



**Asia-Pacific  
Economic Cooperation**

# **APEC Economic Trends Analysis**

**APEC Policy Support Unit**

15 February 2012

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# Highlights

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## Global GDP growth decelerated in 2011

- The intensification of sovereign debt challenges in the Euro area since July 2011 has resulted in slowing economic growth across the world. GDP in some large economies in Europe contracted toward the end of 2011.
- The APEC region was also struck by a series of natural disasters which caused immeasurable human losses and record economic costs.
- The slowdown in global growth in 2011 was less synchronized. Economic activity in advanced APEC economies generally picked up after a subdued performance in the first half of 2011. In most emerging APEC economies, economic growth was resilient throughout 2011, although the momentum has slowed since Q3 2011.
- Inflationary pressure in the APEC region began to ease in the second half of 2011, consistent with the global trend, as commodity prices began to stabilize.
- Inflationary pressure is low in advanced APEC economies, despite measures to boost economic growth, while many emerging APEC economies successfully reduced inflation by the end of 2011.
- Equity prices in most APEC markets have exhibited sharp swings in the second half of 2011 with emerging APEC markets generally underperforming as investors sold their positions to cover losses in European markets.
- Frequent fluctuations in investors' risk sentiment have also caused volatility to return to exchange rate markets, especially during the second half of 2011.

## Prospects for growth are uncertain and downside risks have intensified

- Global GDP is forecast to slow to 3.3% in 2012 before accelerating to 3.9% in 2013, mainly due to the continued economic weakness in the Euro area. Real GDP in the APEC region is projected to grow by 4.1% in 2012 and 4.5% in 2013. However, an escalated sovereign debt crisis in the Euro area could potentially send the global economy back into recession.

- Economic growth in the APEC region is likely to remain under pressure. In advanced APEC economies, both governments and households are expected to tighten spending in order to reduce their debt positions. In some emerging economies, asset price bubbles and a sudden reversal of the buoyant capital inflows are among the main concerns.
- Risks to global inflationary pressure remain in 2012. Oil prices, which have held up in recent months, could surge higher as a result of geopolitical concerns. The easing of monetary policies pursued by both advanced and emerging economies to bolster growth could also drive up prices further.

## Policy implications for APEC

- Uncertainty in the economic outlook has created new challenges for businesses, with small and medium-sized enterprises (SMEs) being more vulnerable. In addition to implementing monetary and fiscal policy to maintain macroeconomic and financial stability, policy makers should therefore monitor and provide extra support to SMEs, if necessary.
- The Asia-Pacific region is prone to natural disasters. Given the interconnectedness of the APEC region's supply chains, the adverse consequences of natural disasters on the region's growth and competitiveness could be significant. It is therefore important that APEC members collaborate and strengthen the agenda on disaster preparedness to prevent and mitigate the impact of future events.
- Despite the uncertain economic outlook, APEC economies should continue to pursue the regulatory reform agenda as identified in ANSSR in order to enhance the competitiveness and resilience of the domestic economy.
- APEC can play a significant role by continuing to monitor and report on the region's economic and financial developments. APEC can also contribute by helping to expedite the pace of structural reforms and promoting enhanced awareness among APEC member economies in the areas where structural reforms would add most value.

## I. External Economic Environment

### The global downturn in Q4 2011 was less synchronized

In the last few weeks of 2011, economic data for the global economy became cautiously positive, as reflected in the JP Morgan Global All-Industry Output Index which increased to a nine-month high of 53 points in December 2011. This suggests that global GDP growth remained steady, albeit only modestly in the last quarter of 2011.

However, the data pointed to a deterioration in economic activity in the Euro area. Signs of recovery in Germany were offset by stagnation in France and an ongoing downturn in Italy and Spain. While GDP expanded in the Euro area in Q3 2011, forecasters are projecting a contraction for Q4 2011.

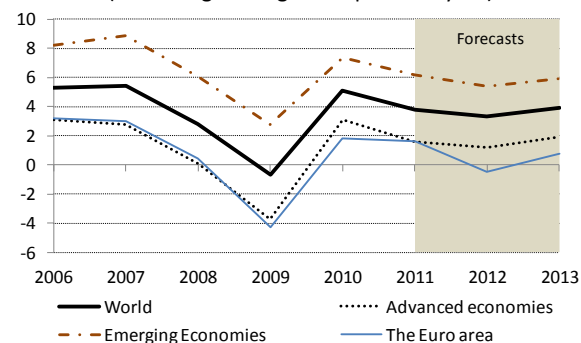
Growth in the Euro area in the first three quarters of 2011 relied heavily on the solid performance of the external sector. Domestic consumption and business investment have been weak. More recent data on retail sales and expectations confirmed a considerable risk of a contraction in domestic demand as confidence among consumers continues to worsen given the deteriorating employment outlook and general economic conditions. The Euro area's aggregate unemployment rate surged to 10.4% in December, the highest level in 14 years. Business investment has also been lowered on a weakening industrial sector. With the escalation of the sovereign debt crisis, it is unlikely that exports will remain the main driver of growth for the Euro area.

### Slower global growth is forecast in 2012 and 2013

In the latest World Economic Outlook (WEO) Update in January 2012, the International Monetary Fund (IMF) forecasts that global GDP growth would slow from 3.8% in 2011 to 3.3% in 2012, before accelerating to 3.9% in 2013 (Figure 1). These forecasts represent significant downward revisions from the September 2011 WEO, which projected that global GDP would grow by 4.0% and 4.5% in 2012 and 2013, respectively. The downward revisions are concentrated in the Euro area, where a mild recession is now expected, as well as in emerging economies. While there are many factors contributing to these revisions, one broad theme is the cascading effect on

international trade, credit and financial conditions associated with the Euro area's ongoing sovereign debt crisis.

Figure 1: IMF Forecasts for Global GDP Growth (Percentage change over previous year)



Source: IMF WEO Update, January 2012

### Downside risks in the global outlook have also risen sharply

Among the risks is the challenge of many advanced economies to strike the right fiscal policy balance between near-term support for growth and long-term sustainability. Emerging economies are also at risk of a hard landing, should there be a reversal in the current trend of buoyant credit and strong asset price growth. But more central to the risk is the future course of the crisis emanating from Europe as slow progress toward a comprehensive solution has resulted in continued volatility in financial markets.

In early January 2012, Standard & Poor's downgraded nine economies of the Euro area. The ratings of the most affected economies (Italy; Portugal; Spain and Cyprus) were lowered by two levels while the top ratings of France and Austria were down by one notch. As a result, global financial markets continue to experience turmoil and the European banking sector is looking increasingly vulnerable. These concerns may be heightened again later in the year due to the fact that large amounts of sovereign debt will need to be refinanced in 2012.

## II. Recent Economic Developments in APEC Economies

2011 was a volatile year for APEC economies with economic recovery being plagued by extraordinary

obstacles. On the domestic front, many APEC economies experienced devastating natural disasters – from earthquakes in New Zealand, earthquakes and a tsunami in Japan, volcanic eruption in Chile, flooding in Australia; the Philippines and Thailand, a deadly typhoon in China and Chinese Taipei, windstorms in the United States and other adverse weather conditions in the Americas. Aside from immeasurable human losses, the economic damage inflicted by these natural disasters reached new highs and had a large impact on the region's supply and production chains.

On the external front, the APEC region was increasingly affected by the spread of negative ripples from the economic and financial disruptions in the Euro area. The magnitude of the impact varies on the degree of an economy's reliance on external trade and finance as well as the capacity to stimulate domestic demand.

### Economic growth in advanced APEC economies generally picked up in the second half of 2011 but concerns are raised over its sustainability

#### The United States

The U.S. economy ended 2011 on a strong note. In Q4 2011, the economy advanced 2.8%<sup>1</sup> on an annualized basis, building on the 1.8% growth in the previous quarter (Figure 2). For 2011 as a whole, the U.S. economy grew by 1.7%, down from 3.0% in 2010.

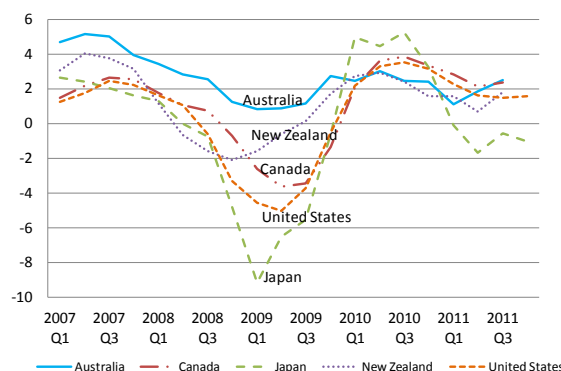
The main contributors to the strong Q4 growth rate were the recovery of private inventory investment (which added 1.9 percentage points) and robust household consumption (which added 1.5 percentage points). There were also gains in exports and residential fixed investment. These gains were offset by a significant contraction in government expenditure which deducted almost a percentage point from the growth rate. One encouraging note was the continuing decline in the unemployment rate which fell for the fourth consecutive month in December to 8.5%, the lowest level in three years.

However, the pace of growth is likely to slow in the coming quarter. Government expenditure is expected to decline more sharply, reflecting the ongoing process of fiscal austerity. But more importantly, the

<sup>1</sup> This figure is based on the U.S. Bureau of Economic Analysis' advance estimate and is subject to large revisions.

strength of growth in Q4 2011 was built on the large swing in inventory spending, which tends to be quite volatile and is unlikely to be sustained.

Figure 2: GDP Growth – Advanced APEC Economies (year-on-year (y-o-y) percentage change)



Source: Thomson Reuters

#### Japan

Economic activity in Japan was interrupted in March 2011 by the devastating earthquakes and accompanying tsunami. Nevertheless, the restoration of the supply chain has improved consumer sentiment and pushed up private consumption. Accordingly, real GDP in Q3 2011 advanced by an annualized rate of 6.8%, with private consumption contributing around 2.4 percentage points of this growth rate.

However, the growth momentum has slowed in Q4 2011 with GDP contracting by an annualized rate of 2.3%. The closure of some nuclear power plants following the March natural disaster, combined with slowing global demand and a strong currency, has caused exports to slow and imports to rise. Japan closed 2011 with its first trade deficit (of JPY 2,496 billion or 0.5% of GDP) since 1980. The contraction in Q4 was also caused by other temporary factors, including the disruption in the manufacturing supply chain due to flooding in Thailand.

In the near-term, the strong Japanese yen (JPY), which remains near its peak against the US dollar (USD), will contribute to lowering import costs while at the same time having a negative effect on exports. However, growth is likely to gain traction in the coming quarters, backed by a modest recovery in the U.S. economy as well as an accelerated pace of public investments.

#### Other advanced APEC economies

Economic activity in Australia; Canada and New Zealand picked up in Q3 2011. On an annualized

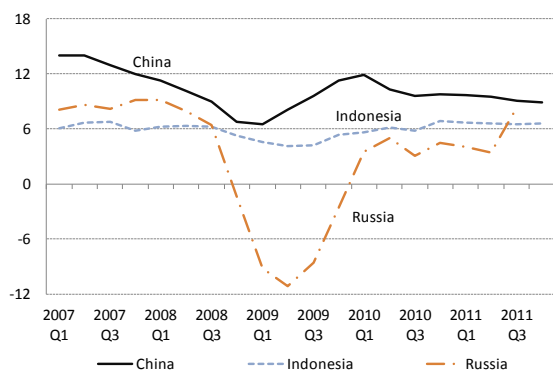
basis, the Canadian economy advanced by 3.4%, a turnaround from a 0.5% contraction in the previous quarter. In Australia and New Zealand, GDP expanded by 3.8% and 3.9%, respectively. The drivers of growth differed, however.

For Canada, the strong recovery in export earnings was by far the most important driver, partly thanks to the resilience of the U.S. economy and the sharp decline in the Canadian dollar (CAD). The domestic economy, on the other hand, has lost some of its positive momentum. Consumer spending growth softened as households struggle with historically high debt levels and weak income growth. Business investment was also dragged down by large decreases in investment in machinery and equipment.

Australia and New Zealand were both confronted with devastating natural disasters in 2011. Flooding in Queensland and earthquakes in the Canterbury region of New Zealand's South Island caused disruption to businesses and resulted in economic slowdown earlier in the year. In the second half of 2011, strong investment in the resources-related sector has driven the recovery in Australia. In New Zealand, continued seismic activity has delayed the reconstruction process in Christchurch but the economy received some stimulus from a surge in overseas visitors for the Rugby World Cup.

### In large emerging APEC economies, economic growth in 2011 has been resilient although the momentum has slowed

Figure 3: GDP Growth – Large Emerging APEC Economies (y-o-y percentage change)



Source: Thomson Reuters

### China

China's tight monetary policies earlier in the year have succeeded in cooling economic growth. Throughout 2011, the GDP growth rate slowed gradually, but still remained at an impressive 8.9% y-o-y for Q4 2011 (Figure 3). Weak demand for Chinese exports in the European and U.S. markets reduced export revenues. Investment growth also shifted downward on a softened property market outlook. On a positive note, private consumption was strong due to rising incomes.

### Indonesia

The Indonesian economy experienced another year of stellar performance amid global financial turmoil. In 2011, GDP expanded by 6.5%<sup>2</sup>, marking the highest growth rate since the 1998 Asian financial crisis. This economic expansion was broad-based which helped to reduce national unemployment. Rising job opportunities and wages resulted in robust private consumption, which grew by 4.7% in 2011. Despite heightened global market uncertainties, business investment and portfolio capital grew strongly in Indonesia, partly thanks to a sovereign credit upgrading by all three major rating agencies since April 2011. Foreign direct investment surged to a record USD 20 billion in 2011. The external sector also performed well as regional demand for Indonesian exports remained strong. In 2011, net exports grew by 14.4% in comparison with the 8.7% growth registered in 2010.

### Russia

2011 was a robust year for Russia's economic performance. In Q3 2011, real GDP expanded by a strong 4.8% y-o-y as domestic demand was boosted by increased government transfers, rising disposable income and continued credit expansion. So far, weak global growth had only a marginal effect on the real Russian economy as oil prices remain high. However, the pace of growth was expected to slow in the last quarter of 2011 as the slowdown in Europe and China started to affect Russia via financing and trade channels, causing private investment to underperform.

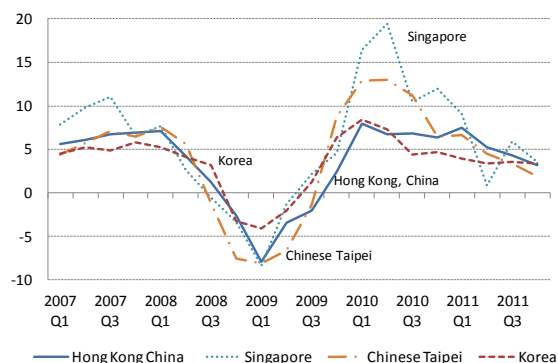
### Growth stories in other emerging APEC economies are mixed

Falling global demand has seen GDP growth rates in trade-dependent economies such as Hong Kong,

<sup>2</sup> According to Statistics Indonesia

China; Korea; Singapore and Chinese Taipei decelerating sharply (Figure 4). In Q4 2011, Singapore's economy contracted by an annualized rate of 4.9%<sup>3</sup>, leaving GDP growth for 2011 at 4.8%, significantly lower than the 14.5% growth recorded in 2010. The cooling momentum in the private residential property sector following the government's newly implemented measures and the decline in the electronics and biomedical production were the main contributors to the economic contraction in Q4.

Figure 4: GDP Growth - Newly Industrialized APEC Economies (NIEs) (y-o-y percentage change)



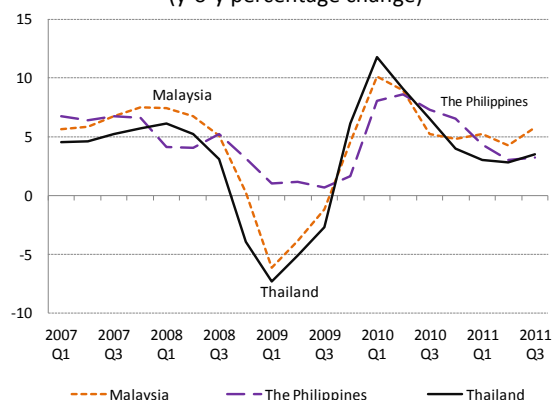
Source: Thomson Reuters

Chinese Taipei also experienced a contraction of 0.98% (annualized rate) in Q4 2011 as the escalated sovereign debt crisis in the Euro area and deleveraging in advanced economies weighed heavily on its exports and investment. Growth in private and public consumption also moderated. Real GDP is estimated to have grown by 4.0% in 2011, less than half of the 10.7% growth registered in 2010.

Economic activity in Hong Kong, China and in Korea steadily slowed over 2011. GDP growth in Hong Kong, China slowed from 5.3% (y-o-y) in Q2 2011 to 4.3% in Q3 and further to 3.0% in Q4, leaving growth for 2011 at 5.0%. In comparison, real GDP grew by 7.0% in 2010. In Korea, weak growth in exports, private consumption and corporate spending resulted in GDP growth declining from 6.2% in 2010 to 3.6% in 2011.

<sup>3</sup> This figure is based on an advanced estimate and is subject to revision.

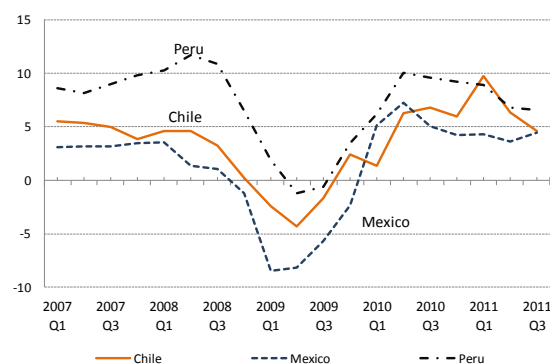
Figure 5: GDP Growth – Malaysia; the Philippines and Thailand (y-o-y percentage change)



Source: Thomson Reuters

After registering strong growth of over 7% in 2010, the pace of growth in Malaysia; the Philippines and Thailand also slowed in 2011 (Figure 5). The deceleration in Thailand's output was partly attributed to disruptions in supply and production chains arising from a series of natural disasters, first in Japan and then in Thailand. Slowing global demand for electronic goods has impacted heavily on the Philippines, where merchandise exports fell by almost 18% between July and November and GDP growth dropped to 3.7% in 2011, less than half of 2010's record growth of 7.6%.

Figure 6: GDP Growth – Latin American APEC Economies (y-o-y percentage change)



Source: Thomson Reuters

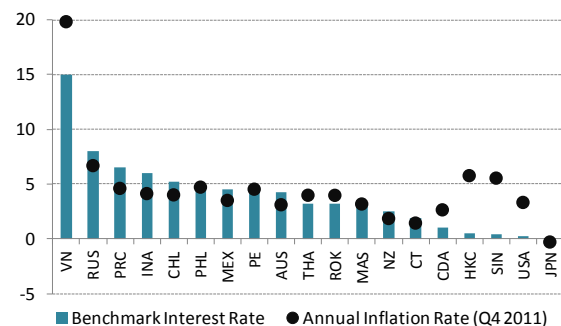
The picture is similar for emerging APEC economies in Latin America (Figure 6). The slowing down in industrial production in the United States contributed to a sharp decline in Mexico's manufacturing activities, especially those related to automobile exports. The price of copper, an export mainstay of

Chile and Peru, fell by 21%<sup>4</sup> in 2011. The disruption in the production of copper in the second half of 2011 in Chile – due to bouts of poor weather conditions and labor disputes – also impacted negatively on export earnings. On the domestic front, private consumption, aided by favorable credit conditions and healthy employment growth, has been the primary driver of economic strength.

Meanwhile, the resource-rich economies of Brunei Darussalam and Papua New Guinea have continued to perform well. In Brunei Darussalam, GDP growth is expected to accelerate to 2.8% in 2011, continuing the trend of economic recovery since 2010 on higher oil and gas production. For Papua New Guinea (PNG), economic activity is expected to expand by an impressive 9.0%<sup>5</sup> in 2011, underpinned by the ongoing development of the PNG Liquefied Natural Gas project, higher commodity prices for its exports and increased government expenditure.

### III. APEC Economies: Evolution in Prices and Monetary Responses

Figure 7: A Snapshot of December 2011 Benchmark Monetary Policy Interest Rates and Annual Inflation Rates for Selected APEC Economies<sup>6</sup> (%)



Source: Thomson Reuters, national sources and PSU staff calculation

<sup>4</sup> Based on London Metal Exchange Copper Prices.

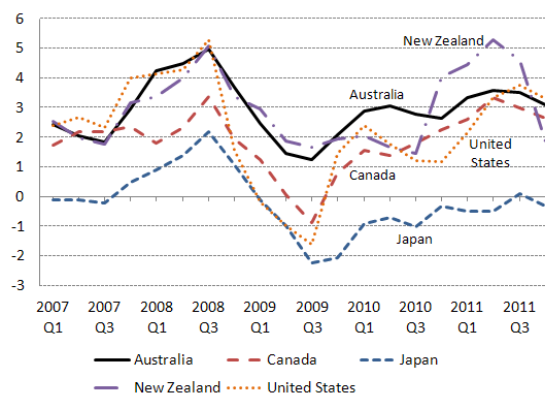
<sup>5</sup> Based on the forecast from the IMF WEO September 2011

<sup>6</sup> Abbreviations used for figures are as follows: Australia (AUS); Brunei Darussalam (BD); Canada (CDA); Chile (CHL); China (PRC); Hong Kong, China (HKC); Indonesia (INA); Japan (JPN); Korea (ROK); Malaysia (MAS); Mexico (MEX); New Zealand (NZ); Papua New Guinea (PNG); Peru (PE); the Philippines (PHL); Russia (RUS); Singapore (SIN); Chinese Taipei (CT); Thailand (THA); Viet Nam (VN).

Inflationary pressure began to ease in the APEC region in the second half of 2011, consistent with the global trend. Commodity prices, which are key drivers of inflation and are typically volatile, have begun to stabilize, helping to ease some inflationary pressure in the short term. Although still elevated, prices for oil and other commodities, including food, which created inflationary pressure in early 2011, have not significantly increased further. Core inflation is also generally subsiding, but remains high in several economies that pay relatively high prices for intermediate inputs, such as chemicals (Korea), precious metals (Indonesia and Viet Nam), and primary commodities (Hong Kong, China). Although the general consensus is that global inflation has already peaked, inflationary pressure continues to be a concern in several APEC economies.

### Despite measures to boost economic growth, inflationary pressure is generally low in advanced APEC economies

Figure 8: Headline Inflation – Advanced APEC Economies (y-o-y percentage change)



Source: Thomson Reuters and PSU staff calculation

To stimulate economic growth, policy makers in advanced economies have pursued a loose monetary policy. However, these measures have not resulted in an increase in the price level for which they are often associated, mainly due to continued sluggish growth in the advanced economies as well as the long economic recovery process that is anticipated.

#### The United States

Headline inflation in the United States increased throughout 2011, with a 3.8% increase recorded in Q3, followed by a 3.3% rise in Q4 (y-o-y) (Figure 8). The monetary easing policy measures undertaken by the Federal Reserve, as well as its announcement that short-term interest rates will likely remain near



zero at 0.25% through late 2014, have added to price pressures. However, the Fed also announced that it will adopt an explicit inflation target of 2%. Additionally, given the slow growth and deleveraging that currently characterizes the U.S. economy, inflationary pressure is expected to remain low. The weak U.S. labor market has also further dampened inflationary pressure as high levels of unemployment weaken wage growth.

### Japan

Although headline inflation increased by just 0.1% in Q3 2011 (the first increase since Q4 2008), Q4 2011 saw another fall of 0.3% (y-o-y) as Japan continues to experience deflation. Most significantly, core inflation continues to decline. The Bank of Japan has pledged to keep its zero interest rate policy – the benchmark interest rate is held in a range of zero to 0.1% – until it achieves the goal of 1% annual inflation. Additionally, the bank announced that it would expand its asset-purchasing program to JPY 65 trillion from JPY 55 trillion in a move to spur economic growth.

### Other Advanced Economies

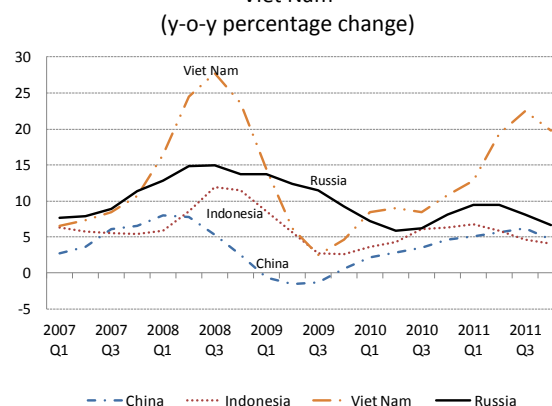
Inflationary pressure in Australia and New Zealand cooled in the last quarter of 2011. Most notable was in New Zealand where consumer prices surprisingly fell by 0.3% over the previous quarter, helping to pull down the annual inflation rate from a rate of 4.6% in Q3 to 1.8% in Q4 2011 (y-o-y). In Australia, consumer prices increased 3.1% in Q4 2011, easing from their rise of 3.5% in Q3 2011 (y-o-y), but still higher than the official target of 2% to 3%. Canada also saw an easing in inflation as consumer prices rose 2.6% in Q4 2011 after increasing 3.0% in Q3 (y-o-y), mostly due to gasoline prices beginning to moderate, and suggesting that the Bank of Canada's policy of maintaining the benchmark lending rate at 1% has not led to large price increases.

The legacy of a strong currency in Australia and New Zealand, which helped to lower import prices, has also helped to moderate inflationary pressure. The cooling down of consumer prices, combined with the unusual degree of uncertainty around global conditions and the moderate pace of domestic demand, has led to expectations of a further loosening of monetary policy in the near term.

## Although inflationary pressure remains a concern in emerging economies, stimulating economic growth has become a bigger priority

In contrast to advanced economies, many emerging economies which experienced high levels of inflation in early 2011 have tightened monetary policy, successfully enacting measures to curb inflation by late 2011. Given the general consensus that global inflationary pressure has eased, emerging economies should still have room to loosen monetary policy in order to boost growth if needed.

Figure 9: Headline Inflation – China; Indonesia; Russia and Viet Nam



Source: Thomson Reuters, national sources and PSU staff calculation

### China

China continues to face challenges in balancing inflationary pressure with stable growth. In fact, the retreat in key commodity prices across the world partly reflects slowing growth in China as a result of its steady monetary tightening. Following a period of elevated inflation throughout 2010, government measures to curb prices began to take effect in 2011, with headline inflation easing to 4.6% in Q4 2011 (y-o-y) from 6.2% in the previous quarter (Figure 9). Nevertheless, rising land, labor and resource costs continue to add inflationary pressure in the long term. Despite this, a possible slowdown in GDP growth may lead to moderate policy easing in order to support growth and restructuring in China.

### Indonesia

Inflation continues to ease in Indonesia, with consumer prices up by 4.1% in Q4 2011 compared with an increase of 6.8% in Q1 (y-o-y). Although price pressures are easing as demand for exports slows, the government's plan to limit subsidized fuel

consumption and to raise electricity tariffs may give pressure to price increases in 2012.

Following reductions in October and November 2011, Bank Indonesia cut its benchmark interest rate from 6.0% to 5.75% in February 2012, the lowest since 2005. This latest move surprised the market, fuelling speculation that stimulating economic growth has become the bank's main focus despite the inflation risk.

### Viet Nam

Among emerging APEC economies, inflation is a most pressing concern in Viet Nam, which experienced double-digit increases in headline inflation in each quarter of 2011. Consumer prices ended 2011 up 19.8%. As a result, policy makers in Viet Nam have less room to loosen monetary policy in order to boost growth against a sluggish global economy and a weak outlook for exports. Although other emerging economies have lowered interest rates, the State Bank of Viet Nam is reluctant to cut their interest rate – which currently stands at 15.0% - until there is evidence of sustained lower inflation, especially core inflation.

### Russia

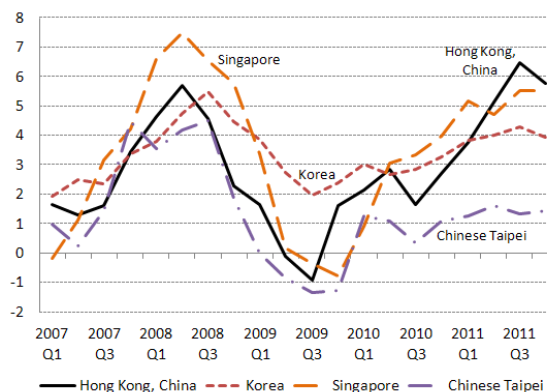
Headline inflation in Russia slowed throughout 2011. Consumer prices rose 6.7% in Q4 2011 (y-o-y), following increases of above 8% in the first three quarters of 2011. However, risks to inflation continue to linger, especially as the government plans to increase public spending and also to raise tariffs on electricity and other public utilities. Policy makers are therefore reluctant to lower the policy rate, even in light of the risks to economic growth, including a possible reduction in the demand for Russia's exports if the debt crisis in Europe continues to worsen.

### Newly Industrialized Economies (NIEs)

With the exception of Chinese Taipei, inflation is elevated in the newly industrialized APEC economies. Consumer prices in Singapore increased by another 5.5% in Q4 2011 (y-o-y) (Figure 10). Even as growth moderates, inflation is expected to remain high in Singapore mainly due to a continued increase in housing rents, rising wage cost pressures, and policies that have increased the price of car ownership. In contrast, price pressures from food and housing rentals are expected to ease in Hong Kong, China as global commodity prices retreat and domestic economic activity slows in line with the global economy. Headline inflation in Hong Kong,

China increased 5.8% in Q4 2011, following a rise of 6.5% in the previous quarter (y-o-y).

Figure 10: Headline Inflation – Newly Industrialized APEC Economies (NIEs) (y-o-y percentage change)

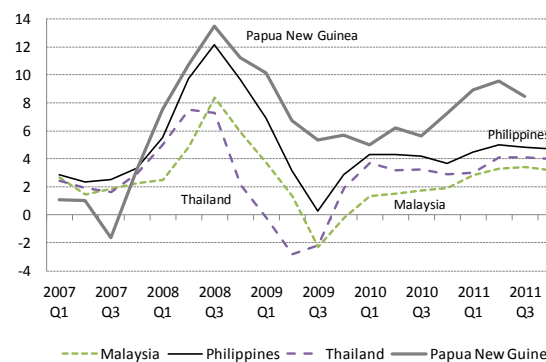


Source: Thomson Reuters, national sources and PSU staff calculation

Headline inflation in Korea was high throughout 2011, rising 4.0% in Q4 (y-o-y). This was due to an increase in the prices of raw materials and other commodities. Despite having already implemented policies to curb prices, policy makers plan to enact a number of measures, including minimizing the increase in utility charges. The Korean government has made tackling rising inflation a top priority, pledging to stabilize consumer prices in 2012 and to keep inflation in the low 3% range. Given continued price pressures, the scope for reducing the policy rate as a measure to combat slowing growth is limited. The official interest rate currently stands at 3.25%.

### Other Emerging Economies

Figure 11: Headline Inflation – Malaysia; Papua New Guinea; the Philippines and Thailand (y-o-y percentage change)

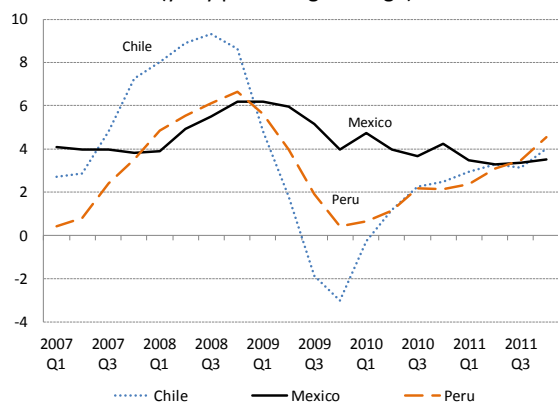


Source: Thomson Reuters, national sources and PSU staff calculation

Although consumer prices in Thailand increased 4.0% in Q4 2011 (y-o-y), inflationary pressure has decreased (Figure 11). Boosting economic growth has become a priority, especially since the economic impact of the flooding has been worse than expected. Accordingly, the Bank of Thailand cut the benchmark rate to 3.0% in January. Similarly, the Philippines' central bank also lowered its policy rate to 4.25% in January as the sluggish global economy threatens growth. Headline inflation in the Philippines rose 4.7% in Q4 2011 (y-o-y), but is considered by policy makers to be contained.

Meanwhile, headline inflation in Malaysia rose 3.2% in Q4 2011, following a 3.4% increase in Q3 (y-o-y). This was the largest rise since Q1 2009, as food and transportation costs increased and a weakening currency made imports costlier. In particular, the flooding in Thailand, which resulted in a loss of an estimated 6 million metric tons of unmilled rice as flooding damaged key plantation areas, has driven imported food prices higher in Malaysia.

Figure 12: Headline Inflation – Latin American APEC Economies (y-o-y percentage change)



Source: Thomson Reuters, national sources and PSU staff calculation

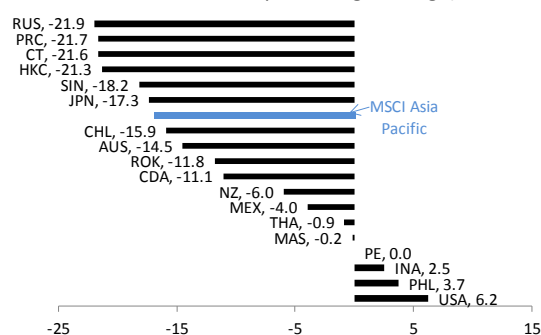
Headline inflation was elevated in Peru throughout 2011, rising 4.5% in the Q4 (y-o-y), mainly due to rising food prices (Figure 12). Policy makers have indicated that the higher than expected inflation, and the expectation that food prices will remain elevated, has prevented them from doing more to bolster economic growth – the policy rate remains unchanged at 4.25%. Chile also experienced a higher than expected increase in headline inflation in Q4 2011 due to higher food prices, rising 4.0% (y-o-y). However, policy makers consider this increase to be short term and the central bank reduced the benchmark overnight lending rate to 5.0% in January

as bolstering economic growth becomes more of a priority. In Mexico, elevated food prices also caused headline inflation to increase higher than expected, rising 3.5% in Q4 2011 – the central bank has maintained the benchmark lending rate at 4.5%.

## IV. Developments in APEC Financial and Currency Markets

### Equity prices in most APEC markets have exhibited sharp swings in the second half of 2011 with emerging APEC markets generally underperforming

Figure 13: Growth of Stock Price Indexes<sup>7</sup> (3 January to 30 December 2011, percentage change)



Source: Thomson Reuters and PSU staff calculation

Despite the impressive performance of the domestic economy, the Chinese stock market experienced large losses in 2011. The Shanghai Composite Index closed the year down 21.7% (Figure 13). The reduction in stock prices in China partly reflected liquidity pressures as the government implemented stringent measures to address real estate and other price pressures.

Share prices also declined considerably in the Russian equity market, partly reflecting the volatility of global commodity and currency markets. Elsewhere in emerging Asia, equity prices also fell sharply on concerns about a possible softer growth profile for China as well as the possible effects on the region's

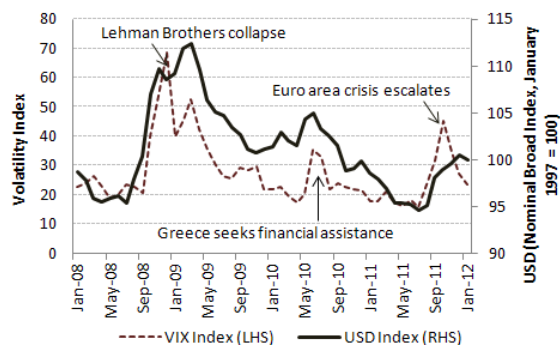
<sup>7</sup> Daily closing stock price indexes of ASX 200 (AUS), TSX Composite (CDA), IPSA (CHL), Shanghai Composites (PRC), Hang Seng (HKC), JCI (INA), Nikkei 225 (JPN), Kospi (ROK), KLCI (MAS), IPC (MEX), NZX 50 (NZ), SE ISP 15 (PE), PSEi (PHL), RTS (RUS), STI (SIN), TAIEX (CT) and DJIA (USA).

exports of continued slower global growth. The exceptions were the Philippines and Indonesia, where the local composite stock indices bucked the global declining trend, ending 2011 at 3.7% and 2.5% higher, respectively.

Equity markets in advanced APEC economies also produced mixed results. The Japanese market ended 2011 at their lowest year-end close in almost three decades. Elsewhere, the declines in hard commodity prices in August and September significantly impacted resource stocks. The composite Australian ASX 200 index lost 18% over this period although it recovered some of these losses toward the end of 2011. On the other hand, U.S. equities rallied strongly during the final days of trading in 2011 on positive news in the economy, reversing most of their earlier losses. The Dow Jones Index closed 2011 at 6.2% higher while the U.S. S&P 500 closed the year with very marginal losses.

### Frequent fluctuations in investors' risk sentiment have also caused volatility to return to the exchange rate markets, especially since the second half of 2011

Figure 14: Evolution of the USD<sup>8</sup> and the Chicago Board Options Exchange Market Volatility (VIX) Index<sup>9</sup>



Source: U.S Federal Reserve and Thomson Reuters

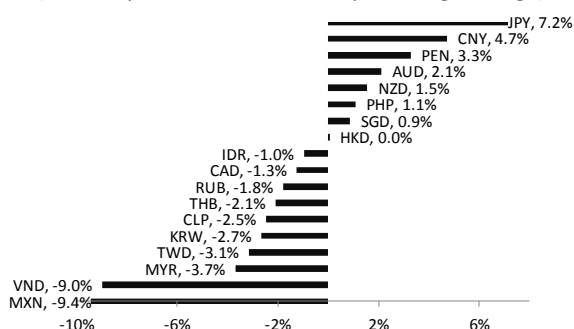
Despite the sovereign credit rating downgrade by Standard and Poor's, the US dollar (USD) has retained its safe-haven currency status (Figure 14).

<sup>8</sup> The USD Nominal Broad Index is a weighted average of the foreign exchange values of the USD against the currencies of a large group of major U.S. trading partners. An increase in the USD index indicates an appreciation of the USD.

<sup>9</sup> The Chicago Board Options Exchange Market Volatility Index (VIX) represents a measure of the market's expectation of stock market volatility over the next 30 day period. An increase in the VIX index indicates greater uncertainty in the stock market.

Amid increased market uncertainty around mid-September, investors withdrew assets in offshore markets and repatriated these funds to the United States and to a lesser extent, Japan. Based on a basket elaborated by the U.S. Federal Reserve (which considers the currencies of the main U.S. trading partners), the USD gained 2.9% in 2011.

Figure 15: Change in Exchange Rates<sup>10</sup> against the USD (6 January to 6 December 2011, percentage change)



Source: Thomson Reuters and PSU staff calculation

The performance of other APEC currencies has been mixed (Figure 15). The Japanese yen (JPY) reached record highs on a nominal basis in late 2011, gaining 7.4% against the USD in 2011. Much of this appreciation can be attributed to increased risk aversion. The Chinese yuan (CNY) has also gradually appreciated against the USD, ending 2011 around 4% higher. In Latin America, the Peruvian sol (PEN) has been the best performing Latin American currency. High commodity prices and a strong economic performance have seen the PEN closing 2011 up 4.5% against the USD.

In other emerging APEC markets, portfolio investment has fallen since August 2011, reversing some of the previous strong flows. Accordingly, currencies of most emerging APEC economies have depreciated, particularly against the USD and the JPY. The sharpest falls occurred in mid September 2011 as concerns about weaker global growth added to Euro area debt concerns. In this context, the Korean won (KRW) was particularly affected, depreciating as

<sup>10</sup> Abbreviations used for Figure 14 are as follows: Australian dollar (AUD); Canadian dollar (CAD); Chilean peso (CHP); Chinese yuan (CNY); Hong Kong dollar (HKD); Indonesian rupiah (IDR); Japanese yen (JPY); Korean won (KRW); Malaysian ringgit (MYR); Mexican peso (MXN); New Zealand dollar (NZD); Peruvian sol (PEN); Philippines peso (PHP); Russian ruble (RUB); Singapore dollar (SGD); Taiwan new dollar (TWD); Thai baht (THB); Viet Nam dong (VND). (Taiwan new dollar is the currency of Chinese Taipei.)

much as 12% against the USD over the August-September period. Since the reported intervention by the Korean Central Bank, the KRW has retraced some of its earlier losses. The Viet Nam dong (VND) also depreciated sharply, ending 2011 9.0% lower against the USD, given a large current account deficit and low foreign exchange rate reserves. In Latin America, the Mexican peso (MXN) has been particularly sensitive to fluctuations in oil prices and developments in the U.S. economy, depreciating by 18% against the USD over the second half of 2011.

## V. APEC Economies: Prospects and Risks

Based on the latest IMF forecasts in January 2012, the short term growth outlook for the APEC region has deteriorated since the September 2011 WEO publication. Real GDP in the APEC region is projected to grow by 4.1% in 2012 and 4.5% in 2013, representing downward revisions of 0.4 and 0.5 percentage points for 2012 and 2013, respectively, relative to the September 2011 WEO forecasts (Table 1). The pace of growth momentum is forecast to slow in many APEC economies but is more pronounced among the NIEs. On the other hand, the economies of Australia; Japan; New Zealand and Thailand are projected to grow faster in 2012 compared to the previous year, partly because of the recovery process from natural disasters.

Table 1: IMF Forecasts for Real GDP Growth for Selected APEC economies<sup>11</sup>

Real GDP growth rates					
y-o-y (%)	Latest projection				
	2010	2011	2012	2013	
Canada	3.2	2.3	1.7	2.0	
China	10.4	9.2	8.2	8.8	
Japan	4.4	-0.9	1.7	1.6	
Mexico	5.4	4.1	3.5	3.5	
Russia	4.0	4.1	3.3	3.5	
United States	3.0	1.8	1.8	2.2	
NIEs	8.4	4.2	3.3	4.1	
ASEAN-5	6.9	4.8	5.2	5.6	
<b>APEC</b>	<b>Jan 12 forecast</b>	<b>5.8</b>	<b>4.1</b>	<b>4.1</b>	<b>4.5</b>
	<i>Sep 11 forecast</i>	5.7	4.2	4.5	5.0
<b>WORLD</b>	<b>Jan 12 forecast</b>	<b>5.2</b>	<b>3.8</b>	<b>3.3</b>	<b>3.9</b>
	<i>Sep 11 forecast</i>	5.1	4.0	4.0	4.5

Source: IMF and PSU staff calculation

On the inflation side, weaker global demand for commodities in the near term is expected to drive

<sup>11</sup> ASEAN-5 are Indonesia; Malaysia; the Philippines; Thailand and Viet Nam.

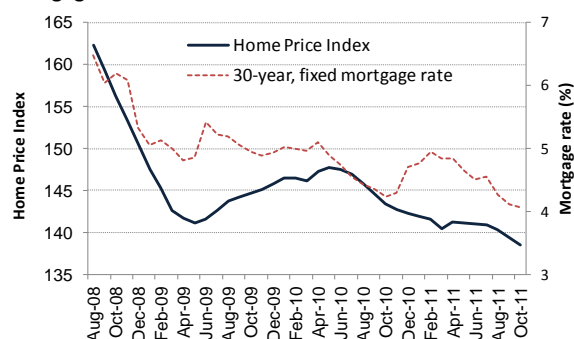
price pressures downward further in 2012. In advanced economies, sluggish growth and well-anchored inflation should help to contain price pressures, whereas emerging economies should benefit from lower food price inflation.

### However, risks to both the economic and inflation outlook remain

Despite recent better-than-expected economic data in advanced APEC economies, concerns remain as to whether this pick-up in growth can be sustainable over the next two years. In the United States, there are three factors that could substantially weaken growth prospects. These include:

- the potential damage to domestic demand and growth from political deadlocks over fiscal spending and taxes;
- the continuing feeble recovery in the housing market despite the decline in home mortgage rates (Figure 16). This in effect is curbing the central bank's efforts to spur economic growth and holding back the recovery of the U.S. financial system and the normalization of credit conditions; and
- the weak labor market outlook. Recent employment gains in the manufacturing sector could be offset by weakness in services sector recruitment, which employs around 80% of the U.S. workforce.

Figure 16: S&P/Case-Shiller Home Price Indices (20 City-Composites) and the average 30-year fixed home mortgage rate



Source: Standard and Poor's and U.S. Federal Reserve

In Japan, causes of concerns over a sustainable recovery include:

- the worsening of Japan's fiscal situation. In order to finance reconstruction spending, it is expected that the government will push for tax increases and lower public spending in other areas, including possibly in social

support to households. This has the consequence of reducing consumer confidence and could negatively impact domestic spending; and

- rising energy costs due to the disruptions of nuclear power plants. This factor, combined with the continued strength of the JPY and deflationary pressure, has prompted many Japanese manufacturing companies to consolidate their overseas affiliates' business while others are considering relocating production offshore. In the absence of any major change in economic policy, the increased relocation of Japanese industries overseas could potentially lower Japan's economic growth via reduced business investment and employment.

Another major risk relates to the possibility of housing bubbles in some economies. In China, for example, the current credit control policy has seen property prices and transaction volumes soften significantly across the economy. As the property sector is an important contributor to local government tax revenues and economic growth, further weakness will likely affect future real estate investment in China and rekindle fears of potential default among local government financing vehicles.

APEC economies are also vulnerable to the ongoing sovereign debt crisis in the Euro area which could potentially send the global economy back into recession. As noted in a report by the PSU<sup>12</sup>, such an event would impact APEC economies through three channels, including:

- lower export earnings;
- high volatility in the currency and financial asset markets; and
- stress in bank funding and higher borrowing costs.

To date, there has been strong evidence of lower export earnings and high volatility in the financial markets in most APEC economies. As the banking sector in APEC is better capitalized now than it was on the onset of the 2008 Global Financial Crisis, the stress in wholesale bank funding has been somewhat limited. However, the risk of intensifying funding stress and rising borrowing costs remains real, if sovereign debt challenges in the Euro area were to escalate further.

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<sup>12</sup> Le, Quynh. *Sovereign Debt Challenges in the Euro area: Implications for APEC*. Policy Brief No. 2, APEC PSU, 2011.

Moreover, some APEC economies are exposed to a large reversal of net capital inflows. According to a report from the Institute of International Finance<sup>13</sup>, net capital inflows to emerging economies are projected to decline by another 18% in 2012, after falling to USD 958 billion in 2011 from USD 1,107 billion in 2010. So far, the loose monetary policy adopted by central banks in large advanced economies has led to strong flows of capital into higher-growth emerging APEC markets, causing concerns over asset price bubbles. The bursting of such bubbles can trigger a deleveraging process that could seriously affect the global economic outlook.

In addition, the current volatility in financial markets could create a significant negative wealth effect that could substantially dampen consumer purchasing power. For some emerging economies, sharp currency depreciation is a cause for concern as it can depress domestic consumption and investment. Sudden currency movements could also increase foreign exchange risks, which can translate into higher interest rates and add additional uncertainty in the real economy.

Finally, risks to global inflationary pressure will remain in 2012. High prices for oil have held up in recent months and are forecast to ease only slightly in 2012. Geopolitical risks to oil prices are expected to remain elevated. Additionally, continued concern over the Euro area and the sluggish growth in many advanced economies combined with the easing measures adopted by advanced economies to bolster growth may result in excessive capital flows to many emerging economies that could further drive up prices.

## VI. Implications for Policy Responses

One of APEC's ongoing priorities is to address obstacles that inhibit cross-border trade and investment by removing barriers to doing business. The above analysis highlights that the current economic landscape has created three new challenges for businesses. These include:

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<sup>13</sup> Institute of International Finance. *Capital Flows to Emerging Market Economies*. IIF Research Note, 2012.

- i. Uncertainty in global growth prospects has resulted in many investment decisions being delayed or cancelled;
- ii. Impeding access to credit as large banks are undergoing the process of balance sheet deleveraging. Substantial declines in the market prices of many financial assets have exacerbated this problem, mostly because it has become more expensive for businesses to raise capital in the equity and bond markets;
- iii. Disruptions in global supply chains arising from natural disasters. This could severely impact corporate financial performance by raising input costs and/or disrupting production lines.

In many emerging markets, businesses are facing extra pressure from the risk of rising inflation. The tightening of monetary policy to curb price pressures, including raising interest rates, increases the costs of borrowing for businesses. On the other hand, expansionary monetary policy pursued by some advanced economies has resulted in low interest rates. Companies however remain reluctant to borrow and spend as they continue to pay down high levels of debt.

These challenges are particularly problematic for small and medium-sized enterprises (SMEs) due to their weaker financial structure (i.e. lower capitalization and lack of requisite collateral) and vulnerability to market fluctuations. As SMEs represent a large segment of the private sector in all APEC economies and are the key generators of employment and income and drivers of innovation and growth, policy responses should therefore seek to address both temporary and structural deficiencies in the SMEs operating environment, in conjunction with other fiscal and monetary measures to maintain the region's macroeconomic and price stability.

The first step toward this should include enhancing mechanisms for tracking, researching and analyzing SME specific data. This data should provide information on the environment in which SMEs are conducting businesses, i.e. trends in market demand, availability of credit and price pressures. Examples of such information could include the Small Business Economic Trends<sup>14</sup> survey which provides up-to-date information on sales, investment and job outlook as well as credit conditions for SMEs in the United

States. In light of the current volatile business conditions, timely data on SMEs operating conditions can be one of the most crucial tools for policy makers in devising effective policy responses.

Additionally, as the current economic downturn is a global phenomenon, greater cooperation among APEC policy makers is essential. APEC economies should work together to strengthen financial sectors so that they can continue facilitating economic activity. In this regard, attention should also be paid to develop a more inclusive financial system that is capable of intermediating financing for investment – particularly for SMEs – in order to promote private sector-led growth.

It is also important to note that the Asia-Pacific is the world's most catastrophe prone region. In 2011, Asia accounted for 90% of USD 270 billion worth of global economic losses from natural catastrophes. Only 20% of the USD 259 billion losses incurred in the first three-quarters of 2011 was insured. The challenge on governments to manage the economic impact and finance the costs of disaster recovery and rehabilitation is compounded by the interconnectedness of APEC economies and supply chains. In order to mitigate the impact on business and economic activities, it is crucial for governments to strengthen the resilience of economies and businesses through effective disaster risk reduction strategies. This may entail widening of natural catastrophe insurance coverage and assessing critical risks to major supply chains to reinforce their ability to withstand emergency situations through public and private sector partnership.

Despite the uncertain economic outlook, it is important that APEC economies continue to pursue regulatory reforms as identified in the APEC New Strategy for Structural Reform (ANSSR) and in the Leaders' Agenda to Implement Structural Reform (LAISR) initiative. For example, reforms that create a more business-friendly environment through removing constraints and barriers to business establishment and growth will provide a necessary platform for the private sector to contribute more to economic growth and job creation. This is particularly relevant for some emerging APEC economies where private enterprises are facing higher regulatory costs. It is also important for advanced APEC economies in which deteriorating fiscal positions imply that in the short to medium term, the public sector will no longer provide the same stimulus to economic growth as before.

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<sup>14</sup> The Small Business Economic Trends survey is provided by the U.S. National Federation of Independent Business.

In areas of regional cooperation, APEC can play a significant role in expediting the pace of structural reforms and promoting enhanced awareness among APEC member economies on the areas where structural reform would be most value added. In this regard, APEC needs to continue monitoring, reporting and discussing the regional economic trends and challenges on a regular basis in order to evaluate existing policy measures and possible areas of cooperation and coordination. APEC can also facilitate the structural reform process by identifying pilot projects that promote best practice and high quality policies, laws and regulations.

**The APEC Policy Support Unit** provides APEC members and fora with professional and tailor-made research, analysis, policy support and evidence-based policy suggestions.

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