



**Asia-Pacific
Economic Cooperation**

APEC Economic Trends Analysis

**Navigating towards Sustainable Growth in a
Changing Landscape**

APEC Policy Support Unit
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Advancing Free Trade for Asia-Pacific **Prosperity**

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HIGHLIGHTS

The recovery of the global economy in 2012 faced disruption for a second consecutive year. Global trade was negatively impacted

1. The global economy experienced a turbulent 2012 as concerns over the health of the Euro area's sovereign debt and the financial sector weighed down business and consumer sentiment. In the second half of 2012, the Central Banks of large advanced economies, including the US Federal Reserve, the Bank of Japan, the Bank of England, and the European Central Bank (ECB), moved aggressively to help stabilize financial markets by keeping interest rates low and expanding the use of non-conventional zero-lower bound policies such as quantitative easing.
2. While efforts by these Central Banks helped to reduce market uncertainty and improve investor sentiment, the recovery of the global economy faced disruption for the second consecutive year. Global GDP growth moderated from 3.9% in 2011 to an estimated 3.2% in 2012, two-thirds of the 5.1% growth registered in 2010.
3. Amid the deteriorating external environment, GDP for the APEC region as a whole grew by 4.1% in 2012, the same growth rate as in 2011.
4. Global trade was particularly weak. By October 2012, the value of global exports barely grew from the level seen in 2011. While reduced import demand from Europe played a relatively large role in decelerating trade flows, rising trade restrictive measures and a reduced availability of trade finance also negatively affected trade. Over the period between mid-October 2011 and mid-October 2012, 308 new restrictive trade measures were implemented, affecting around 1.3% of global imports. With respects to trade finance, the deleveraging by European banks resulted in a 35% drop in lending, compared to pre-crisis levels.
5. Weakening trade was the Achilles' heel for small open APEC economies, including the Newly Industrialized Economies (NIEs) in Asia. GDP growth for these economies slowed sharply to 1.7% in 2012, less than half of the 2011 growth rate.
6. An encouraging trend observed in many APEC economies in 2012 was the recovery of investment and a greater resilience in private demand. Low interest rates, increased volumes of international investment, and strong equity markets improved household wealth and have led to more spending. As a result of this strong domestic demand, many APEC economies managed to offset weakness in the external sector and post strong GDP growth.

Positive signs have emerged in the APEC region in the first quarter of 2013 and growth is expected to strengthen as the year progresses

7. According to the IMF, global GDP is expected to accelerate to 3.5% in 2013 and 4.1% in 2012, from an estimated 3.2% in 2012. APEC's GDP is forecast to grow by 4.2% and 4.7% in 2013 and 2014, respectively. Developing economies are expected to be the main engine of economic progress, contributing to more than 70% of global growth in the short to medium term.
8. Recent developments have been consistent with the forecast of a soft recovery in 2013. Activity in some large APEC economies, Japan and the United States, is steadily improving. The strengthening housing market in the US is a good sign of optimism.
9. Robust activity in the U.S. and in some emerging APEC economies is contributing to a rebound in global trade. The volume of world imports increased by a strong 4.1% (y-o-y) in January 2013, marking the sharpest pick-up since September 2011. Import demand was strongest among emerging Asia, rising 7.6% (y-o-y). The recovery in world demand for traded goods has helped to support prices of these goods as well.

The high level of sovereign debt in some advanced economies, and the risks of asset price bubbles and large currency appreciations associated with large capital inflows, are posing challenges

10. At the heart of risks to the global economy is the high level of sovereign debt in some European economies that could spark renewed tensions in the global financial markets. Significant tensions could re-emerge if a member economy misses its fiscal reduction target due to slower growth. The Euro area region remains vulnerable to political uncertainty which could derail its commitment towards restoring its public finance.
11. The surge in capital inflows, as a result of improved investor sentiment and large quantitative easing policies pursued by Central Banks in major developed economies, is posing a serious challenge to macroeconomic management and financial stability.
12. In some APEC economies, speculative buying has been a key factor contributing to soaring property prices. As the demand for real estate is set to remain strong, aided by low interest rates and abundant capital, property prices may surge further, thus raising concerns about housing bubbles.
13. Strong inflows of foreign capitals are putting pressure on exchange rates. The steady appreciation of currencies in some trade-intensive APEC economies is eroding export competitiveness. It is of concern that the attempt to regain competitiveness may result in a simultaneous currency intervention by monetary authorities. If that were to occur, it would create larger imbalances in the patterns of global trade and investment. It is important that APEC to remain committed to refrain from competitive devaluation of currencies.

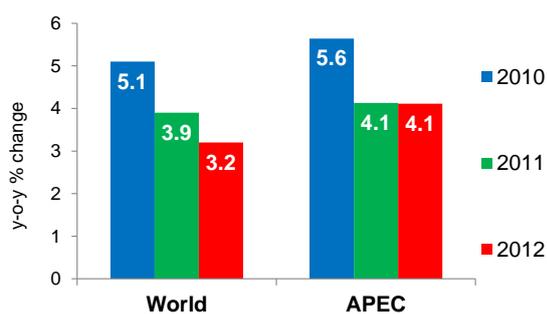
Fine-tuning the pace and the composition of fiscal adjustment packages; increased vigilance on capital flows; strengthening the financial markets and institutions and enabling an environment to channel capital inflows towards productive infrastructure investment are essential to navigate the region towards more resilient growth

14. Given that the recovery of the global economy will be tepid and vulnerable to setbacks, it is imperative that policy makers in APEC take proactive measures in order to secure sustainable growth.
15. For some industrialized APEC which are implementing fiscal austerity measures, it is important that the pace and composition of fiscal savings is fine-tuned with the pace of economic recovery. Achieving this requires governments to transparently communicate the medium-term targets which should also be backed up with a credible plan to raise revenue and address expenditure pressure.
16. Governments should also be vigilant towards monitoring the flows of capital in order to minimize of risks of asset price bubbles. In some emerging APEC, the lack of depth and liquidity of the local capital market makes it more susceptible to pressures from large capital flows. In order to minimize the risks associated with large capital inflows, APEC needs to make progress towards strengthening the local financial systems and institutions.
17. APEC economies should also take advantage of low borrowing costs and accessible capital to finance productive investment. In particular, governments should channel the inflows of capital towards financing much needed infrastructure developments.
18. The combination of subdued growth in the short-term and high volatility is making long-term investment more appealing to investors who seek to diversify their portfolios by staging investments across longer time horizons. This pursuit of long-term investments by investors creates a good platform for policy makers to engage in public-private-partnership. Infrastructure investment, in particular, would benefit greatly.

I. APEC economies in 2012: Key trends and developments

The global economy continued its turbulent journey in 2012 as concerns over the health of both the Euro area's sovereign debt and the financial sector continued to weigh down business and consumer sentiment. Faced with the risk of a sharp slowdown in economic activity, the Central Banks in major advanced economies, including the U.S. Federal Reserve, the Bank of Japan and the Bank of England have aggressively pursued a mixture of unconventional quantitative easing monetary policies (Appendix). On top of that, the European Central Bank (ECB) maintained record low interest rates and put forward measures to ensure liquidity flows to the banking sector. While these efforts have helped to reduce the perceived probability of a severe crisis in the Euro area and improve investor sentiment, the recovery of the global economy faced disruption for the second consecutive year. Global GDP (on Purchasing Power Parity basis) moderated from 3.9% in 2011 to an estimated 3.2% in 2012, two-thirds of the 5.1% growth registered in 2010 (Figure 1).

Figure 1: Global and APEC GDP (annual % change)



Source: IMF, Thomson Reuters and PSU calculations

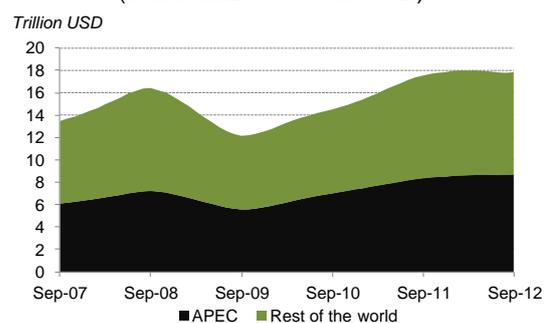
In the APEC region, GDP is estimated to grow by 4.1% (y-o-y) in 2012, the same growth rate as in 2011. Although the region as a whole fared better than the rest of world, growth momentum varied sharply. The differing growth speed among

individual economies depended to a large extent on how domestic economies responded to two opposite global forces: weaker external demand and increased liquidity.

Heightened financial tensions in Europe in the second quarter of 2012 translated into sluggish activity and reduced import demand for many major economies

Global trade growth weakened substantially in 2012. In the year to October 2012, world merchandise export growth was averaging 0.5% (y-o-y) per month, a sharp drop from an average monthly growth rate of 19.7% in 2011 (Figure 2). Weak demand from Europe was a main factor in the slowdown: the total annualized value of shipments to Europe contracted 4.8% (y-o-y) in October 2012 as weakness in activity spread from Greece and Portugal to the larger economies including Spain, Italy, France and Germany. With the EU being the world's largest importer of merchandise goods, accounting for 35% of global imports, its reduced demand had a relatively large impact on key trading partners, including some developing APEC economies in Asia.

Figure 2: Global merchandise exports (in annualized nominal USD)



Source: Thomson Reuters and PSU calculations

Global trade was also affected by the imposition of new trade restrictive measures. According to the December 2012 WTO report¹, between mid-October 2011 and mid-October 2012, 308 new measures that restrict or distort trade were recorded. This

¹ WTO (2012). "Reports on recent trade developments". 5 December 2012

affected around 1.3% of global imports. Of particular concern is that these new impositions have added to the existing large stock of trade restrictive measures which have been implemented since the 2008 global financial crisis. Cumulatively, trade restrictions are affecting around 3.5% of global imports, an equivalent of USD 625 billion worth of world import values. The most frequently affected products are iron and steel, electrical machinery and equipment, vehicles, vegetables, beverages and spirits and chemical products.

Another driver of weaker global trade was a reduction in trade finance. Since the 2008 Global Financial Crisis (GFC), trade finance has never fully recovered. According to Dealogic, global trade finance in 2012 fell to USD 170 billion, down 5% from the 2011 volume of USD 180 billion. The slowdown in trade finance in 2012 partly reflected reduced lending from European banks which previously held a pivotal role in world trade finance provisions. The shortfall of bank lending for trade finance purposes was most severe in Africa and Europe. In the case of Europe, about 50% of trade finance needs were not met in 2012.

In the APEC region, the deleveraging of European banks also resulted in a reduction of their trade finance provisions. The stress of this was felt most keenly on small and medium sized enterprises (SMES). Many SMEs in the region turned to multilateral development banks (MDBS) for funding, resulting in an increase in demand for MBDs' trade finance related products. The Asian Development Bank, for example, reported a 30% increase in the demand for its trade finance facility. In general, the trade finance gap in most APEC economies has been small, with increased lending support seen from other sources, such as domestic banks.

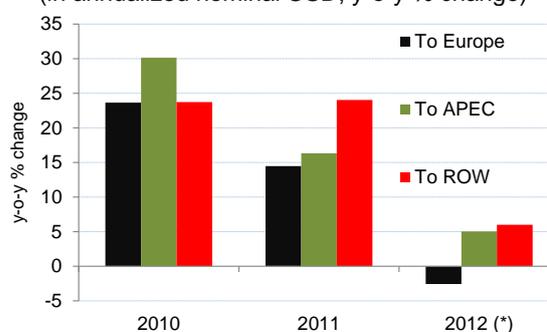
Weak trade was the Achilles' heel for small open APEC economies in Asia

The external sector of the APEC region in 2012 was also hit hard by lower global demand. The strong appreciation of some APEC currencies against the

USD aggravated the difficulties faced by some APEC members trying to reinvigorate exports. The value of APEC trade² to the world grew by 3.1% in 2012, a sharp drop from the 18.4% growth rate in 2011. APEC export growth fell sharper than that of imports, thus widening APEC's trade deficit with the rest of the world.

In line with global trends, shipments of APEC merchandise goods to European trading partners were particularly affected in 2012 (Figure 3). In the year to October, APEC exports to Europe fell 2.6% (y-o-y) in value. With APEC demand for goods from Europe remaining relatively strong, the APEC/Europe trade surplus narrowed substantially, from around 160 billion USD in 2011 to 71 billion USD by October 2012. Outside Europe, the demand for APEC merchandise exports held up relatively well. Intra-APEC trade inched up 5.0% (annualized, y-o-y) in October 2012 while exports to other regions outside Europe and APEC increased by 6.0%.

Figure 3: APEC's merchandise exports to different trading partners (in annualized nominal USD, y-o-y % change)

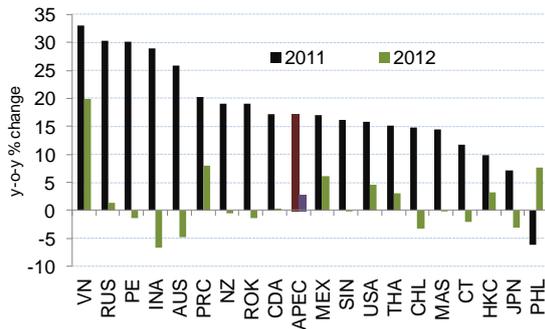


Source: Thomson Reuters and PSU calculations
 (*) Data for 2012 was only available up to October 2012.

Among individual APEC economies, export performance varied markedly (Figure 4). The Philippines bucked the global trend of slowing exports. Exports grew by 7.6% in nominal terms in 2012 as the external sector recovered from the disruption in production that occurred in 2011.

² Exports and imports

Figure 4: Export performance of individual APEC economy³ in 2011 and 2012 (in nominal USD, y-o-y % change)



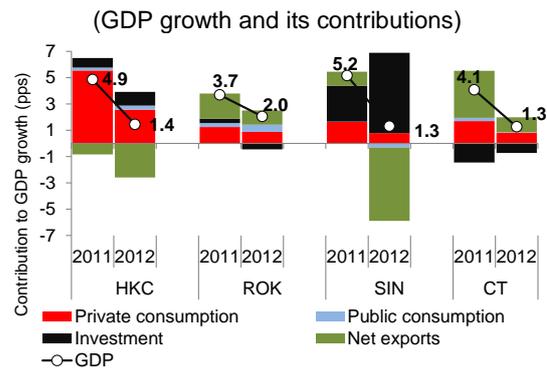
Source: Thomson Reuters and PSU calculations

For some APEC economies, the combination of a suppression in external demand for higher value added goods (e.g. IT products) and the high proportion of these goods in their total exports, has caused their external sectors to underperform. In addition, strikes at some automobile plants in the second half of 2012 affected orders for auto parts and components. In real terms, Japan's exports contracted by 0.2% in 2012 while that of Hong Kong, China; Malaysia; Singapore and Chinese Taipei barely grew, in sharp contrast to the double digit growth rate recorded in 2010.

In the case of Singapore and Hong Kong, China, the slowdown in export growth outpaced that of imports, causing net exports to be a significant drag on GDP growth. As exports accounts for more than 200% of GDP in Singapore and Hong Kong, China, the slowdown in GDP growth in these two economies was sharp (Figure 5). Singapore's GDP growth fell from 14.8% in 2010 to 5.2% in 2011 and to 1.3% in 2012 while that of Hong Kong, China fell to 1.4%, less than one-third the 2011 growth rate.

³ Abbreviations used for APEC 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); Philippines (PHL); Russia (RUS); Singapore (SIN); Chinese Taipei (CT); Thailand (THA); United States (USA); Viet Nam (VN).

Figure 5: APEC NIEs were among the most affected by weak external environment (GDP growth and its contributions)



Source: Thomson Reuters and PSU calculations

In other Asian Newly Industrialized Economies (NIEs), a high degree of exposure to the global economy meant that domestic consumption was heavily tied to global cyclical factors. In Korea and Chinese Taipei, consumer and investor confidence suffered from the poor performance of equity markets in the middle of 2012. Concurrently, uncertainty about growth prospects caused businesses to put investment plans on hold. In Korea, high levels of household debt also constrained growth in domestic consumption. As a consequence, GDP growth in Korea and Chinese Taipei was subdued. GDP growth in Chinese Taipei fell to 1.3% in 2012 from 4.1% in 2011 while Korea's GDP dropped to 2.1% from 3.6% in 2011.

Strong domestic consumption has helped many APEC economies to withstand external economic and financial stress

A notable trend across the majority of APEC economies (with the exception of Asian NIEs) has been the recovery of investment and the resilience of household consumption (Figure 6 & Figure 7). A number of factors have accounted for this phenomenon, both domestically and internationally.

Figure 6: Domestic demand in some APEC economies fared relatively well in 2012 (GDP growth and its contributions)

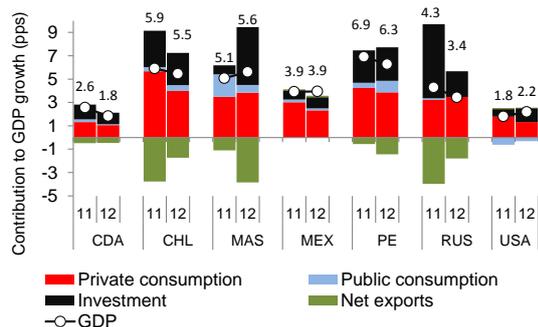
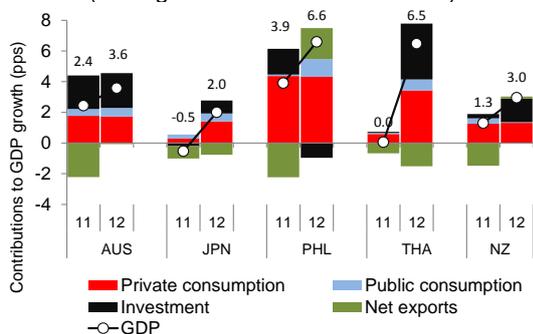


Figure 7: Reconstruction work helped growth to advance (GDP growth and its contributions)



Source: Thomson Reuters, PSU calculations

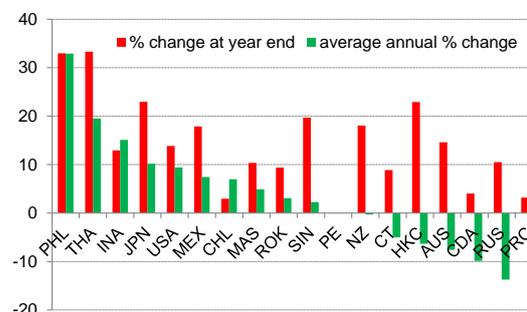
Internationally, successive rounds of monetary easing measures and large-scale asset purchase programs that have been implemented by large central banks have lowered international interest rates, influencing the flows of international investment and capital (Box 1).

In the APEC region, the pattern of capital inflows has mirrored the global trend of lower FDI but with stronger portfolio inflows (Table 1). Buoyed by reduced borrowing costs, bond issuance by corporates in the financial and energy sector (e.g. oil and gas) in China; Mexico and Russia was particularly strong. Increased international liquidity and improved investor sentiment also helped equity prices across the APEC region to rally with most markets ending higher in 2012 (Figure 8).

The Philippines and Thailand stood out with their stock markets rising by around 33% in 2012. That positive performance put them among the top ten best-performing stock markets in the world last

year. They also enjoyed increased FDI inflows thanks to continuing government efforts to create a business-friendly environment. Thailand reduced the corporate income tax rate from 30% to 23% in 2012 while all three major credit agencies – Standard and Poor's, Moody's and Fitch – have upgraded their ratings for the Philippines. Latin America also bucked the global trend of declining FDI inflows. In Chile and Peru, FDI inflows rose 52.7% and 34.2%, respectively, as investors were attracted by improving prospects in the mining sector.

Figure 8: APEC equity markets in 2012



Source: Thomson Reuters, PSU calculations

Table 1: FDI inflows to selected APEC economies, 2010-2012

	2010	2011	2012	Growth rate 2010-11	Growth rate 2011-12
Billion USD					
Australia	35.2	65.8	48.5	-26.3	-26.3
Canada	29.1	41.1	47.2	14.8	14.8
Chile	15.4	17.3	26.4	52.6	52.6
China	114.7	124	119.7	-3.5	-3.5
Hong Kong, China	82.7	96.1	72.5	-24.6	-24.6
Indonesia	13.8	19.2	19.2	0.0	0.0
Japan	-1.3	-1.8	-0.4
Malaysia	9.1	12	10	-16.7	-16.7
Mexico	21	20.8	17.4	-16.3	-16.3
Peru	8.5	8.2	11	34.1	34.1
Philippines	1.3	1.3	1.5	15.4	15.4
Korea	10.1	10.2	9	-11.8	-11.8
Russia	43.3	52.9	44.1	-16.6	-16.6
Singapore	48.6	64	54.4	-15.0	-15.0
Thailand	9.1	7.8	8.1	3.8	3.8
United States	197.9	226.9	146.7	-35.3	-35.3
Viet Nam	8	7.4	8.4	13.5	13.5

Source: UNCTAD

Consumption and investment in some APEC economies was bolstered to some extent by improvements in the financial markets. Increased stock prices improved household wealth which in turn led to an increase in consumer spending.

Investment also saw positive gains. Higher share prices and the low cost of bond issuances increased the incentive for firms to expand productive capacity.

Spending by households and businesses across many APEC economies was encouraged by continued easing monetary policies domestically. As inflation pressure was lower last year, most monetary authorities in the APEC region has reduced the policy rates or kept them unchanged from the 2011 levels. Improved labor conditions and rising wages also supported spending growth.

As a result of strong domestic demand, many APEC economies managed to offset weakness in the external sector and post strong GDP growth. In some cases, such as Japan; New Zealand and Thailand, part of the acceleration of GDP growth (from -0.5% in 2011 to 2.0% in 2012 for Japan; from 1.3% to 3.0% for New Zealand and from 0.1% to 6.8% for Thailand) was attributed to the reconstruction process following major natural disasters in 2011. In the Philippines, a stellar performance was seen in almost all sectors of the economy. A record remittance of USD 21.4 billion also provided a helpful boost for domestic demand.

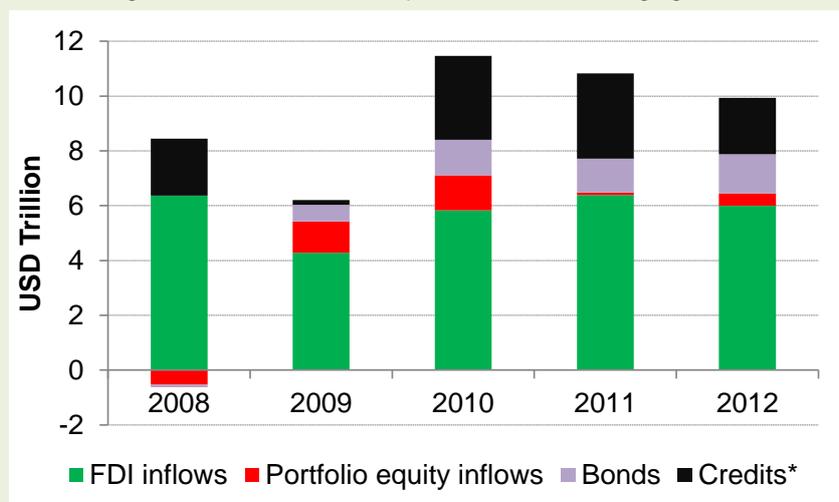
BOX 1: Evolution of international capital flows in 2012

Since the 2008 global financial crisis, cumulative expansionary monetary policies pursued by large central banks in developed economies have led to a decline in interest rates in these economies. Many developing markets, with relatively better prospects and higher interest rates, became attractive to investors seeking better returns on their investments. Toward the end of 2012, capital inflows to emerging markets bounced back strongly, supported by an ease in international financial market tensions. The rebound, however, was not strong enough to offset the softness in capital flows that occurred earlier in the year. For the whole 2012, net private capital inflows into developing economies was estimated at USD 993 billion, about 8% lower than 2011's flow of USD 1,082 billion (Figure 9).

The reduction of capital inflows into emerging markets in 2012 relative to the previous year reflected the slowdown in private foreign direct investment (FDI) and credit flows. Net FDI inflows fell to an estimated USD 600 billion in 2012 from USD 638.8 billion in the previous year as the uneven pace of global economic recovery reinforced the wait-and-see attitude of companies looking to invest abroad. Tighter rules and deleveraging processes in the banking sector, especially in Europe, also caused private credit flows to decline by 33% (i.e. syndicated bank lending and short term debts).

In contrast with weakness in FDI and credit flows, the recovery of portfolio and bond issuances was much stronger. Bond issuances by corporates in emerging markets rose from USD 123.8 billion in 2011 to a record high of USD 143.4 billion in 2012 while portfolio equity inflows quintupled the 2011's inflows to reach USD 44.4 billion. The recovery in bond inflows in particular reflects a changing landscape of international financing. With the cost of bond issuance lowering to around half of the 2008 peak of 11%, bond issuance has become more affordable. At the same, a contraction in international bank lending has raised the cost of bank borrowing. Although the cost of bond issuance remained higher than that of borrowing from banks, the gap between the two has narrowed from around 6 percentage points in 2008 to less than half of a percentage point by the end of 2012. As a result, bond financing has been viewed as an alternative for bank lending.

Figure 9: Evolution of net capital inflows into emerging markets



Source: World Bank

(*) Credits include syndicated bank lending and debt flows

II. Outlook for the global economy

In the January World Economic Outlook (WEO) Update, the International Monetary Fund (IMF) forecast that world output growth would accelerate from an estimated 3.2% in 2012 to 3.5% in 2013 and to 4.1% in 2014 (Table 2). In comparison, GDP growth in the APEC region as a whole was forecast to accelerate from 4.1% in 2012 to 4.2% in 2013 and to 4.7% in 2014.

Table 2: Gross Domestic Products (constant price, annual % change)

	2012	2013(f)	2014(f)
Australia	3.6	3.0	3.2
Canada	1.8	1.8	2.3
China	7.8	8.2	8.5
Japan	2	1.2	0.7
Mexico	3.9	3.5	3.5
Russia	3.6	3.7	3.8
United States	2.2	2	3
NIEs	1.7	3.2	3.9
ASEAN-5	5.7	5.5	5.7
World	3.2	3.5	4.1
<i>APEC</i>	<i>4.1</i>	<i>4.2</i>	<i>4.7</i>
<i>Rest of the World</i>	<i>2.1</i>	<i>2.6</i>	<i>3.3</i>
<i>APEC Industrialized</i>	<i>2.3</i>	<i>2.0</i>	<i>3.0</i>
<i>Other Industrialized</i>	<i>-0.2</i>	<i>0.2</i>	<i>1.3</i>
<i>APEC Emerging</i>	<i>5.9</i>	<i>6.3</i>	<i>6.6</i>
<i>Other Emerging</i>	<i>3.7</i>	<i>4.4</i>	<i>4.7</i>

Source: Thomson Reuters, IMF WEO January 2013
Note: Figures for 2013 and 2014 are forecast

Most of the improvement in growth in the APEC region is expected to take place in developing economies while growth in industrialized economies is forecast to remain subdued. As a group, emerging APEC is expected to grow by 6.3% in 2013 and by 6.6% in 2014.

The robustness of emerging APEC reflects a new phase in the evolution of the global economy in which the emerging group will be the main engine of growth. Two decades ago, emerging economies made up only 31% of global GDP (measured in Purchasing Power Parity terms). Its share in 2012 had increased to almost 50%. The contribution to global GDP growth also increased from an average of 42% in the 1990s to almost 80% in recent years.

The global economy starts 2013 on a firmer footing

Up to now, developments have been consistent with the forecast of a soft recovery in 2013. Recent figures in the Composite JP Morgan Global Manufacturing and Services Index – at 53.2 for January and 53.0 for February⁴ – indicated that global manufacturing production and services continued to expand at the start of 2013, albeit at a moderate pace.

Global financial markets have also stabilized

Since the last quarter of 2012, perceptions of downside risks in the global economy and financial markets have subsided due to three events: (i) the U.S. averting the so-called 'fiscal cliff'; (ii) the acceleration of China's GDP growth in Q4 2012, after decelerating for seven consecutive quarters, allaying fears of a 'hard landing'; and (iii) the ECB's Outright Monetary Transaction bond-purchase program (OMT) and Greece's financial assistance package and agreements reached in the December 2012 EU summit which reassured the market about Europe's commitment to preserve the Euro.

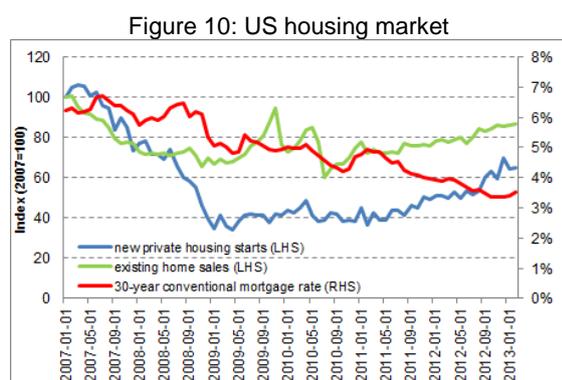
As a result of the above, conditions in global financial markets have improved. Sovereign Credit Default Swaps (CDS) rates for high spread European markets have trended downward. More importantly, improved risk sentiment has helped Portugal to regain access to the international long-term debt market in January for the first time since 2011.

Economic activity in some large APEC economies is gaining strength

⁴ A reading of 50 indicates no change in activity from month earlier; above 50 indicates expansion; below 50 indicates contraction

One of the few causes for optimism in the global economy is the strengthening housing market in the United States. With 30-year mortgage rates at less than half the 2008 level, the market has seen a gradual recovery in demand. This has, in turn, helped house price to rise by a strong 4.9% (y-o-y) in the last quarter of last year. New housing starts in the United States have also increased, averaging 904,000 in the last quarter of 2012, the highest level since Q2 2008.

So far this year, signs of improvement have continued (Figure 10). In February 2013, home sales rose to almost 5 million, over 40% higher than in July 2010 when sales volumes were at their lowest point since the start of the global financial crisis in late 2008. In addition, the ratio of houses for sale to houses sold fell to 4.1 in January 2013, the lowest level since 2005, after peaking at 12.2 in January 2009. The National Association of Realtor's Pending Home Sales Index, which measures the number of agreed sales transactions during a given month is currently 28.5% higher than in it was March 2008. It has seen an almost constant improvement since May 2010 as buyers have better access to home mortgage. Foreclosure has become less common as well, with new foreclosure notices being served on 0.7% of new mortgage loans, less than half the peak in August 2009.



Source: Thomson Reuters, US Federal Reserve Bank of St. Louis

With the U.S. housing market at the centre of the global financial crisis in 2008, its recovery has provided a new breath of confidence towards

broader progress in U.S. economic activity. On top of the strengthening housing sector, good news is also emerging in the U.S. labor market. The unemployment rate in February fell to a post-recession low of 7.7% while employment has risen steadily since October 2010. Although employment is still about 1.5% below the pre-crisis level of mid-2008, households have become more confident about job security. Improved house prices and job prospects have together helped consumer spending to remain resilient.

Over coming quarters, the Federal Reserve's commitment to keeping monetary policy accommodative is expected to provide continuing support to the housing and job markets. This in turn should provide some cushion for private demand against payroll tax increases.

In Japan, the pace of activity has started to pick up after a weak performance in the second half of 2012 when GDP fell by 3.8% (q-o-q saar) over the third quarter and by 0.4% (q-o-q saar) in Q4. Business sentiment has improved since January following the announcement of monetary and fiscal stimulus plans which included a fiscal package of JPY 10 trillion.

Emerging APEC economies are expected to gather further momentum as the year progresses

Elsewhere in other emerging APEC, the pick-up in activity has been robust and most of these economies are projected to maintain firm growth in both 2013 and 2014.

So far in 2013, the stock markets in most APEC economies have continued to perform well. Equity prices in Indonesia; Malaysia; the Philippines; and Thailand; reached record highs in early 2013. FDI inflows to these economies are also expected to strengthen, partly due to their relatively lower labor costs which are attracting companies searching for alternative locations to manufacture labor-intensive goods. The good prospects of increased capital

inflows in these economies will help to spur spending and investment.

In addition, a strong pipeline of government infrastructure projects in support of the fast pace of urbanization and economic development in Brunei Darussalam; Indonesia; Malaysia; the Philippines and Viet Nam will also support the strength of domestic demand in these economies. Increasingly, infrastructure developments are taking the center stage in government agendas. Indonesia, for example, has raised its budget for capital spending by 28% to IDR 216 trillion in 2013 (USD 23 billion or 2.5% of Indonesian GDP), with 95% of this capital funding to be used to finance new infrastructure development. According to the Indonesia Contractor Association, this increased capital spending is expected to boost Indonesia's construction market by around 20% in 2013, increasing its contribution to GDP from 10% last year to around 12% this year.

Similarly, in Brunei Darussalam, the government has steadily improved its domestic infrastructure. Construction projects such as the Pulau Muara Besar port and industrial zone, the expansion of the international airport to double its passenger handling capacity and the upgrading of power transmission and broadband lines will not only underpin the strength of domestic demand in the short-term but will also enhance the competitiveness and connectivity of the economy to the rest of the world, thus helping to support longer-term growth.

However, the pace of recovery has been uneven

Robust activity in the U.S. and in some emerging APEC economies is contributing to a rebound in global trade. The volume of world imports increased by a strong 4.1% (y-o-y) in January, marking the sharpest pick-up since September 2011. Import demand was strongest among emerging Asia, rising 7.6% (y-o-y). The recovery in world trade has also helped to support prices of trade goods as well. By January 2013, fuel prices

rose 15.6% above their 2012 trough while prices for other primary commodities increased by 4.8%.

However, some APEC economies, including APEC NIEs, have not yet reaped the benefits of improving global demand. Industrial production in Korea; Singapore and Chinese Taipei has continued to be weak in the first few months of 2013, reflecting a weak demand for their exports. Singapore's economy contracted by 0.6% (q-o-q) in the first quarter of this year, mostly due to the subdued external demand for their pharmaceutical products and electronics. In a similar vein, China's GDP growth unexpectedly eased back to 7.7% (y-o-y) in Q1 2013 from the 7.9% growth rate in the previous quarter, in line with a weaker growth in industrial production.

Over the next few quarters, APEC NIEs should see a mild recovery in line with the gradual progress in global trade. In particular, the external sector of these economies will benefit from the stabilization of the global IT industry which recorded a turnaround growth of 4.7% in the last quarter of 2012. Tentative signs in early 2013 appeared to support the expectation of further improvement in final IT demand with robust technology spending coming from consumers in the U.S. and China. In China, the economy is likely to gather pace as increased infrastructure investment will help to support domestic investment and consumption.

III. Risks

While most forecasts point to an expansion of the global economy at a faster rate in 2013 than last year, a decisive recovery cannot be taken for granted. The path towards a sustained and strong global economic recovery faces a number of worrying challenges. At the heart of these is the high level of sovereign debt in some European economies that could spark renewed tensions in global financial markets. The recent fall in global stock markets associated with the proposal to tax bank deposits in Cyprus⁵ is a poignant reminder that investors remain highly concerned about the ability of European institutions to address sovereign debt issues in the region.

The relatively poorer growth prospects of some advanced economies in an environment of abundant global liquidity implies that capital flows into developing and emerging economies will continue to surge in the foreseeable future. This poses a serious challenge to macroeconomic management and financial stability. In particular, it is a concern that excess and sudden capital inflows can cause asset prices to soar and potentially fuel price bubbles. Furthermore, some economies may experience large appreciations in their currencies, which in turn can constitute a loss of competitiveness.

a) **Renewed tensions over sovereign debt issues in Europe**

⁵ In late March 2013, the rally in the financial market came to a brief halt following the proposal of taxing bank deposits in Cyprus. The original proposal, which was demanded as a condition for Cyprus to receive a €10 billion (an equivalent to 52% of Cyprus GDP) international financial assistance package, included a 6.75% levy on deposits of €100,000 or less while those greater than that amount would be taxed at 9.9%. The plan quickly proved to be unpopular among investors. Concerns were raised that such measure would set unfortunate worrying precedent that could put the European banking systems at risk, leading to runs on regional banks.

While risks of a disorderly break-up of the Euro area and loss of market access for some larger Euro area economies – i.e. Italy and Spain – have receded, the fundamental problems are far from being completely resolved. The region's economic growth has been constrained by a concerted and upfront fiscal austerity. The recent improvement in risk sentiment has not yet translated into a widespread return in confidence among households and firms. The high and rising unemployment rate has restrained household spending while firms have been reluctant to invest amid the uncertain economic outlook. Although low levels of economic activity have been particularly pronounced in smaller Euro area members, weakness has also been transmitted into larger economies such as Germany and France, due to weaker trade flows.

In addition, the banking systems in Europe remain impaired and vulnerable to capital flight. It is estimated that banks in smaller Euro area economies have lost between 10% and 20% of their deposits on ongoing concerns about solvency and risks of currency redenomination.

As a result, tensions could re-emerge in full force if a member economy misses its fiscal reduction targets due to slower growth. Furthermore, the region remains vulnerable to political uncertainties (e.g. civil unrests in opposing large fiscal spending cuts or changes of governments), which could derail its commitment to advance the necessary reforms that are needed to restore the health of public finance and positive economic growth.

b) **Increased capital inflows could put pressures on asset prices in the APEC region**

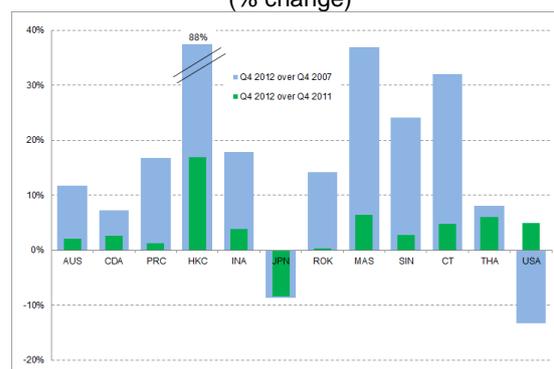
Since the 1990s when many emerging APEC economies gradually liberalized their capital markets, substantial capital inflows have coincided with rapid appreciation of asset prices. Many have attributed the boom in asset prices to the fast credit expansion brought about by cheap international

capital. For example, some studies⁶ on the equity and housing markets in emerging East Asia confirmed that capital flows, together with other factors (e.g. improved financial institutions, better economic fundamentals and higher domestic liquidity), played a large role in driving up asset prices in these economies over the period between 2000 and 2007. Land prices rose by almost 180% in Indonesia and Thailand during this period while house prices in China; Korea and the Philippines increased by a magnitude of 40%. Since capital flows are volatile, there is a risk that a sudden reversal of capital inflows would lead to sharp asset price corrections which could cause detrimental damage to the real economy.

The property markets in some APEC economies are vulnerable to speculative behavior

In many developing APEC economies, the property market has been relatively buoyant in recent years (Figure 11). In some cases, long-term factors such as the fast pace of urbanization and strong economic growth are underpinning the strong demand across all property types and consequently driving up prices. This is particular evident in China; Indonesia and Malaysia where economic and urbanization expansion rates over the past decade have been faster than the world's average. In these economies, the rise of property prices in major cities has been notable: between February 2009 and February 2013, average prices for real estate had risen by 72% in Beijing, while those in Shanghai have doubled.

Figure 11: House price index in selected APEC (% change)



Source: Thomson Reuters, Oxford Economics House Price Index

Property markets in Latin American APEC economies have also been strong in recent years. The average real home-price in Chile; Mexico and Peru has been rising at an annual rate of roughly 6% between 2005 and 2011. Property markets in large cities experienced faster growth. According to the Peruvian Chamber of Construction, 2012 saw the highest number of residential properties sold in 17 years. Property prices nearly doubled in value in some districts of Lima in just three years. In Santiago, Chile's capital, houses and apartments saw a large jump in demand in recent years, with sales growing at 28% in 2011 and 23% in 2012. In these economies, the rise in property prices has occurred at the same with the improvement in housing finance. In Peru, real mortgage credit increased by an average 20% p.a. in 2010-11 while that of Chile rose by around 12% p.a.. While credit expansion has to some extent improved households' ability to purchase houses, most of the rises in prices in APEC Latin American economies can be attributed to sustained economic growth, strong fundamentals and legal reforms that have generally raised living standards.

Cyclical factors such as low interest rates and speculative buying have also been at play. The role of these has been most pronounced in the property market of APEC NIEs, with Korea being an exception. In Hong Kong, China, the property market has been fuelled by demand from overseas buyers. Residential property prices in 2012 were

⁶ Asian Development Bank (2009). "Policy options for managing capital inflows in emerging East Asia".

88% higher than they had been in 2007, which has made it one of the world's most expensive property markets. The property market in Singapore has also seen large gains over the past several years. The average house price in 2012 was 24% higher than it was in 2007. Singapore's property market has also attracted foreign investors due to its effective protection of property rights and low currency risks.

Meanwhile, in Chinese Taipei, many domestic investors remained cautious following the global financial crisis, preferring to enter the property market rather than invest in the stock market. Chinese Taipei's low interest rates and low property taxes have also made its property market attractive to foreign investors. Accordingly, its house price index was 32% higher in Q4 2012 than it had been five years earlier.

Large increases in property prices in some APEC economies have been a cause of concern for policy makers. This has prompted some governments to introduce measures to cool the market. Some of these measures have been aimed at curbing speculative demand and have been calibrated to tighten property ownership for investment and overseas buyers. In Hong Kong, China and in Singapore, foreign buyers of residential properties are required to pay an additional 15% stamp duty. In Chinese Taipei, the government implemented a "luxury tax" in June 2011, under which there is a 10% tax on properties sold between one and two years after purchase, while second homes sold within one year of purchase are faced with a 15% tax. In March 2013, the Chinese government announced its latest round of measures to try to cool the property sector, including stricter enforcement of the existing 20% capital gains tax on home sales as well as increased mortgage rates on second homes in selected cities.

In some markets, cooling measures appeared to have limited impact on deterring the upward trend for property prices. Residential property prices in

Hong Kong, China continued to rise 29% (y-o-y) in January 2013. In Singapore, after seven rounds of cooling measures, the market appeared to be only moderately affected. Given the fact that Hong Kong, China and Singapore have managed exchange rates, any effects are expected to be short-lived and their property markets will continue to rise until international interest rates increase. More recently, the property market in Hong Kong, China, has already quietened down after the announcement of the latest demand management measures in February and the subsequent mortgage rate hike by several local banks. Whether the latest round of measures would have long-term impact on the market remains to be seen.

Going forward, the high volume of international capital seeking investment in higher yield markets, combined with the low interest rates, will continue to support the demand for properties. According to a report from Jones Lang LaSalle⁷, direct investment flows into real estate globally have strengthened further and are estimated to reach USD 500 billion in 2013, up 13% from last year. In the absence of any policy changes, a good portion of this real estate investment will flow into APEC's markets, thus reinforcing the strength of property prices across many markets in the region.

For some APEC economies, property is an important sector. In China, for example, real estate accounts for about 20% of investment and has contributed significantly to economic growth. It is therefore important that governments ensure the stability of the property market as it is closely linked with the overall macroeconomic and financial stability.

Strong inflows of foreign capitals are putting pressure on exchange rates

The prolonged ultra-low interest rate environment is fuelling the demand for high-yield APEC currencies

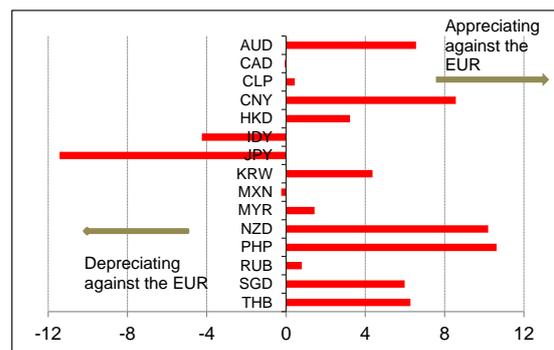
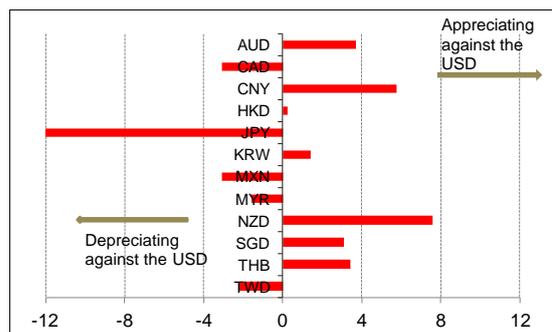
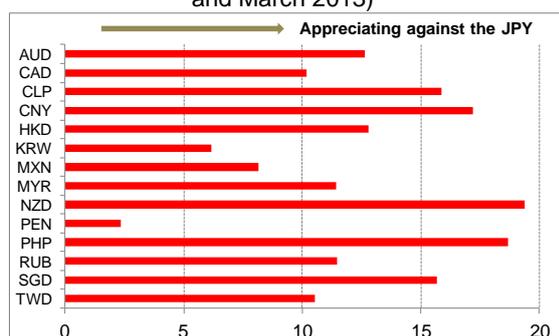
⁷ Jones Lang LaSalle (2012). "Improving sentiment", *Asia Pacific Property Digest*, Fourth Quarter 2012.

while keeping the value of the USD, JPY and EUR weak (Figure 12). Most notable was the sharp appreciation of most APEC currencies against the JPY during the period when the Bank of Japan had announced new quantitative measures.

In some cases, the recent appreciation of the local currencies against the USD and JPY has been large in comparison with historical averages. The value of the AUD against the USD by March 2013 was almost 37% higher than the 2000-2007 average while NZD was 33% higher. Strong portfolio inflows have also pushed the THB to its strongest level against the USD since July 2007.

In some trade-intensive APEC economies, the steady appreciation of their currencies is eroding export competitiveness against large competitors. The strength of the currency also encourages households and firms to shift toward imports and leads to a deterioration in external balances. For some economies such as Australia and New Zealand, the persistent high exchange rates are complicating government efforts to tackle large current account deficits, making them more vulnerable to external shocks.

Figure 12: The values of APEC currencies against the JPY, USD and EUR (% change over the period between January 2011 and March 2013)



Source: Thomson Reuters, U.S. Federal Reserves, the European Central Bank and PSU calculations.

At the 20th Economic Leaders' Meeting in Vladivostok, Russia in September 2012, Leaders of APEC economies, have stated that APEC would refrain from competitive devaluation of currencies and enhance exchange rate flexibility to reflect underlying fundamentals⁸. More recently in February 2013, G-20 finance ministers have pledged to refrain from competitive devaluation as a means to gain a competitive advantage⁹. However, the recent large scale monetary-easing programs pursued by some advanced economies have raised some concerns of possible currency intervention by other monetary authorities. If that were to occur, it would create larger imbalances in the patterns of global trade and investment. Therefore, it is important that APEC to remain committed to refraining from targeting the currency for competitive purposes.

⁸ APEC (2012). "2012 Leaders' Declaration Vladivostok Declaration , *Integrate to Grow, Innovate to Prosper*". September 2012

⁹ G20 (2013). Communique of G-20 Finance Ministers and Central Bank Governors. February 2013.

IV. Policy implications

It has been more than five years since the 2008 global financial and economic crisis. Positive developments in the first few months of 2013 have brought about fresh optimism that the global economy is finally on the mend. However, there is no room for complacency. Without bold structural reforms, the recovery of the global economy will be tepid and vulnerable to setbacks. It is therefore imperative that policy makers take proactive measures in order to secure sustainable growth.

a) Striking the right balance between fiscal consolidation and growth

As many developed economies will implement or continue to pursue fiscal austerity measures over the next few years, their growth prospects remain bounded. In the United States, for example, with the sequester being in effect since March 2013, approximately USD 85.4 billion (0.5% of GDP) in fiscal spending has been cancelled for fiscal year 2013, with similar spending reductions expected through to 2021. While the full impact of these spending cuts will not be felt immediately, it is estimated that real GDP growth could be around 0.6 to 0.8 percentage points lower, at least for 2013. The recovery can be derailed altogether if policy makers are unable to reach agreements on raising the debt ceiling¹⁰ and/or introducing policies to put U.S. public finance on a more sustainable footing.

For some industrialized APEC economies with high deficits and debt, a strengthening of public finances would be the most effective tool towards achieving longer-term sustainability. However, in an

¹⁰ In the United States, the debt ceiling, in law since 1917, limits the amount of debt that the government can issue. The limit is typically raised by Congress once the national debt approaches the limit. Failure to have done so in 2011, when the national debt was approaching the debt ceiling of USD 14.3 trillion that had been set in February 2010, would have resulted in the U. S. defaulting on its sovereign debt, in what has become known as the debt ceiling crisis.

environment of slow growth, each economy may need to adjust the pace and the composition of its fiscal savings processes to prevent a large disruption in economic activity. Achieving this requires governments to transparently communicate the medium-term deficit and debt targets, which should also be backed up with a credible plan to raise revenue and address expenditure pressures. Transparency in fiscal plans will also help to anchor creditor's expectation which in turn helps to avoid any possible deterioration in market perception of government creditworthiness.

b) Mitigating the risks associated with capital inflows

With the interest rates in advanced economies expected to remain low, capital flows into emerging APEC markets are forecast to maintain strong momentum and will feature as a key new aspect of the global monetary system. This trend of surging capital inflows can pose serious challenges (e.g. currency appreciation, greater exposure to external shocks, asset price inflation and increased volatility in the financial and exchange markets). Managing this volatility of capital flows is a difficult and complex task. Experiences of capital controls in many APEC economies have yielded mixed results. In some cases, imposing capital control measures could inadvertently reverse previous business-friendly policies.

In some emerging APEC, the local capital markets are still in the early stages of development. The lack of depth and liquidity of the local capital market makes these more susceptible to pressures from large capital flows. Several studies have found that the risk associated with capital inflow is minimized when the local financial system is sound and deep enough to allow a smooth channelling of foreign capitals into other productive sectors of the economy. For example, firms should be able to access the capital market to issue bonds for investment needs while there should be a wide

selection of sound investments for investors to diversify their portfolios.

In order to increase the benefit of capital flows and minimize associated risks, it is important that APEC economies, especially emerging APEC, make progress in strengthening local financial systems and institutions. Well-developed and diversified capital markets will lead to a better allocation of financial resources towards productive investments, thus minimizing the risk of asset price bubbles. In addition, the large and volatile nature of international capital flows also increase the need for policy makers to make greater use of macroprudential instruments. Some macroprudential policies such as imposing targeted regulations on banks engaged in cross-border activities can help to manage the procyclical nature of capital flows while policies to influence banks' balance sheet (e.g. reserve requirement and loan to value ratio) can discourage excessive risk taking behaviour.

APEC should also continue to advance broad-based structural reforms to complement necessary financial and prudential reforms. Sound macroeconomic fundamentals and a good business environment will not only establish a good foundation for retaining capital inflows but also help to attract sources of financing that are more stable and productive (e.g. FDI). According to the OECD, an economy with more competition-friendly market regulation, higher institutional quality and greater capital account openness will attract a larger component of FDI inflows and a smaller amount of short-term debt.

c) Channelling the inflows of capital toward infrastructure investment

While capital flows can pose substantial risks, they can also support long-term growth by providing additional resources for productive investment. In the current environment of low borrowing costs, policy makers in APEC economies should seize this

opportunity to channel foreign capitals toward financing productive investments.

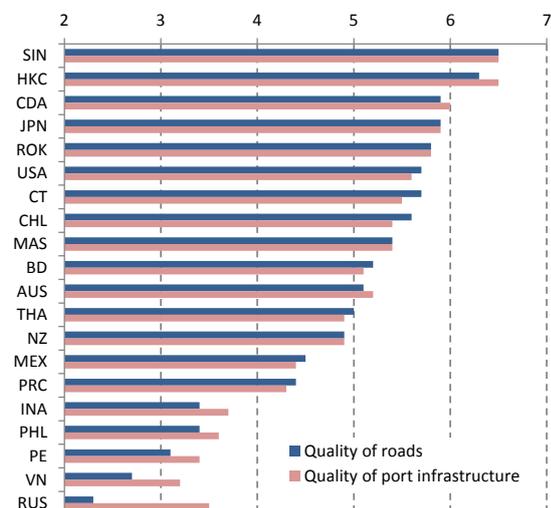
One unique characteristic of the combination of subdued growth in the short term and increased liquidity is that it makes long-term investment more attractive to investors. Rather than settle for low returns in the volatile near term, it would be more prudent for investors to adopt diversification strategies that include staging their investments across longer time horizons. This would also help investors to bypass any potential bubble collapses and reap the benefits of the strengthening global economy in the longer term.

This pursuit of long-term investments by private investors creates a good platform for policy makers in the APEC region to engage in public-private-partnership. Infrastructure investment, for example, would benefit significantly from greater public-private partnership. As the host of APEC this year, Indonesia has identified infrastructure investment as one of the gateways to achieving greater connectivity that should bring with it balanced and sustainable growth with equity. Currently, an APEC-wide "Infrastructure Investment Framework for Connectivity" and "APEC Guidelines on Delivering Bankable Projects" are among the APEC's pipelines to promote infrastructure development in the region.

According to the OECD, the world needs to invest around USD 53 trillion over 2010-30 in new infrastructure in order to accommodate economic growth and to address issues related from climate change, urbanization and growing congestion. The need for infrastructure investment is shared equally between industrialized and developing APEC economies. In some industrialized APEC, parts of the infrastructure system have become obsolete while those in most emerging APEC are not adequate for rapid economic and urbanization expansion. Developing APEC, excluding the NIEs, scored poorly on quality of roads and ports assessment (Figure 13). In some cases, transport

and road conditions can be among the biggest constraints in doing businesses, particularly for industries that produce perishable goods including agricultural products¹¹.

Figure 13: Assessment on quality of roads and ports



Source: World Economic Forum

Note: 1 = extremely underdeveloped & 7 = well developed

Currently, the public sector is not well placed to fully finance substantial infrastructure investments. According to the OECD, around 35% of the world's new infrastructure investments cannot be met through government fiscal budgets. In the United States, for example, it is estimated that cumulatively, around USD 2.75 trillion of infrastructure investment is needed by 2020¹². However, the projected funding available only amounts to USD 1.6 trillion, leaving a gap of USD 1.1 trillion. Failure to fund this gap would have a cascading effect on the economy by negatively affecting business productivity and competitiveness.

Given the substantial infrastructure spending needs and limited public resources, tapping into the private

¹¹ Hredzak, Tammy and Le, Quynh (2012).

“Challenges to achieving food security in APEC”, APEC Policy Support Unit.

¹² American Society of Civil Engineer (2013).

“Failure to act: the impact of current infrastructure investment on America’s economic future.

sector’s funding and expertise would be essential for the APEC region to adequately tackle the challenges facing infrastructure development in the long run. Achieving this would help APEC to make significant progress towards achieving sustainable and inclusive growth.

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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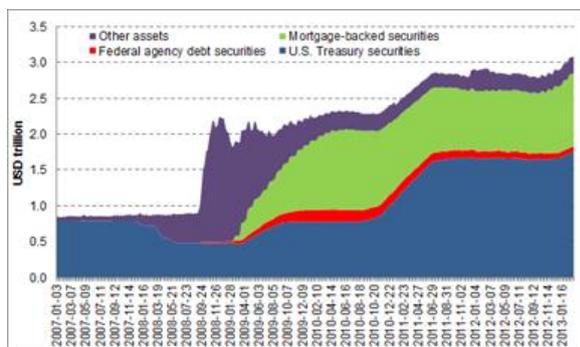
APPENDIX

A REVIEW OF MONETARY POLICIES IN SOME LARGE DEVELOPED ECONOMIES IN RECENT YEARS

The United States

In the wake of the 2008 financial crisis, the United States began an aggressive asset-buying program in an attempt to support the weakened housing market. The initial round of quantitative easing, known as QE1, resulted in a total of USD 1.25 trillion in mortgage-backed securities (MBS), USD 175 billion in mortgage agency debt, and USD 325 billion in long-term Treasuries being purchased by the Federal Reserve between November 2008 and March 2010 (Figure 14). In addition, the central bank's key short-term lending rate was lowered in December 2008 to just 0.25% where it has remained since. The goal was to increase bank lending, thereby stimulating the economy, by raising the amount of credit available and reducing the cost of borrowing. However, total commercial bank loans actually fell from USD 7.3 trillion in November 2008 to USD 6.6 trillion in March 2010 as many banks instead used the credit to write down existing underperforming debt and/or raise their capital ratios.

Figure 14: United States Federal Reserve Assets, by type



Note: Other assets include central bank liquidity swaps, loans, repurchase agreements, and net portfolio holdings.

Source: United States Federal Reserve

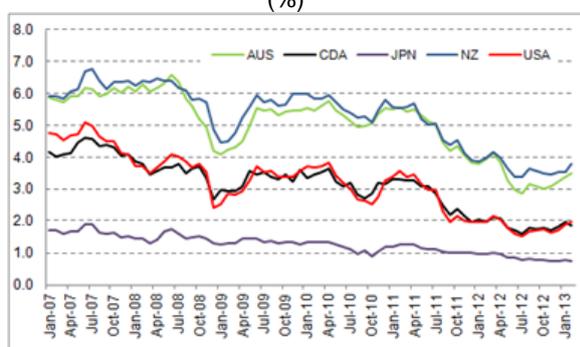
The Federal Reserve then launched QE2, under which an additional USD 600 billion of long-term Treasury securities were purchased between November 2010 and June 2011 with the goal of spurring demand by creating mild inflation. In September 2011, the Maturity Extension Program, or "Operation Twist", was announced. The Federal Reserve would use USD 400 billion from its sales of short-term Treasury bills to buy long-term Treasury notes, thereby lowering long-term yields and therefore interest rates. In June 2012, the U.S. announced that an additional USD 267 billion would be used in Operation Twist. As a result, both bank lending and the housing market began to pick up. However, economic growth remained sluggish as new jobs were not being created. In fact, there were 1.5 million fewer jobs in the United States in June 2012 than there had been in November 2008 at the start of QE1.

In September 2012, with the monthly unemployment rate having remained above 8% since February 2009, the United States launched its third round of quantitative easing (QE3), an open-ended program in which the Federal Reserve will purchase USD 40 billion of MBS and USD 45 billion of long-term Treasuries every month until the labor market improves "substantially". This was followed by an unprecedented announcement in December 2012 that the central bank would keep the federal funds rate near zero until the unemployment rate falls to 6.5% or inflation looks likely to exceed 2.5%, events that officials do not expect to occur until around mid-2015¹. Also, Operation Twist was ended as short-term debt would now be rolled over.

As a result of its expansionary monetary policy, interest rates in the United States have indeed fallen. Between October 2008 and February 2013, the 30-year fixed rate for mortgages fell from a monthly average of 6.20% to 3.53%, while the yield on 10-year Treasury notes declined from a monthly average of 3.81% to 1.98% (Figure 15). Inflation has also generally remained within range of the Federal Reserve's target of 2% as the central bank has worked to reduce uncertainty, allowing

investors to incorporate the central bank's actions into their expectations. However, total assets of the U.S. Federal Reserve have more than tripled since the start of the financial crisis to over USD 3 trillion. At its meeting in January 2013, some officials expressed concern over the efficacy, costs, and risks of the asset buying program, leaving many investors uncertain over whether the Federal Reserve will reduce or end its purchases of securities before there is a substantial improvement in the outlook for the labor market.

Figure 15: Benchmark 10-year government bond yields (%)



Source: AUS; CDA; JPN; NZ; USA Reserve Banks

Japan

The economy of Japan has faced a decades-long struggle with low growth and deflation. Between 1994 and 2012, real GDP increased by just 0.8% per year, while consumer prices (less food and energy) fell by 4.2%. In an effort to tackle its sluggish economic growth, monetary policy in Japan has been expansionary since the late 1990s. More recently, the central bank's policy rate, the uncollateralized overnight call rate, has ranged from 0 to 0.1% since January 2010. In October 2010, the Bank of Japan announced the Asset Purchase Program, under which the central bank will purchase Japanese government bonds (JGBs), treasury discount bills (T-bills), commercial paper, corporate bonds, exchange-traded funds (ETFs), and Japanese real estate investment trusts (J-REITs). Following several enhancements to the program that raised its size from an initial JPY 35 trillion, a total of JPY 101 trillion (USD 1.1 trillion, or

21.2% of GDP) is to be used to buy assets through the end of 2013.

In January of this year, Japan enacted an aggressive mix of fiscal and monetary policies to combat its economic malaise. The government announced a JPY 10.3 trillion (USD 117 billion, or 2.2% of GDP) fiscal stimulus package with the majority of spending directed to disaster preparedness and infrastructure as well as stimulating private investment. Meanwhile, the Bank of Japan doubled its inflation target to 2% and announced that in 2014 it would switch to an open-ended approach of buying JPY 13 trillion in assets each month, similar to the approach currently being pursued in the United States under QE3. The central bank plans to purchase JPY 10 trillion in treasury discount bills, JPY 2 trillion in long-term government bonds, and JPY 1 trillion in private debt.

Following a change in leadership at the Bank of Japan in March, the central bank announced in early April that it would double its government bond holdings over the next two years by purchasing over JPY 7 trillion of long-term government bonds each month, thereby targeting the size of the monetary base. The Bank of Japan will also increase its purchases of ETFs and REITs, buying an additional JPY 1 trillion and JPY 30 billion, respectively, per year. While analysts were expecting further monetary easing measures following the leadership change, the scale of the increase in the asset purchase program rattled markets. Even though the change in the type of assets purchased was expected (and investors had been purchasing relatively longer-term government bonds in anticipation)¹³, the yield on 10-year JGBs fell to a

¹³ Unlike in the United States where the average maturity of the Federal Reserve's Treasuries portfolio is currently around 10 years, the Bank of Japan had only bought government bonds with terms of up to three years. Its latest monetary policy measures will raise the average maturity of its holdings of JGBs to seven years.

record low of 0.425% following the announcement¹⁴.

The United Kingdom

Similar to the United States and Japan, the UK has also implemented an asset buying program to address weak growth following the global financial crisis. In March 2009, the Bank of England cut its policy rate to the current 0.5% and began an Asset Purchase Programme in order to boost nominal demand and with an aim to meet the 2% inflation target in the medium-term. Following an initial asset purchase of GBP 200 billion, mostly in UK government bonds (“gilts”), total asset purchases by the Bank of England reached GBP 375 billion (USD 568 billion) in July 2012. With GDP contracting by 0.3% in Q4 2012 and overall growth of just 0.2% in 2012, the Bank of England is currently considering whether to increase the scale of the asset buying program to GBP 400 billion to support economic recovery, despite inflation being above target for the past several years. Since the start of the UK’s Asset Purchase Programme, the yield on long-term UK gilts fell from 3.00% to 1.92% in February 2013.

The Euro area

Other members of the European Union continue to try to address the substantial economic challenges brought on by the Euro area sovereign debt crisis that began in late 2009. Although the specific causes varied by member, sovereign debts increased sharply in many European economies as a result of bailouts of the banking system as well as government measures to stimulate growth following the global financial crisis in late 2008. Total government debt in the euro area rose steadily from 68% of GDP (EUR 6.3 trillion) in Q3 2008 to 90% in Q3 2012 (EUR 8.5 trillion). In May 2010, spreads between 10-year government bonds of some Euro area members relative to German government bonds had risen to record highs, mainly due to increasing concern about the sustainability of public

finances. As confidence in the ability of several of these economies to service their debt payments continued to erode, Greece, Ireland, and Portugal each in turn saw the interest rate on their government debt rise above 10% between mid-2010 and mid-2011, straining domestic budgets and increasing the risk of default.

The Euro area’s monetary authority, the European Central Bank (ECB), has undertaken several actions in response to the global financial crisis and the subsequent Euro area sovereign debt crisis. In October 2008, the ECB began a series of cuts to its benchmark refinancing rate, which saw it fall from 4.25% to 1.00% in May 2009, and implemented a number of measures to ensure liquidity in the banking sector¹. Most notably, the maturity of the long-term refinancing option (LTRO) was gradually expanded from 3 months in early 2008 to 36 months, with the ECB providing over EUR 1 trillion to banks through two 36-month LTROs in December 2011 and February 2012. To address the sovereign debt concerns, the ECB announced the Securities Markets Programme (SMP) in May 2010, which enabled the ECB to purchase debt securities in the Euro area. By the end of 2012, the ECB had purchased EUR 218 billion in securities, nearly half of which were issued in Italy. In September 2012, the ECB ended the SMP and announced the Outright Monetary Transactions (OMT), a conditional program that allows the ECB to purchase an unlimited amount of 1- to 3-year government bonds upon request from a Euro area member. Though not yet employed, the existence of the OMT facility has helped to lower long-term government bond yields in the Euro area.

¹⁴ The monthly average yield on 10-year JGBs has remained below 2% for the past 14 years