2.5% decline in GDP for the quarter, it points however to a recessionary direction for the economy, an economy that has emerged as the Philippines’ most important trading partner (Japan has overtaken the US as the main market for Philippine products in the first four months of 2011).

The Philippine economy is basically a consumer economy and not a producer economy, with 51% of its labor force in the services sector, a sector that contributes around 55% to GDP. The two main drivers of the economy are the export sector and the services sectors. Both sectors have contributed roughly around USD 70 billion to the Philippine economy last year.

The recent US credit rating downgraded by Standard & Poor was negatively received by the global markets as evidenced by the huge losses incurred by the world’s important bourses and the wild volatility that ensued in the past couple of weeks. The emotional sell-off in the equities markets due to the one-notch downgrade from AAA to AA+ of US’s credit rating may be attributed to the fact that it is the first downgrading of the US debt rating since the ratings started in 1917. This is definitely a “no confidence” vote on the US leadership in resolving its financial problems.

All the financial markets’ attention will be on the US’s Q2 growth figures. A negative number will definitely douse cold water on the rallying equities markets and put more pressure on the US greenback. It will also signal a possible “double dip” recession in the US.

The Philippines export and services sectors are both wary of a possible “double dip” recession in the US, Japan and Europe, although this has been dismissed by some economic managers as purely speculative. They have argued that some economic indicators are still holding firm. Already, Japan and Switzerland have both announced bold measures to counter the speculative strengthening of their currencies vis-à-vis the greenback. This is to stem the current unrestrained appreciation of their currencies, in order to lend support to their export sectors.

Chairman Ben Bernanke of the Federal Reserve announced that he will maintain US interest rates at all-time low levels until 2013. This statement was in fact an admission that US monetary policy and QE (quantitative easing) have not been successful enough to generate jobs for the workers (almost 10% of its labor force) who lost their jobs during the global financial crisis. He favors buying bank assets with long maturities at least until 2013. Such policy will definitely put upward pressure on the strong Philippines Peso.

The Philippines interbank call rates stand at around 4.75% at the moment and will
unconditionally be raised by the Philippine Central Bank (BSP) without hesitation anytime inflation sets in, in view of its inflation targeting policy. The Filipino micro, small and medium enterprises, which comprises about 90% of businesses nationwide, will be faced with great and daunting challenges until 2013. Foreign direct investments will suffer a decline should the world’s wealthiest nations go into a recession (as the saying goes “when America sneeze, the whole world catches a cold).

The situation might be exacerbated by trade liberalization, not to mention that there are indeed several benefits the Philippines may avail itself of from its bilateral and multilateral agreements with its trading partners. Among the negative reasons is that Philippine inbound logistics have been so inefficient due to poor infrastructure coupled by the lack of investments in modernization of plant equipment and machinery. A lot of firms in the micro, small and medium category have continued to go the way of price competition with the likes of China and Vietnam, a futile battle that they will never win under the current circumstances.

There will be a process of “natural selection” when markets in the free trade zones trade without boundaries. Cheap imports from China, Vietnam and Myanmar Republic will definitely put some local MSMEs (micro, small, and medium enterprises) out of business. There are probably around 4,000 and 5,000 exporters in the entire economy and a hefty number (90%) of them are in the MSME classification. One prominent Filipino economist said that “if we continue down our current growth path, we will find ourselves falling further behind our neighbors.” I fully agree that if we continue to compete on price of our export products we will definitely crash and burn. I have been advocating since 2005 that the way to go is to compete with our competitors on product quality and innovative products.

Strategic exporting is the key. We have embarked on an “educational” campaign wherein MSME exporters are trained on advanced market research, strategic pricing, value and supply chain mapping and analysis, product diversification/innovation, market diversification, lean production, smart networking and risk management (currency, financial, etc.).

On currency risk management we have imparted to MSMEs the basic knowledge on currency hedging and avoiding risks in trade negotiations by explaining INCOTERMS 2010. We have also convinced the Aquino administration to institutionalize an export support fund that will be invested in export promotion and development as well as in capital equipment that will be entrenched in common service facilities that will benefit the MSME exporters who are too small to invest in expensive mass production equipment and machinery themselves.

Other projects that will be implemented are export coaching (to help MSMEs draft their respective export marketing plans), business matching (with the help of donor organizations), market intelligence services (buyer, competitor and economy profiling, credit reports on potential trade partners, market statistics, scenario planning and opportunity alerting, etc.). Also in the pipeline is a project on sustainable consumption and production, quality management, process control and corporate social responsibility.

So, going back to the question “Can the Philippines survive a “double dip” US recession?”, I would say: yes, it can, as long as all actors in the sector, including government agencies and instrumentalities put their hearts into fulfilling their assigned roles for the good of the industry. (The author is managing editor, Philexport Cebu News Service.)

**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 semceditor@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.
In recent years, APEC member economies have actively engaged in trade liberalization. Trade liberalization indeed brings benefits to SMEs, but at the same time it also generates risks. In responding to this, APEC SME Crisis Management Center (APEC SCMC) has held “APEC Symposium on Enhancing SME Capacity of Managing the Risks Associated with Trade Liberalization” on 16th and 17th August 2011 in Taipei. Domestic and foreign distinguished experts and scholars from various fields are invited to discuss the risks with the aim to assist APEC SMEs in expanding their overseas markets.

Trade liberalization truly helps SMEs expand the market; however, it also exposes SMEs to greater risks. Those risks can be mainly seen in two parts: first, trade liberalization makes many SMEs engage in international trade with numerous hidden risks, including political risks, credit risks, foreign exchange risks, regulatory risks, commodity risks, price risks, transportation risks, and product liability risks, etc.; and second, since foreign products can freely enter the domestic market after trade liberalization, some domestic-based SMEs have to face the risks of international competition and the pressure for transformation. To make SMEs truly benefit from international trade, SMEs are required to improve risk management capability while engaging in trade liberalization.

In the past, APEC has emphasized on the benefits of trade liberalization but has neglected possible associated risks. To compensate the insufficiency, this symposium has shared relevant experience and proposed practical strategies for SMEs to manage various risks associated with globalization and liberal trade environment.

The symposium started with a unique sand painting performance, representing the APEC spirit. Dr. Robert Lai, Executive Director of APEC SCMC and Director General of Small and Medium Enterprise Administration (SMEA), Ministry of Economic Affairs, has delivered a speech for the opening ceremony. As trade liberalization and economic globalization continuously accelerate, he hopes to build a platform through this symposium to share strategies related to trade liberalization and to improve SME capacity to respond to different situations. It is believed that this platform will become a driving force of trade liberalization and facilitation. Dr. Cho, Director General of Bureau of Foreign Trade, Ministry of Economic Affairs, and Franklin L. Lavin, Former Under Secretary of the US Department of Commerce also made keynote speeches for the symposium.

Engaging trade liberalization requires managing relevant risks

There was outstanding communication and discussions in this symposium on risks associated with trade liberalization and on possible effects of trade liberalization. Former Under Secretary, International Trade at the US Department of Commerce, Franklin L. Lavin, who currently serves as the Chairman of the Public Affairs Practice for Edelman Asia Pacific, further indicated that trade liberalization would not make SMEs
automatically engage in foreign trade. Besides trade liberalization, SMEs have to overcome many risks and obstacles. SMEs should be prepared with wider professional abilities to play a role in the keenly competitive international market. Lavin believed that trade liberalization is the trend, which causes anxiety, especially for SMEs with limited capacity to export or enter into new markets. However, as there are two sides to one coin, liberalization brings not only competitiveness but chances.

When facing present fluctuation of exchange rates due to the European and US debt crises, experts participating in this symposium proposed suggestions based on their professional experience. Professor Sheng-Yung Yang, Executive Director of EMBA, National Chung Hsing University, indicated that even a domestic-based enterprise would be affected by the fluctuation of exchange rates because the exchange rate influences the competitiveness of foreign competitors in the domestic market. Therefore, almost all enterprises need to manage the currency risk.

In recent years, US dollars experienced depreciation and violent fluctuation, and this trend may continue. The uncertainty in the foreign exchange market poses threats to the profitability, competitive position, cash flow and corporate value of SMEs. In order to effectively manage the currency risk in the long term, SMEs should have full knowledge relating to exchange rate fluctuation.

**Hedging Strategy for Currency Risk**

On the other hand, experts also considered that exchange rate forecasting is extremely difficult. It would be better to be well prepared with coping strategies rather than to make strenuous effort in forecasting. Experts proposed numerous responding strategies, such as forward foreign exchange hedging and contract hedging. They also recommended different types of coping methods. However, John Rush, Principal Consultant of Oakbridge Limited Financial Consulting Group, Australia, on the other hand, recommend that foreign exchange hedging is not the core business of SMEs and should be dealt with by experts.

David Deakins, Director of the New Zealand Centre for SME Research, primarily focused on the effect on the ability of SMEs. Trade liberalization is an important and influential factor for SMEs. On the one part, it develops new opportunities; on the other part, it brings increasingly keen business competition. Each government needs to balance the allocation of scarce resource and enhance SME capacity of managing changes in globalization. He further took New Zealand as an example to share his experience of how to establish a dynamic monitoring system between the New Zealand Centre for SME Research and the government to assist SMEs in enhancing their capacity of hedging risks caused by trade liberalization.

**Conclusion**

This symposium was successfully concluded in Taipei. APEC SCMC suggested that governments of APEC member economies should assist SMEs in managing trade liberalization from five main aspects:

1. Improvement in corporate environment,
2. Increase in entrepreneurial opportunities,
3. Application of information technology,
4. Assistance in operating and marketing management strategies, and
5. Strengthening of Credit Guarantee.

For example, the APEC SME Economic Crisis Monitor issued by SCMC every month provides SMEs with more information on related analyses and strategies for managing crises and challenges from financial situations, exchange rate, price, and market.

APEC SCMC expects to improve the soft power of enterprises and will continue to hold relevant symposiums for SMEs to provide SMEs with more chances of international exchange.
Remember The Black Swan (by Nassim Nicholas Taleb) we introduced in the last issue of the Crisis Monitor? In general, people tend to pay attention only to the things that they are familiar with, and to predict the unpredictable by normal distribution model. This is flawed, however, and may probably lead the investment decisions to a wrong direction. The new book we are introducing here—Whoops!! Why Everyone Owes Everyone and No One Can Pay by John Lanchester—conveys the same concept and furthermore elaborates how this kind of fallacy has developed into the current problems facing modern finance: piles of debts as well as various financial messes.

The complex operation of modern finance has confused most people, and many experts have sighed about how the madness of capitalism causes so many bizarre financial phenomena. As a novelist and a financial journalist who is especially sensitive to financial turmoil, the author John Lanchester has been observing and tracking the origins and developments of financial crises from the perspective of a “non-financial professional.” In this book, Lanchester has made story-telling efforts to explain the origins and the development of global debt crises in simple ways, allowing those who have less financial knowledge can understand these debt phenomena happening around the world and the real nature of modern finance.

While human desires keep growing and everyone is investing and betting more by loaning, who will be the one eventually pays the bills? And who will become the most hopeless victim? When one of the safe havens—US bonds—is downgraded by credit-rating institutions and no more safe, what kind of secure investment target can we trust? This book will offer you clear clues to all these questions hidden in every investor’s mind.

A Fake Golden Age When Everyone Is in Debt

Today, banks have not only become the core of developed economies and the center of credit creation, but banks are also the main driver of capitalism. As Lanchester elucidates, banks create credits, which in turn lead to the operation of the economy. From this perspective, credits are the economy itself, whereas the economy is the circular flow of credits, like a ceaseless cycle.

Under the present domination of capitalism, where it faces no reprimands from any opponents, credits are extraordinarily cheap in this era of free economy. Lending institutions (such as banks) irresponsibly consider finance as a profitable natural resource, which could be nurtured. This sense has led to many crises ended up to be paid by the government and people, for example, the nearly bankruptcy of Iceland, the collapse of Bear Stearns...
Investment Bank, the bankruptcy of the Lehman Brothers, the Enron scandal, the subprime crisis, and so forth.

In Iceland or anywhere else, people have been encouraged to utilize cheap credits and gradually learn to desire and consume in every way. Under this capitalism atmosphere, we have been educated how to spend and how to use the extremely cheap credits: satisfying our desires by loans, stocks, houses, cars or anything we want. Zealous desires for various commodities turn to be consumptions, which in turn becomes economic growth. The economic growth, then, is rendered as a heaven, with increasing the government funds without raising tax rates.

The idea that “debts can create assets” indeed sounds really nice, doesn’t it? However, when the growth of economy and the luxury of living are built upon debts, who is going to pay the bill once all the debts collapse? Lanchester also sighs for this phenomenon: “…we’ve just lived through an economic golden age. It turned out to be a fake golden age, one based on debt and on an unsustainable credit bubble and underpinned by a financial system…”

“No Risk!”—When Bankers Make Mistakes in the Mathematical Calculation of Risks……

All the formula concluded from contemporary economics based on rational hypothesis does not describe the reality, but an ideal situation, which should be taken into account in practice. Lanchester acutely points out the fact that the global financial system has been brought into danger because bankers mistakenly calculate risks based on flawed formula. This has forced some banks ruined and some others becoming state-owned, which has spent hundreds of billions taxpayers’ money and has led many economies stuck in stagnation.

As Lanchester exemplified, the stock market crash on Black Monday, 1987, has been considered as a 10-sigma event; the Russian debt default in 1998 is viewed as a 7-sigma event, meaning such an event may possibly happen only once in 30 billion years; and even Goldman Sachs has claimed a 25-sigma event to the situation in which people with poor credit are unable to pay the mortgage when the house price sharply dropped. Lanchester points out: “If your mathematical model tells you that something is impossible—with very little likelihood of happening, but it still happened—then you know for sure that your mathematical model is wrong.”

Step by Step towards Crisis

Most people consider the financial tsunami was caused by a minority of greedy financial professionals. Nevertheless, Lanchester has seen through the entire crisis development process clearly from a comprehensive perspective, and he has claimed differently: this is not merely caused by a minority of greedy financial professionals from the financial sector, although the financial industry certainly has to be responsible. As Lanchester expressed, “they [the financial industry] have not only laid a disaster but also making sure that it will come.” He has pointed out that the credit bubbles and asset bubbles would not have happened without our allowance to the deregulation of the government and banks out of our own greed and stupidity.

Also, the author compares the “credit storms” with a heart attack: it forces a person to face the true condition of him/herself, and to accept a healthier way of life. What we need to do now, therefore, is to re-examine the bank system and the government’s policies and measures, and to bring some changes in order to make sure that the history will not repeat. It is time for us to think about how to recover the financial industry back to its original role to serve the society, instead of robbing it. To the world with limited resources that are gradually running out, shouldn’t we tell ourselves “Enough”—enough money and enough material desires—and think about whether or not we need so many things we desired?

1 In the theory of Normal Distribution, the measurement of unlikelihood is called Standard Deviation, which is usually expressed by sigma.