



**Asia-Pacific
Economic Cooperation**

APEC Economic Trends Analysis

CAUTIOUS STEPS TOWARDS RECOVERY

APEC Policy Support Unit

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Advancing Free Trade for Asia-Pacific **Prosperity**

Prepared by:
Quynh Le
Policy Support Unit
Asia-Pacific Economic Cooperation Secretariat
35 Heng Mui Keng Terrace
Tel: (65) 6891-9500 Fax: (65) 6891-9690
Email: psugroup@apec.org Website: www.apec.org

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KEY MESSAGES

1. Between Q3 2012 and mid-May this year, cumulative expansionary monetary policies pursued by central banks in some large economies, supported strong flows of capital internationally. The equity and stock markets in many emerging and developing economies (EM&Ds) were buoyed by this capital inflow recovery.
2. In mid-May, tensions in the financial markets increased, partially due to an announcement by the U.S. Federal Reserve (U.S. Fed) on its strategy to reverse the expansion of its balance sheet, on the backdrop of weaker than expected economic growth in some EM&Ds.
3. Yields on U.S. Treasury bonds rose by 80 basis points between the end of May and the first week of September. The June inflows of portfolio to EM&D fell to half the amount seen in May.
4. Government bond yields in some APEC economies also rose. It appeared that bond yields increased to a greater degree in economies with larger current deficits and rising inflation.
5. During May and September this year, equity prices in APEC developing economies underperformed compared to those in APEC industrialized and newly industrialized economies (NIEs). Over the same period, the depreciation in currencies was larger among APEC commodity exporters.
6. The much anticipated recovery of global trade did not occur in the first half of this year. APEC trade was growing at a progressively moderate rate with exports to Europe contracting sharply.
7. There were signs of funding tightening in EM&Ds in Q2 2012. Investment growth was slowing in the first half of this year. In some APEC economies, this was due to the reduced rate of expansion in the mining sector.
8. Against the difficult backdrop of rising financial tensions and slower trade, the IMF downgraded its forecasts for the global economy and for the APEC region. APEC GDP is expected to moderate from 4.1% in 2012 to 3.9% this year, before accelerating to 4.4% in 2014. Much of the downward revision in the forecasts is due to slower than expected economic activity in some APEC EM&Ds in the first half of this year.
9. As a group, APEC GDP rose at 3.5% in Q2 2013, a touch higher than the 3.4% in Q1 2013. This suggests APEC economic activity is shifting gears, from growing at slower pace towards a recovery.
10. The normalization of monetary policies in some large economies, however, has implications on the global economy going forward.
11. The first channel of impact is the rise in international interest rates which may have an adverse impact on markets with large external debt burdens. Most APEC economies,

however, have made good progress in reducing their stock of external debt. The ratio of external debt to GDP for APEC EM&Ds fell from 41% in 1986 to 15% in 2011.

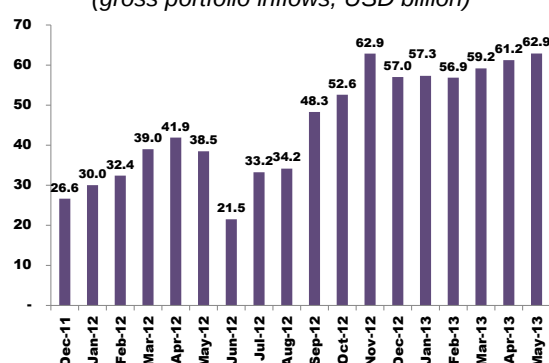
12. The second channel of impact is the transmission of rising international interest rates into higher domestic lending rates, which in turn can cause lower investment and decreased domestic consumption.
13. There is a concern that rising interest rates may complicate the task of re-engineering the economy towards stronger domestic demand. In the face of subdued trade growth, moderate domestic demand may derail the economic recovery.
14. With appropriate policy measures, the shift in monetary stance will not impact domestic demand.
15. APEC in particular can play a significant role by continuing to make progress on the broad agenda of ensuring macroeconomic and financial stability. Doing so will reduce uncertainty in the economic outlook and help to support consumer and business confidence.
16. APEC should also continue to make progress on the agenda to make the investment climate more favorable to investors. This is reflected in some of APEC's current working agenda, which includes the "APEC Ease of Doing Business (EoDB) Action Plan. Despite the progress made to date, there is still a wide divergence among individual APEC economies. This suggests there is room for APEC to intensify efforts in achieving a better business climate.
17. APEC EM&Ds account for 82% of APEC's total population but this group's household spending accounts for only 30.5% of the total APEC consumer expenditure. Therefore, policies to encourage more consumer spending in EM&Ds are critical for the pursuit of sustainable and inclusive growth.
18. Policies that improve social safety nets and other insurance mechanisms can also be effective in promoting consumption.
19. In the longer term, it is more fiscally sustainable to spur consumer spending by ensuring a healthy labor market and strong income growth.

I. Recent developments in the global financial and economic activity

One of the most notable developments over the past few quarters has been the rapid shift in the flow of international capital. Between Q3 2012 and mid-May this year, cumulative expansionary monetary policies that were pursued by large central banks in developed economies, combined with an easing of global market tensions, have supported strong flows of capital internationally.

Thanks to their relatively better growth prospects and higher interest rates, many emerging and developing economies (EM&Ds) became attractive to investors seeking better returns on their investments. Towards the end of 2012, portfolio inflows into emerging markets bounced back strongly and reached USD 62.9 billion¹ in May 2013, almost triple June 2012 inflows (Figure 1).

Figure 1: The recovery capital flows into emerging and developing markets during late 2012 to May 2013
(gross portfolio inflows, USD billion)



Source: World Bank

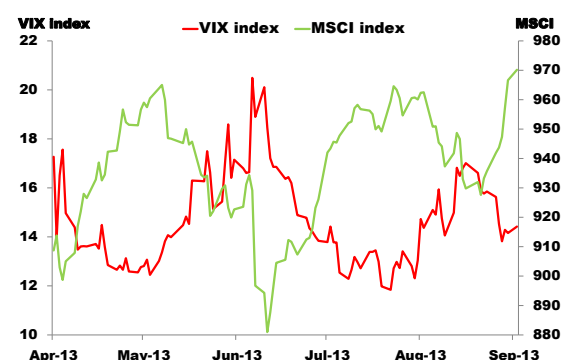
This trend swiftly reversed in late May following consideration by the U.S. Fed of a scaling back in its asset purchase program, known as Quantitative Easing² (QE). One of the most immediate effects was a sharp sell-off in the U.S. bond market. The

¹ 3-month moving average

² Under the current policy, the U.S. Federal Reserve is buying USD 85 billion worth of U.S. Treasuries and mortgage-back securities each month.

10-year Treasury yields jumped from 2.13% on 31 May to 2.74% on 26 July and subsequently to 2.93% on 6 September, despite the Fed's clarification in late July that the start of a tapering was in fact not imminent. Volatility in the financial markets also rose, with the VIX index increasing to a 6-month high of 20.5 points in mid-June. This rise in the VIX index was accompanied by a sharp decline in the global equity market (Figure 2). Within a month, the MSCI lost almost 9.0% in values, from a high of 965 points in May 2013 to 880 points in late June.

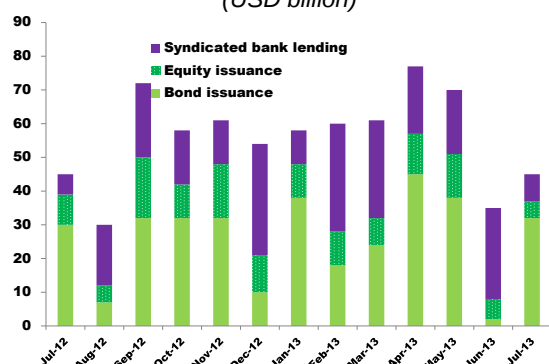
Figure 2: Rising risk aversion caused a sharp drop in global equity values in June



Source: Yahoo finance, Thomson Reuters

The indication of the U.S. Fed's intention to end its QE occurred against a backdrop of weaker than expected economic activity in some emerging and developing economies. As a result, many EM&Ds witnessed an outflow of capital in June. The effects of capital adjustment were notable in the flows of portfolio (i.e. equity, bond and bank loans) with total gross inflows to emerging and developing markets in June falling to half the amount they were in May (Figure 3).

Figure 3: Gross portfolio flows into emerging and developing economies (USD billion)



Source: World Bank

II. Recent developments in the APEC region

Borrowing costs rose for most APEC economies

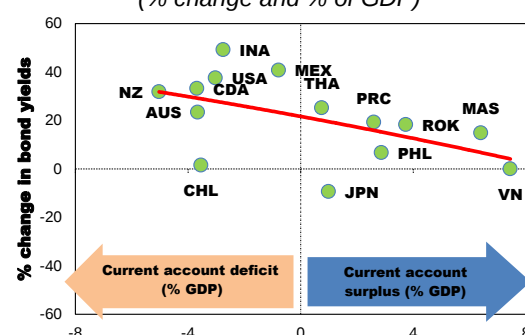
The sell-off of government bonds was not confined to the U.S. market but quickly spread to other APEC markets. As illustrated in (Figure 4), there was a clear correlation between the balances in current account and the extent of long-term bond yield appreciation during late-May to early September. Typically economies with larger current account deficits saw their bond yields rising at a faster pace.

In Indonesia, the 10-year bond yields jumped over 370 basis points, from 5.22% in mid-May to reach 8.92% in September. The relatively sharper rise in Indonesian bond yields over this period was a confluence of many factors, including rising inflation and a high level of foreign ownership in local currency government bond markets. The bond market in Mexico, which is highly correlated to the bond market in the U.S., was also affected with yields for 10-year bonds rising substantially from a low of 4.54% at the beginning of May to a high of 6.39% in early September.

Bond yields for Hong Kong, China and Singapore, also increased by 77% and 52%, respectively. These large increases were at odds with the fact that these two economies are running current account surpluses (at 18.6% of GDP in the case of

Singapore) and inflation in their economies has been stable. The rise in yields in these economies may be attributed to the reassessment of risk in the entire region. Furthermore, the large participation of foreign investors in their bond markets means that they are vulnerable to changes in global investor sentiment.

Figure 4: Changes in bond yields over May-September were larger among economies with current account deficits³⁴ (% change and % of GDP)



Source: Bloomberg, ADB, IMF & PSU calculations

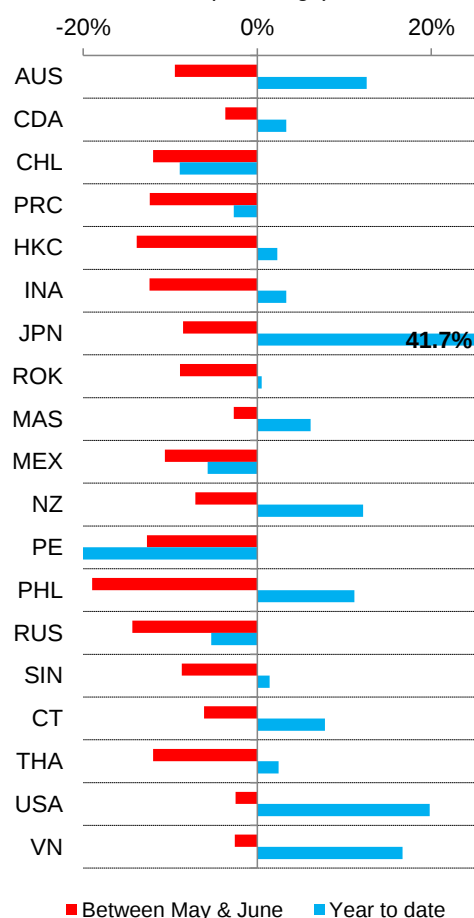
The shift in capital flows contributed to notable declines in APEC equity prices and currencies

Stock markets in virtually all APEC economies were affected by a reversal in investor sentiment during late May and June. Some APEC economies even recorded a double-digit loss in equity values between May and June (Figure 5).

³ The fitted trend line in this chart is the result of the linear regression of changes in bond yields against current account balance

⁴ Abbreviations used for APEC's members' names 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); United States (USA) and Viet Nam (VN).

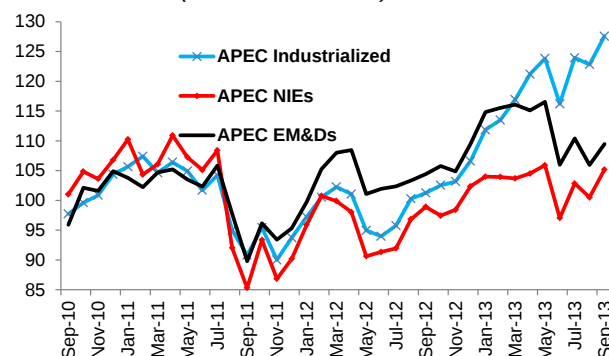
Figure 5: APEC equity markets in 2013
(% change)



Source: Thomson Reuters & PSU calculations

The U.S. Fed's announcement in September that they would be delaying the reversal of Quantitative Easing measures has helped APEC equity market to recover (Figure 6). The stock market in industrialized APEC outperformed the rest of the region. Japanese stock prices - which fell by 16% from a peak in May to a trough in June - recovered quickly as investors revised upwards their earnings expectations. The 41.7% year-to-date gain placed Japan as the best-performing stock market in the APEC region so far this year. The stock markets in the other four APEC industrialized economies – Australia; Canada; New Zealand and the United States – also showed resilience. Year-to-date, overall stock prices for industrialized APEC were up 14%. In contrast, equity markets of the emerging and developing APEC economies in mid-September were 4.7% lower.

Figure 6: Equities in APEC developing economies underperformed those in APEC industrialized and NIEs⁵
(Index, 2011 = 100)



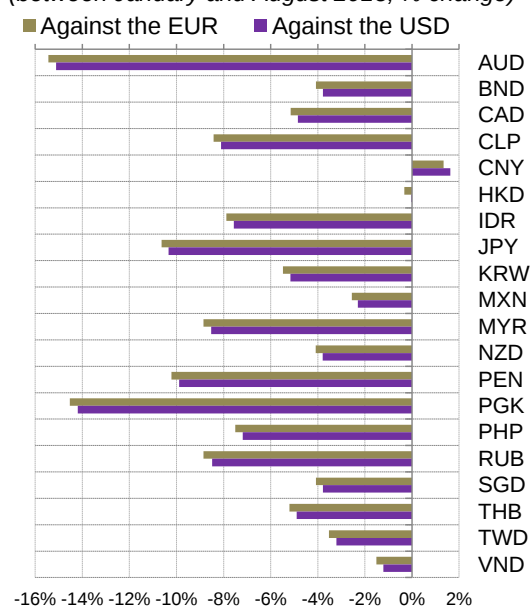
Source: Thomson Reuters & PSU calculation []

Developments in central bank policy in the major developed economies have also resulted in fluctuations in the currency market. At the beginning of this year, many APEC economies were experiencing pressure associated with large appreciations in their currencies. The AUD, for example, reached its highest level since 1985 on a trade-weighted basis in early April while the THB registered its strongest level against the USD since July 2007.

The reassessment of the market on the future path of U.S. monetary policy is attributed to large depreciations in almost all APEC currencies against the USD and the EUR (Figure 7). The depreciation was larger among commodity exporters, including Australia; Chile; Malaysia; Peru; Papua New Guinea and Russia, partly due to the recent declines in commodity prices. In the case of Japan, where the government has also implemented monetary and fiscal stimulus measures, the JPY depreciated by more than 10% against the USD and the EUR over the period between January and August this year.

⁵ APEC Industrialized Economies include Australia; Canada; Japan; New Zealand and the United States. APEC Newly Industrialized Economies include Hong Kong, China; Korea; Singapore and Chinese Taipei. APEC developing economies include Brunei Darussalam; Chile; Indonesia; Malaysia; Mexico; Papua New Guinea; Peru; the Philippines; Russia; Thailand and Viet Nam.

Figure 7: Most APEC currencies depreciated against the USD and EUR (between January and August 2013, % change)



Source: Thomson Reuters

Investment growth in the APEC region has been slowing

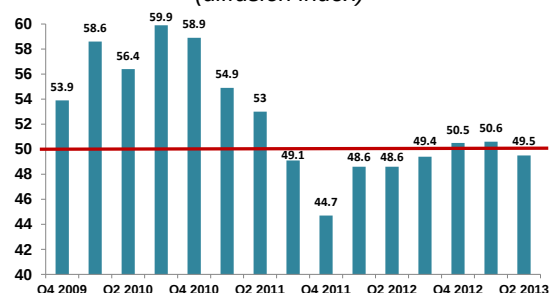
For many APEC economies, the recent changes in the equity and currency markets have helped to ease concerns about losses in export competitiveness and risks of asset price inflation. The adjustment in capital flows however has contributed to a tightening of liquidity conditions in some markets. The Emerging Market Bank Lending Conditions Index, for example, fell below 50⁶ in Q2 2013 after improving in the previous two quarters (Figure 8).

Together, large currency fluctuations and more stringent lending conditions which occurred on the backdrop of continuing uncertainty about the global economic outlook, have impacted firms' decisions to expand investment plans. With the exception of Chinese Taipei, investment growth in the first half of this year in many APEC economies was reduced substantially in comparison to the second half of

⁶ The emerging markets bank lending conditions index is compiled by the Institute of International Finance. Values above 50 indicate improving conditions while values below 50 indicate deteriorating conditions

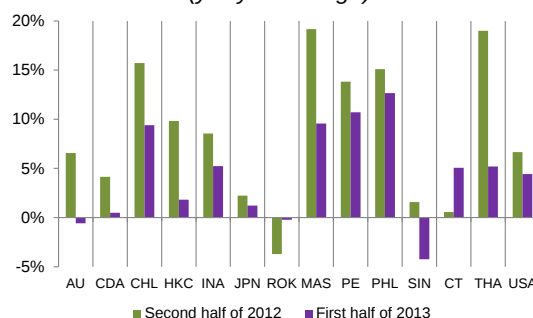
last year (Figure 9). In Australia; Chile; Indonesia and Peru, reduced investment growth also reflected the winding down of the mining sector.

Figure 8: Bank lending conditions in emerging and developing economies (diffusion index)



Source: Institute of International Finance

Figure 9: Investment growth in APEC economies (y-o-y % change)



Source: Thomson Reuters & PSU calculations

APEC trade moderated further on weak external demand

The weak performance of global trade seen in 2012 has persisted in the first half of this year. In volume terms, global trade this year has grown at a meager rate of 1.8% (y-o-y), lower than the 1.9% growth registered last year (Figure 10). In comparison, trade was growing at an average annual rate of 6.8% between 2000 and 2007. The slowdown in trade growth is mostly explained by a contraction in import demand from advanced economies, which declined at 1.7% in the first half of this year. Import demand from emerging and developing economies also saw slower growth in the second quarter of this year at 5.6%, compared with a 6.3% growth in Q1 2013.

Figure 10: The deceleration in global trade growth persisted in the first half of 2013
(trade volume, index and annual % change)

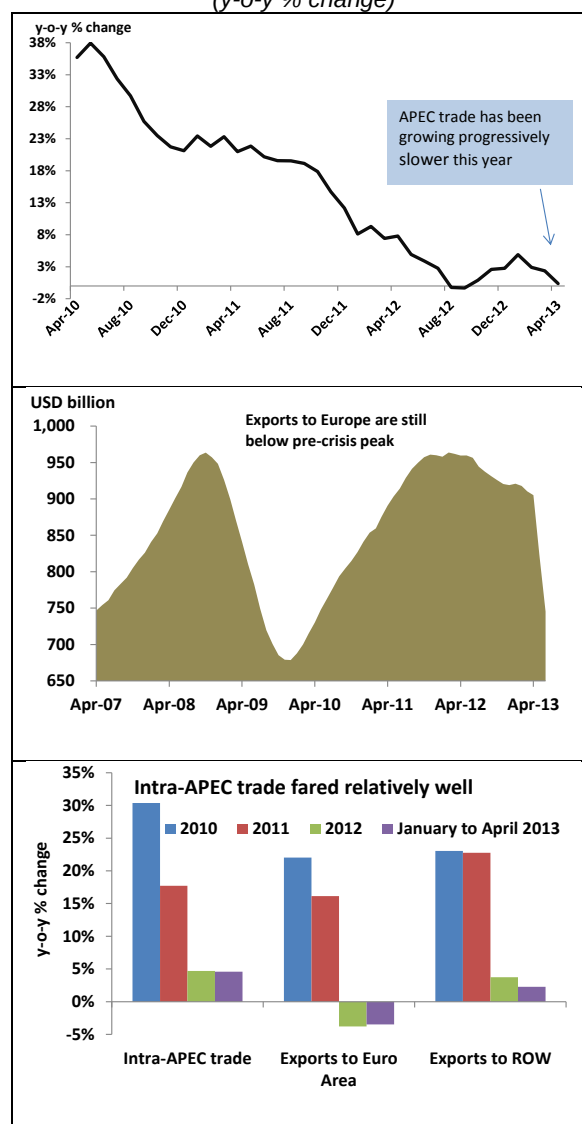


Source: CPB Netherlands

The external sector of the APEC region has continued to feel the impact of lower global demand (Figure 11). The value of APEC trade in USD has been growing at a progressively slower speed this year. In April, the rate of growth fell to 0.4%. Shipments of APEC merchandise goods to the Euro area have still not yet recovered. By April of this year, the value of APEC exports to Europe continued to decline to around 94% of the pre-crisis peak. In contrast, intra-APEC trade has held up relatively well. In the year to April, the value of APEC exports to other APEC economies inched up 4.6%, roughly at the same pace recorded last year. Outside the Euro area and APEC, exports to other economies grew at 2.3% during January to April, less than two-thirds of last year's growth rate.

APEC emerging and developing economies have been particularly affected by the slowdown in global demand. Malaysia and the Philippines recorded a contraction in their export earnings this year. In Thailand, after a strong recovery of 19.8% growth, the increase in exports fell to 2.7% in Q2 2013. In China, net exports contributed to only 1.3% of the total GDP growth in Q2 2013, a sharp slowdown from the 14.3% contribution in the previous quarter.

Figure 11: Evolution of APEC trade
(y-o-y % change)



Source: IMF & PSU calculations

Against the difficult background, the APEC region showed uneven growth dynamics

In the second quarter of this year, GDP for the APEC region is estimated to grow at 3.5%. While this is still below the average 4.3% growth rate in 2012, it marks the first time GDP is growing at a faster pace (compared to the previous quarter) since Q1 2012 (Figure 12). This aggregate growth for APEC masks the different trends in individual APEC economies. Among industrialized and newly industrialized economies (NIEs), there are emerging signs of a turnaround in economic growth, albeit at a moderate pace. On the other hand, growth in APEC emerging and developing economies (EM&Ds) is still trending downwards.

Figure 12: Q2 2013 saw a turnaround in APEC GDP growth (y-o-y % change)

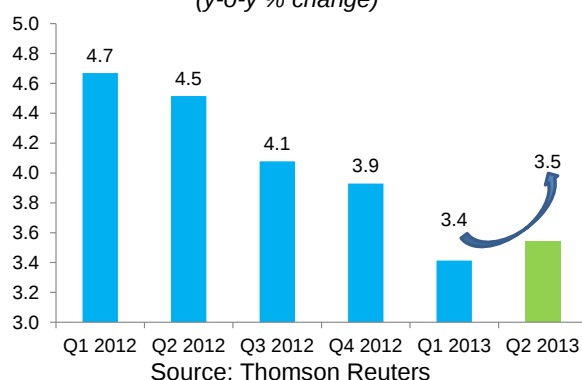
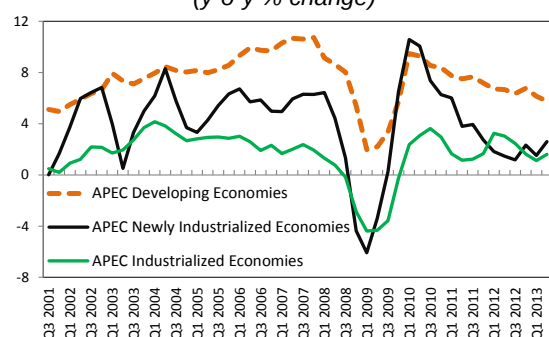


Figure 13: The pace of growth picked up in the APEC industrialized and NIEs but still trended downwards in APEC developing economies (y-o-y % change)



Source: Thomson Reuters & PSU calculations

III. Outlook for growth

Table 1: IMF July 2013 forecasts

	Gross Domestic Product (constant prices, annual % change)			Difference from April 2013 WEO forecasts	
	2012	2013 (f)	2014 (f)	2013	2014
World output	3.1	3.1	3.8	-0.2	-0.2
APEC	4.1	3.9	4.4	-0.2	-0.3
Rest of World	1.8	2.0	3.0	-0.3	-0.2
United States	2.2	1.7	2.7	-0.2	-0.2
Japan	1.9	2	1.2	0.5	-0.3
Canada	1.7	1.7	2.2	0.2	-0.2
Russia	3.4	2.5	3.3	-0.9	0.5
China	7.8	7.8	7.7	-0.3	-0.6
Mexico	3.9	2.9	3.2	-0.5	0.2
ASEAN-5	6.1	5.6	5.7	-0.3	0.2

Source: IMF

In the July 2013 World Economic Outlook update, the International Monetary Fund (IMF) revised downwards its growth forecasts for global output. World GDP is expected to grow at 3.1% in 2013 and 3.8% in 2014. In the APEC region, growth is

expected to moderate from 4.1% in 2012 to 3.9% this year, before accelerating to 4.4% in 2014.

Recent data points to a tentative stabilization in the coming quarters

The downward revision in the outlook of the global economy partially reflects weaker than expected economic growth in the first half of this year. For the second half of this year, there is a growing consensus that growth will strengthen. The results of the latest survey on global manufacturing and services, produced by JP Morgan and Markit, showed the rate of global economic activity expansion reached a two-and-a-half year high in August (Table 2).

Table 2: Results of surveys on global economic activity pointed to a strengthening economic activity (Index, below 50 indicates contraction while above 50 indicates expansion)

	Jul	Aug	Change	Summary in the rate of change
Global Output Index	50.8	51.7	+	Expanding at faster rate
Global Employment Index	50	50.5	+	Increasing from no change
Emerging Markets Output Index	49.5	50.7	+	Expanding from contraction
Composite Index for selected developing markets				
China	49.5	51.8	+	Expanding from contraction
India	48.4	47.6	-	Contracting at faster pace
Brazil	49.6	49.7	+	Contracting at reduced rate
Russia	48.7	51.4	+	Expanding from contraction

Source: Markit

Encouragingly, the report pointed to a continuing improvement in global employment with the rate of jobs growth reaching a six-month high. Economic improvement is not broad-based however. Growth in advanced economies has been firming in Q3 this year while the rate of economic expansion is still weak in Brazil and India.

Risks to global growth have reduced but remain on the downside

The 0.3% (q-o-q) growth rate registered by the Euro area in the second quarter of this year was hailed with enthusiasm around the globe. This moderate growth rate marks the re-emergence of the Euro area from its longest recession in at least three

decades. The slower pace of fiscal tightening⁷, as well as strong export growth, has provided support to growth.

Financial market tensions have eased substantially. Greece looks set to attain a primary fiscal surplus this year. Fears of contagion from Cyprus have been contained on favorable assessment by official creditors on the government's implementation of the financial assistance program. Going forward, the decision of the U.S. Fed to continue asset purchases in September has helped to push down the costs of issuing government bonds. This is particularly helpful for economies with a large debt servicing burden, including Italy and Spain.

Although the risk of acute financial stress in the Euro area has subsided, growth is forecast to be anemic, at least over the course of next year. The IMF forecasts the region's GDP will contract by 0.5% this year before turning to a 0.9% growth next year. Many of the region's fundamental challenges remain un-resolved. Among some of the key challenges include the high unemployment rate, which currently stands at 12% and is expected to rise further until mid-2014. The region's financial system is still fragile with many European banks remaining thinly capitalized and over-leveraged. There is also a lingering concern that some economies may fail to attain the requirements set out in the financial assistance program. For example, in its assessment on Portugal, the IMF highlighted that the "hitherto sturdy social and political consensus that has buttressed strong program implantation has weakened significantly. In this context and with financial conditions having improved as markets debt tolerance has improved, the appetite for reform is waning"⁸.

⁷ The European Commission announced in May that it was extending the timeframe for some member economies meet their budget deficit targets. According to the current policy setting, the pace of fiscal tightening is set to fall from 0.8% of GDP this year to around 0.5% of GDP in 2014-15.

⁸ International Monetary Fund (2013). "Portugal: Seventh review under the extended arrangement

Economic activity in the APEC region is expected to gather momentum in the second half of this year

In the United States, factors that support private consumption – the key pillar in the U.S economy – have become more positive. The housing market has continued to strengthen with house prices rising by about 14% since early 2012. With the U.S. housing market at the center of the global financial crisis in 2008, its recovery has provided a new breath of confidence towards broader progress in U.S. economic activity. Gains in U.S. equity values in recent months also add strength to household net worth and help to boost consumer confidence. In addition, consumer spending appeared to be relatively resilient against the pressure of higher payroll taxes.

In Japan, the revision of second quarter GDP growth from 0.6% to 0.9% (q-o-q) has played a role in bolstering consumer and business confidence. It now appears that the newly implemented three-pillar economic plan, known as "Abenomics", is bearing fruit in terms of reviving economic activity (Box 1). Recent data has pointed to a continuing recovery. The supply side of the economy firmed up further in July with industrial production⁹ increasing by 3.4% over the previous month. Meanwhile, the rate of capacity utilization – which refers to the extent to which the economy is using its production potential – rose 3.7% (m-o-m) in July. On the demand side, although data on retail sales moderated in recent months, consumer confidence has remained strong in comparison to last year. Year-to-date, the index of consumer confidence averaged at 44.2 points, a marked progress compared with the average of 40 points in 2012 and 37.7 points in 2011.

and request for modification of end-June performance criteria". June 2013

⁹ Japan's industrial production index measures change in the total inflation-adjusted value of output produced by manufactures, mines and utilities

In China, the manufacturing sector has gained vigor steadily over August and September with the HSBC Manufacturing index reaching a 6-month high of 51.2 in September. In addition, the property sector in China continues to grow strongly, despite the government's newly implemented measures to curb speculation and maintain housing affordability. House prices in some large cities, including Beijing and Shanghai, gained around 12% to 16% (y-o-y) in Q2 2013. As the housing sector in China is supported by strong underlying demand fundamentals, its prospects remain strong in the near future.

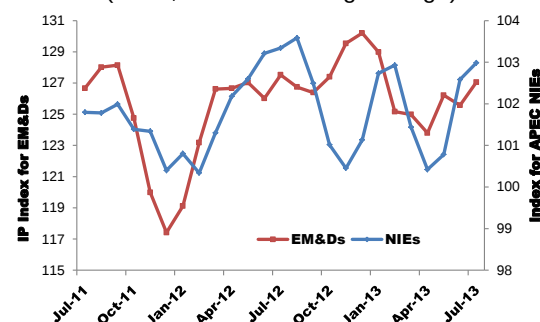
The demand side of China's economy is expected to strengthen over the coming months on increased public spending on infrastructure. Recent proactive fiscal stimulus measures - which include a waiver of value added tax (VAT) and other business tax for small and medium enterprises - will also help to boost private investment.

In other APEC economies, cyclical factors that aggravated the slower than expected growth in the beginning of this year have diminished, to an extent. The firming up in economic activity in large APEC economies suggests APEC trade will recover, albeit moderately. Industrial production in APEC NIEs and other EM&Ds has toned up in recent months (Figure 14).

Some APEC economies will also benefit from increased government spending in coming quarters. In some economies, including Hong Kong, China; Malaysia; the Philippines and Thailand, governments are stepping up plans to enhance infrastructure. In the case of Thailand, the government plans to increase public investment growth in real terms from 6.8% in 2012 to 15% in 2013. Some of these projects, such as a water management project, are already underway and thereby providing support to growth. In Mexico, public expenditure in the first half of this year has been lower as some projects were delayed. However, it is expected that public outlays will

accelerate in the second half of this year and will play an important role in contributing to growth.

Figure 14: Industrial production in APEC NIEs and APEC EM&Ds (index, 3-month moving average)

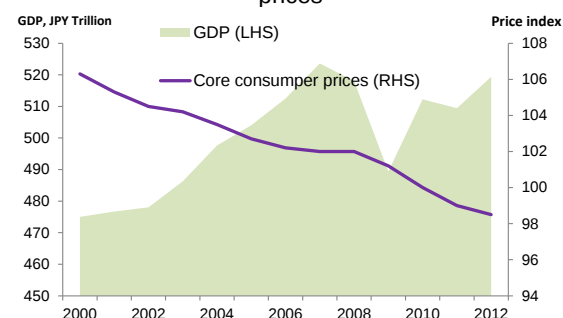


Source: Thomson Reuters

Box 1: Japan and the three-pillar economic strategy

The economy of Japan was hard hit by the 2008 Global Financial Crisis. In 2008, GDP fell by 1.1%, followed by a further sharp contraction of 5.5% in 2009 (Figure 15). By the end of 2012, Japan's GDP was still 0.8% lower than the level seen in 2007. In addition, the economy has been battling with deflation in which prices have fallen since 1999. Under the leadership of Prime Minister Shinzo Abe, who assumed office on 26 December 2012, the government introduced a three-pillar economic plan, which has become known as "Abenomics", in an effort to revive the economy.

Figure 15: Evolution of Japan's GDP and consumer prices



Source: Thomson Reuters

Expansionary monetary policy is the first pillar of the plan in which the Bank of Japan increases its inflation target from 1% to 2% and conducts money market operations so that the monetary base will

increase at an annual pace of about JPY 60-70 trillion. The second pillar of the plan includes a fiscal stimulus package worth of JPY 10.3 trillion (USD 117 billion or 2.2% of Japan's GDP) with a large portion of spending directed at disaster preparedness and infrastructure, as well stimulating private investment. The third pillar of the plan concerns a structural reform program which aims to raise potential growth through product and labor market reform.

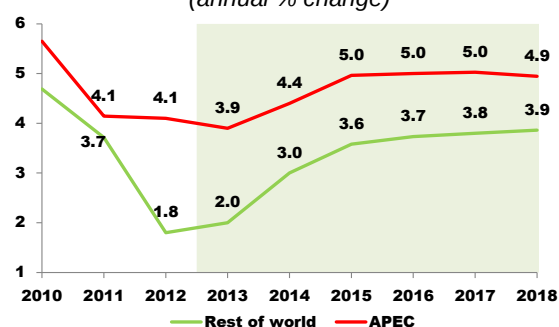
The new policy has provided a massive confidence boost to firms and households. The weaker JPY, which lost 26.5% in value between June 2012 and May 2013, has provided strong support to the export sector. Japanese exports, in nominal JPY, rose by 3.3% in Q1 2013 and 8.7% in the second quarter, a marked improvement from the 2.5% contraction recorded in 2012. Good news also emerged in the labor market. The unemployment rate fell to 3.8% in July this year, from a 4.4% rate recorded in 2012. The leading composite index, which is designed to gauge the pace of business activity, rose to a 70-month high in May this year.

Japan's GDP is forecast to grow at 2.0% in 2013, a slight acceleration from the 1.9% growth in 2012. While the mixture of fiscal and monetary expansion and structural reform policy is expected to contribute significantly to this growth, there are concerns as to whether this momentum can be sustained in the longer term. In particular, fiscal stimulus measures are adding more burden to the government debt which has already reached over 200% of GDP. The sustainability of Japan's economic growth relies critically on an effective implementation of structural reform to enhance the economy's competitiveness.

Obstacles to APEC's economic recovery remain

Despite the downward revision in forecasts for GDP growth, the APEC region remains on a firmer footing than the rest of global economy (Figure 16). However, in this new environment of continuing uncertainty, there is no room for complacency. The trends that have been seen in the past few months have highlighted an emergent issue that requires attention from APEC policy makers: the impact of higher interest rates on output.

Figure 16: Evolution of GDP growth for APEC and the rest of the world (annual % change)



Source: IMF and PSU calculations.

Note: Figures for 2013-2018 are forecasts

As of the end of September 2013, global financial markets enjoyed renewed optimism as the U.S. Fed postponed its plan for scaling back Quantitative Easing measures. However, this improvement may be short-lived. A normalization of monetary policy in large economies will eventually need to take place. There is a danger that investors - who have become reliant on unconventional monetary policies that have helped to keep down the cost of borrowing and enhance the availability of liquidity - may overreact to changes to this setting and potentially lead to a re-emergence of financial market disturbances.

Even in the absence of financial distress, higher international interest rates can bring about adverse effects on economies with large external debt obligations. Fortunately, in this regard, most APEC emerging and developing APEC economies have made impressive progress in reducing their external indebtedness. The ratio of external debt to GDP for

APEC EM&Ds was reduced from a high of 41% in 1986 to 15% in 2011 (Figure 18). Individually, most APEC EM&Ds economies have lower exposure to external lending than many other non-APEC developing economies. The stock of external debt in most APEC EM&Ds was less than 50% of GNI, with Papua New Guinea being the only exception (Figure 18). In comparison, many non-APEC economies have a stock of debt reaching over 80% of GNI. This progress of reducing external debt will help to mitigate the vulnerability of APEC EM&Ds from changing investor's sentiment.

Figure 17: Stocks of external debt to GDP for APEC EM&Ds (% of GDP)

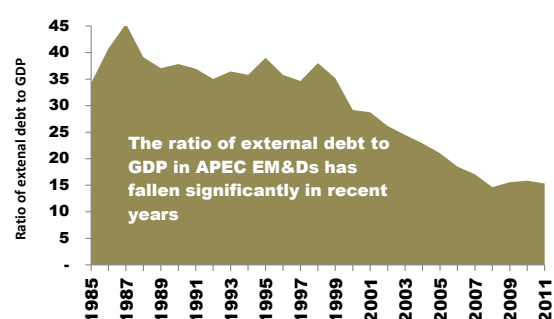
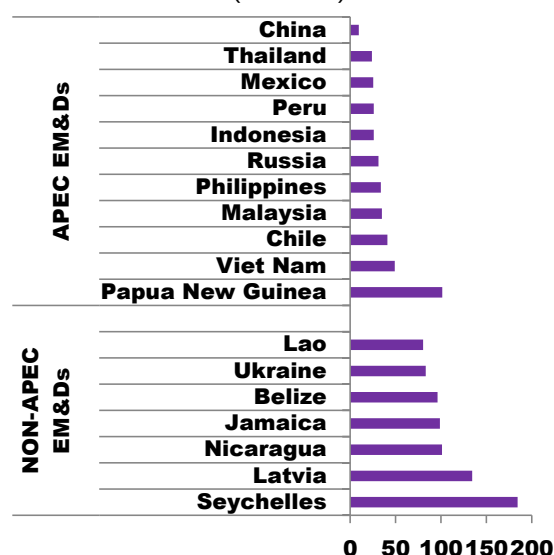


Figure 18: External debt stocks in selected APEC economies versus non-APEC economies (% of GNI)



Source: World Bank

Apart from the direct effect of rising international interest rates, APEC economies could also feel an impact from higher domestic rates. As the global financial system has become increasingly

integrated, changes in the interest rates of a large economy can cause lending rates to rise in other economies.

Often, the extent of these lending rate increases is expected to be large among economies with fixed-exchange rates¹⁰. In the case of flexible exchange rates, Edwards (2012)¹¹ established that actions by the U.S. Fed tended to be fully transmitted into interest rates in emerging economies in Asia¹² while the effect was approximated equal to one half for some Latin American economies¹³. One possible attributing factor to the variance of the spillover effects to domestic lending rates from movements in global interest and risk aversion may be the degree of openness of the capital account. Chandra and Unsal (2012)¹⁴ suggested that the contribution of U.S. interest rates to domestic rates is smaller in markets that are less financially integrated and have relatively less open capital accounts, such as China. The contribution can also be larger if there is a large foreign presence in domestic financial markets. Among APEC economies, the transmission can be notable in the bond markets of Indonesia and Malaysia given the large participation rate of foreign investors in their bond markets. In other economies including Hong

¹⁰ Bluedorn, John C. & Bowdler, Christopher (2006). "Open economy codependence: U.S. monetary policy and interest rate pass-through". University of Oxford, Department of Economics, Discussion Paper Number 290. This paper showed that the pass-through to the domestic interest rate can exceed unity under a fixed exchange rate regime if the changes in foreign interest rates were unpredictable; and between 0 and unity if the changes were predictable.

¹¹ Edwards, Sebastian (2012). "The Federal Reserve, emerging markets, and capital controls: A high frequency empirical investigation". National Bureau of Economic Research, Working Paper Number 18557.

¹² Indonesia; Korea and the Philippines were included in this study

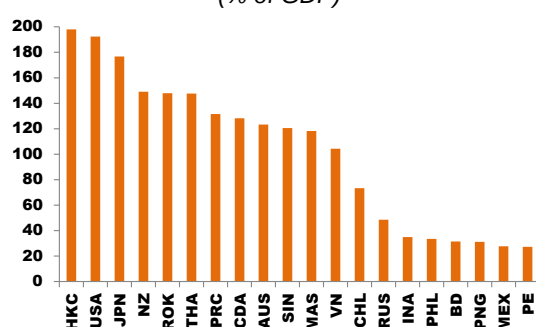
¹³ Brazil; Chile; Colombia and Mexico were included

¹⁴ Jain-Chandra, Sonali & Unsal, D. Filiz (2012). "The effectiveness of monetary policy transmission under capital inflows: Evidence from Asia". IMF Working Paper 12/265.

Kong, China and Singapore, the high percentage of foreign claims in the banking system may contribute to larger rises in domestic interest rates.

Rising domestic lending rates can constitute a risk to the economic recovery of many APEC economies. In particular, an ultra-accommodative monetary policy stance has fueled a rapid rise in credit growth. Credit to the private sector in Hong Kong, China jumped from 136.7% of GDP in 2007 to almost 200% of GDP in 2012. The ratio of private credit to GDP also jumped by over 30 percentage points in Singapore and Thailand over the same period. Currently, domestic credit to the private sector exceeds 100% of GDP in more than half of APEC economies (Figure 19). To an extent, the rapid credit growth in the past few years has played a role in bolstering consumption and investment in some APEC economies. In some cases, a large portion of this credit growth is destined towards the property market. Higher interest rates can therefore relieve some of the burden associated with rising asset prices. On the other hand, if consumption and investment in other productive sectors of the economy were to be affected, appropriate policy responses will need to be undertaken.

Figure 19: Domestic credit to the private sector (% of GDP)



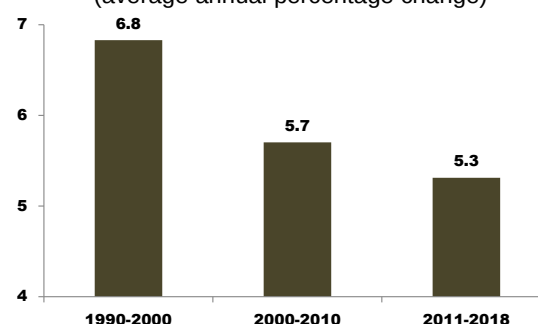
Source: World Bank

IV. Policy implications

The month of September 2013 marked the fifth anniversary of the start of the global financial crisis originating from the fall of Lehman Brothers. Since then, the pace of economic recovery has remained

patchy. An underlying factor is that global trade has been playing a lesser role in contributing to the global economy. This trend is expected to continue in the near and medium term as slower expected growth for advanced economies will impede demand for imports. According to the IMF latest forecasts, global trade is expected to grow at an annual average rate of 5.3% over the period between 2011 and 2018, representing a sharp slowdown from a 6.8% p.a. during the 1990s and 5.7% over the last decade (Figure 20).

Figure 20: Global trade growth (average annual percentage change)



Slower trade growth suggests that in order to secure sustainable growth, governments - particularly those of emerging and developing economies - need to accelerate the process of rebalancing the economy towards domestic demand. Rising international and domestic interest rates therefore may complicate the task of promoting stronger domestic demand to support growth.

With appropriate policy measures, the shift in monetary stance in advanced economies will not constrain domestic demand

While the interest rate is an important component underlying the decisions of households and firms to spend and invest, it is not the sole determinant. Confidence about income growth is also critical in influencing business and consumers to invest and spend. This calls for APEC to continue to make progress on the broad agenda of ensuring macroeconomic and financial stability.

Specific policies targeting investment growth are also desirable. In making investment decisions, a firm peruses a broad range of elements– including the expected return on investments, factors other than the interest rates that influence the costs of capital such as the legal and institutional framework and the level of investor protection. Governments, therefore, can play a decisive role by lowering the cost of doing business via taxation and other fiscal stimulus policies. In addition, a better investment climate will lower the institutional costs of investment and enhance business prospects.

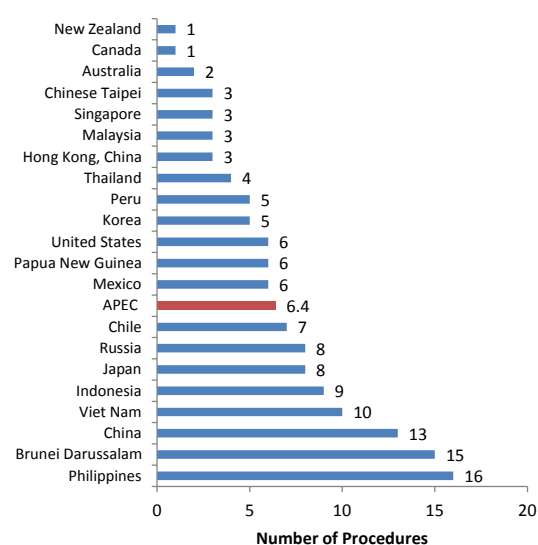
APEC has long recognized the importance of improving the investment climate. In 2009, APEC Leaders launched the APEC “Ease of Doing Business (EoDB) Action Plan” which sets an APEC-wide aspirational target of making it 25% cheaper, faster and easier to do business within APEC economies by 2015¹⁵. The results of the interim assessment in 2012 showed encouraging progress, especially in facilitating new business start-ups. Over the period between 2009 and 2012, APEC reduced the number of procedures to start a business by 19.3% (from 7.9 to 6.4), cut the time by 22.5% (from 28.1 days to 21.8), the cost by 16.5% (from 8.8% of income per capita to 7.4%) and the paid-in minimum capital requirement by 35.3% (from 9.8% of income per capital to 6.4%)¹⁶. The overall EoDB score for the five priority areas for the APEC region showed an improvement of 11.5% over the period between 2009 and 2012, against the benchmark requirement of 10% increment.

But progress within the APEC region has been uneven. For instance, in New Zealand and Canada, it takes only 1 procedure to start a business (Figure 21). At the other end of the scale,

it involves between 7 and 16 procedures in Brunei; Chile; China; Indonesia; Japan; the Philippines; Russia and Viet Nam. While a firm can set up new businesses within 3 days in New Zealand; Australia; Singapore and Hong Kong, China, a similar procedure would take 51 days in Papua New Guinea and 101 days in Brunei (Figure 22). This wide divergence in the “EoDB” performance suggests there is room for APEC to intensify efforts to achieve a better business climate. Specific policies can include:

- Reforming the tax system to make sure that it is efficient and does not place excessive burdens on businesses;
- simplifying regulation to promote more business start-ups;
- eliminating corruption to lower the costs of doing business; and
- improving infrastructure , including transportation, power and communications, in order to achieve better connectivity between consumers and firms and increase the chance for firms to specialize and achieving economies of scale.

Figure 21: EoDB – Starting a business: Procedures to start a business 2012

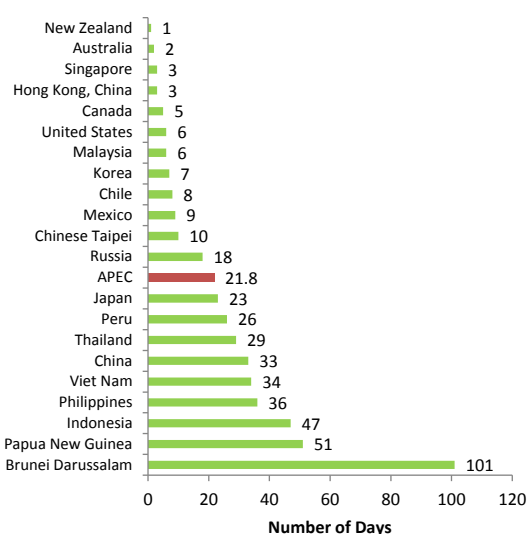


Source: World Bank

¹⁵ APEC leaders in 2009 endorsed an APEC-wide improvement of 25% by 2015 in five key areas of doing business: 1) Starting a Business; 2) Dealing with Permits; 3) Getting Credit; 4) Trading Across Border; and 5) Enforcing Contracts.

¹⁶ Carlos, Kuriyama & Oragon, Azul (2013). “APEC’s Ease of Doing Business – Interim Assessment 2009-2012”. Policy Support Unit, June 2013

Figure 22: EoDB – Starting a business: Days to start a business, 2012



Source: World Bank

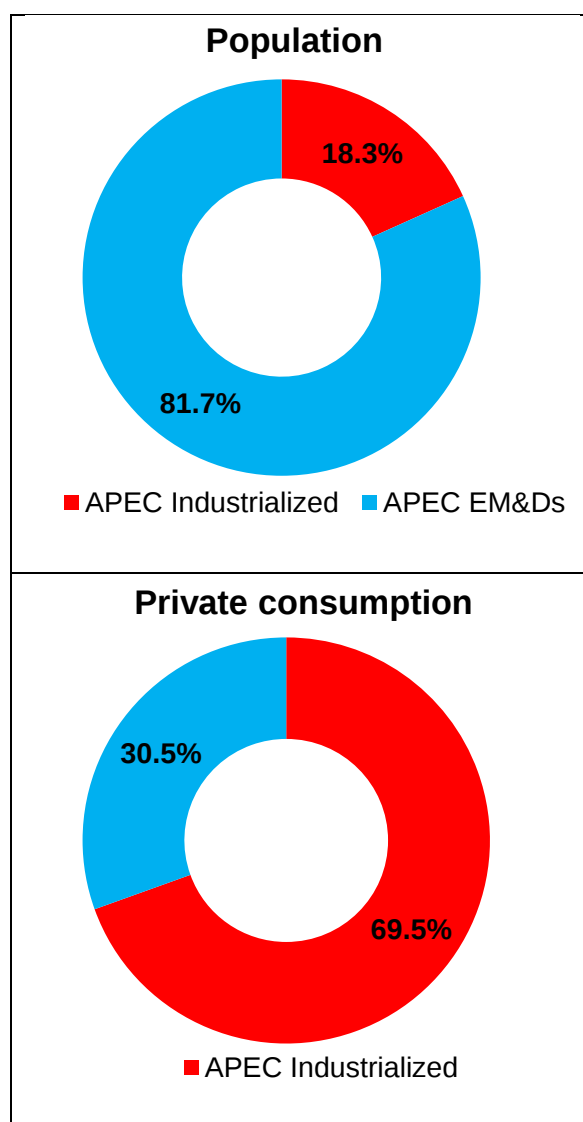
In tandem with policies to promote investment, policies to encourage private consumption should also be at the forefront of APEC policy agenda

In 2012, consumers in APEC emerging and developing economies spent on average USD 3,111 per annum. This is only 10% of the USD 31,738 being spent by an average consumer in APEC industrialized economies. As a group, APEC emerging and developing economies account for almost 81.7% of APEC population (Figure 23). However, household expenditure for this whole group of economies accounts for 30.5% the total APEC's household spending. Therefore, the promotion of household consumption is critical not only for APEC's pursuit of sustainable growth but also to ensure that growth is equitable and inclusive.

There is a growing consensus that improving the social safety net and other insurance mechanisms are among the most effective policies in promoting consumption. In addition, measures that increase household disposable income will also encourage consumer spending. This can be achieved via tax and transfer policies, either by a cut in income tax or a transfer from other sectors of the economy. In the longer term, it is more fiscally sustainable to

spur consumer spending by ensuring a healthy labor market and strong income growth.

Figure 23: A breakdown of APEC population and household consumption



Source: IMF & PSU calculations