II. International and domestic economic and financial conditions

2.1 International economic and financial conditions

The global recovery continued to accelerate in 2010, but at varying speeds across countries and regions. In emerging and developing economies, particularly in Asia, the economy grew strongly, but the macroeconomic risks of overheating were building. In advanced economies, the risk of a double-dip recession subsided, though recovery proceeded moderately and unemployment remained high. In the euro area periphery, affected by the combined interactions of weak sovereign balance sheets and financial pressures, economic growth was modest or even declined. Meanwhile, Mainland China experienced a rapidly accelerating economy. The implementation of a tightening monetary policy and macroprudential policies to tame the housing boom contributed to moderating excessive credit expansion and surging house prices, but inflationary pressures remained elevated.

Over the year 2010, the global financial system witnessed marked improvement, but financial stability was still not secured. In advanced economies, slow growth prospects and weak fiscal positions, together with sovereign-debt-crisis driven refinancing pressures in the euro area funding market, resulted in the financial system remaining vulnerable. At the same time, strong capital inflows to emerging economies raised concerns about rapid credit growth and asset price bubbles, contributing to a build up of macrofinancial risks.

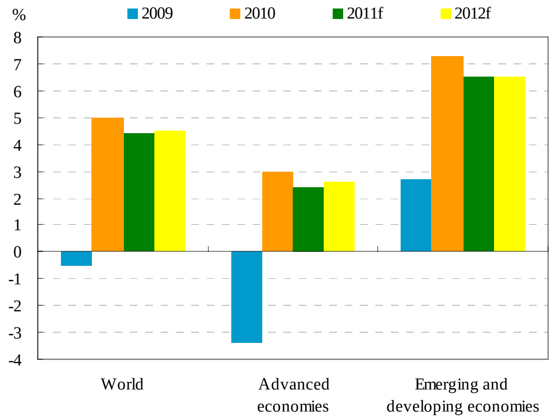
Global recovery proceeded at a solid pace, but speeds varied across regions

The global economic recovery solidified in 2010. A rise in inventory rebuilding and fixed investment, boosted by the buoyant activity in manufacturing and world trade transactions, fueled the strong growth in output in the first half of 2010. From the second half of 2010 onwards, however, the buildup of downside risks in advanced economies, driven by waning inventory rebuilding along with setbacks in resolving ongoing sovereign debt turmoil, the global economy moved to a more moderate rate of growth. International Monetary Fund (IMF) statistics stated that the global economic growth rate rebounded substantially to 5.0% through 2010 from -0.5% a year earlier.[11] Looking forward, although political uncertainty in Northern Africa and the Middle East has heightened fears of oil supply hazards, it is offset by

[11] Except as otherwise noted, all IMF estimates and forecast data and information related to economic growth rates and CPI annual growth cited in this chapter relate to those published in the World Economic Outlook (WEO), April 2011.

improving conditions in global financial markets, continued robust economic activity in emerging and developing economies, as well as returning confidence in the output of advanced economies. As a consequence, the global economy is forecast to experience an ongoing growth rate of 4.4% and 4.5% in 2011 and 2012, respectively (Chart 2.1).

Chart 2.1 Global economic growth rates



Note: Figures for 2011 and 2012 are IMF estimates.
Source: IMF, "World Economic Outlook," April 2011.

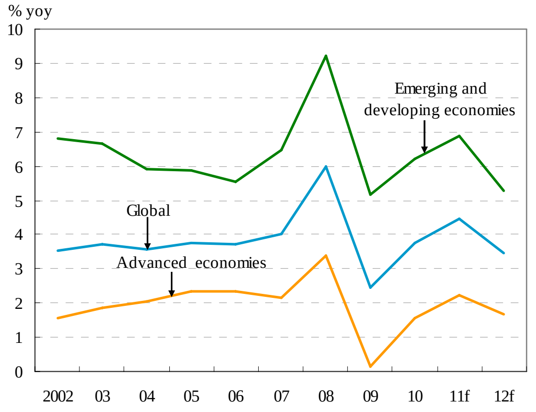
The recovery remained unbalanced across regions. Thanks to continued increases in domestic demand and strong world trade transactions, emerging and developing economies grew at a robust pace. The IMF estimated that output growth expanded by 7.3% in 2010, particularly in emerging Asia, which has continued to outpace other regions with an economic growth rate of 9.5%. Looking ahead, output growth in emerging and developing economies is expected settle down to a more modest 6.5% in 2011 and remain broadly unchanged in 2012 (Chart 2.1).

Recovery continued in advanced economies, but proceeded at a tepid pace. Supported by the recently implemented fiscal stimulus measures to spur growth momentum, together with a stronger-than-expected rebound in private consumption expenditure, output in the United States and Japan witnessed a favorable improvement after reaching a trough and gradually began to recover. The full impact of the earthquake in March 2011 on Japan's macroeconomy is projected to be limited, but uncertainty remains elevated.[12] Growth in the periphery of the euro area has been subdued and even declined as a result of fiscal imbalances and still-moribund real estate markets. Fortunately, this adverse impact was mainly offset by an expansion in output in Germany, boosted by stronger domestic demand. The IMF estimates that real GDP in advanced economies rebounded by 3.0% in 2010 from -3.4% a year earlier, still well below the growth rate of 7.3% in emerging and developing economies, and will register a moderate growth rate of 2.4% and 2.6% in 2011 and 2012, respectively (Chart 2.1).

[12] Regarding potential economic impacts on Japan, the IMF projects Japan's output to decrease by 1.4% in 2011, a downward revision of 0.2 percentage points compared to the October 2010 WEO, and then pick up to 2.1% in 2012, a 0.3 percentage point upward revision. In addition, the Global Insight preliminary estimates suggest that the adverse impact on global growth in 2011 will be in the 0.1-0.2% range, with a correspondingly small rebound in growth in 2012. It also projects that Japanese real GDP growth could drop by 0.05% in 2011, and then rebound to 3.57% in 2012, boosted by the subsequent reconstruction effort.

As for consumer prices, from early 2010 onwards, in response to robust global demand, sluggishness in the supply of selected commodities, and the depreciation of the US dollar, prices for both oil and raw materials surged. This, together with adverse weather conditions, continued natural disasters and geopolitical uncertainty, spurred hikes in crop and energy prices. The inflationary pressure is expected to continue an upward trend in 2011 before becoming more subdued in 2012. In some emerging and developing economies, overheating pressures are building in response to soaring food prices, rapid credit growth and rising asset prices. The IMF estimates that headline inflation rates (consumer price index, CPI) in emerging and developing economies increased to 6.2% in 2010 from 5.2% one year earlier. With surging inflationary pressures, the CPI inflation rate is predicted to keep elevating to 6.9% in 2011, and then exhibit a downward trend to 5.3% in 2012. In advanced economies, inflationary pressures were broadly contained as economic growth moderated and inflation expectations were well anchored. Headline inflation is estimated to rise slightly to 1.6% in 2010 and projected to remain positive at 2.2 % in 2011, before settling at about 1.7% in 2012 (Chart 2.2).

Chart 2.2 Global headline inflation rates



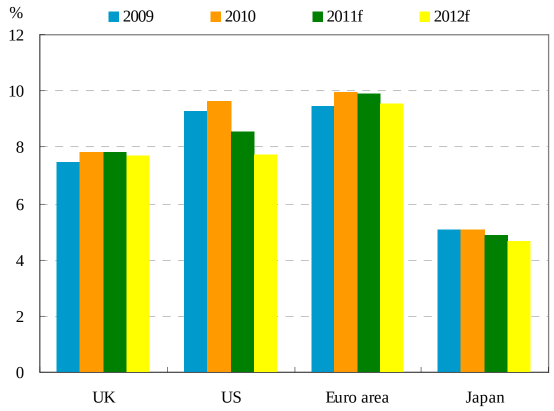
Note: Figures for 2011 and 2012 are IMF estimates.
Source: IMF, "World Economic Outlook," April 2011.

In 2010, unemployment rates remained persistently high in many advanced economies. Among major advanced economies, the US saw a peak of 9.6% during the year but by April 2011 it had fallen to 9.0%.[13] Nevertheless, the labor market remains slack. In the UK, the unemployment rate continued to rise and stood at 7.88% in 2010 owing to a reduction of jobs in the public sector. The average unemployment rate in the euro area registered 9.98% for 2010. The Netherlands and Austria benefited from stronger labor markets, while unemployment rates moved upward in Portugal, Italy, Ireland, Greece and Spain. Among those economies, Spain suffered from the highest unemployment rate of 20.1%. In Japan, the unemployment rate peaked in June 2010 and then declined moderately, bolstered by the ongoing economic recovery. The IMF projects that the unemployment rate in advanced economies would decrease somewhat in 2011 and 2012 (Chart 2.3).

[13] The figure is based on a U.S. Bureau of Labor Statistics (BLS) news release on 6 May 2011.

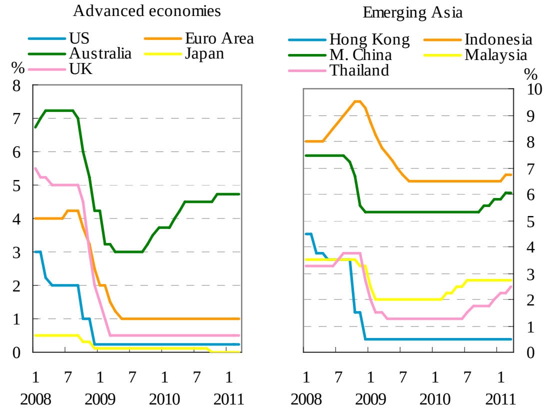
Regarding monetary policy, most advanced economies continued to adopt easy monetary policies in 2010[14] in an effort to boost domestic recovery, given well-anchored inflation expectations and soaring unemployment rates. The Board of Governors of the Federal Reserve System (FED), the Bank of England (BOE) and the European Central bank (ECB) all kept their policy rates unchanged.[15] Meanwhile, the Bank of Japan (BOJ) cut the policy rate and brought back its zero interest rate policy in October 2010[16] in view of continued deflation, an appreciating yen and sluggish stock market. In contrast, the Reserve Bank of Australia successively raised the cash rate target four times, each by 25 basis points, to 4.75% from March to November 2010 due to concerns about mounting inflationary pressures. In emerging Asian economies, some central banks (for example, Mainland China, Malaysia and Thailand) subsequently hiked policy rates in 2010 as a result of sustained economic growth, accelerating inflation and excessive credit expansion, while others such as Hong Kong and Indonesia kept policy rates unchanged. In the beginning of 2011, Mainland China and Thailand saw continued hikes in policy rates. Additionally, the Bank of Indonesia and the ECB also raised policy rates by 25 basis points in February and April of the year, respectively, in the face of rising inflationary pressures (Chart 2.4).

Chart 2.3 Unemployment rates in major economies



Note: Figures for 2011and 2012 are IMF estimates.
Source: IMF, "World Economic Outlook," April 2011.

Chart 2.4 Policy rates in selected economies



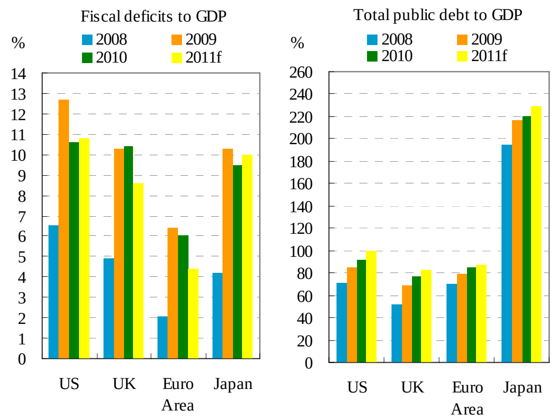
Notes: 1. Advanced economies: figure for Australia is based on cash rate target; for the US, federal funds rate target; for the UK, official bank rate; for the euro area, the main refinancing operations fixed rate; and for Japan, uncollateralized overnight call rate.
2. Emerging Asia: figure for Hong Kong is based on discount window base rate; for Mainland China, financial institution one year lending base rate; for Thailand, 1-day repurchase rate; for Indonesia, Bank Indonesia rate; for Malaysia, overnight policy rate.
3. Figures are end-March 2011 data.
Source: Central banks' websites.

[14] For instance, the Federal Open Market Committee (FOMC) unleashed its second round of quantitative easing (QE2) in November 2010 and planned to purchase a further US$600 billion of longer-term Treasury securities by the end of June 2011.

[15] As of March 2011, the FED maintained the target range for the federal funds rate at 0 to 0.25%, while the BOE policy rate remained at a historical low of 0.5% from March 2009 onwards.

[16] The BOJ cut the uncollateralized overnight call rate from 0.1% to be within the range of 0 to 0.1% in October 2010.

Chart 2.5 Fiscal deficits and public debt in major economies



Note: Figures for 2011 are IMF estimates.
Source: IMF.

As for fiscal policy, fiscal deficits in advanced economies with fragile fiscal positions improved notably in 2010 from a year earlier. This improvement was mainly backstopped by increasing fiscal revenues due to economic recovery, together with a reduction in fiscal expenditures as financial supports were being phased out following the retrenchment of government spending. Nevertheless, the IMF foresees that the pace of these fiscal consolidations will moderate and proceed at varying speeds across countries in 2011. With the unwinding of new fiscal stimulus packages, the US and Japan, which also encountered reconstruction problems after the earthquake, both delayed their pace of fiscal adjustments. By contrast, major European economies tended to remain on course regarding the retrenchment of their fiscal deficits. For example, the fiscal stimulus measures in Germany and France were subsequently phased out, while Spain and the UK fulfilled sharper cuts in their government spending. Similarly, sizable fiscal adjustment plans are also under way in Greece, Ireland and Portugal (Chart 2.5). In 2009, fiscal positions in major emerging economies (for example, Brazil, Mainland China and India) became weaker due to fiscal expansion. Nevertheless, the IMF estimates that the overall fiscal balance in emerging economies is anticipated to improve with a broadly stable government debt level, mainly spurred by higher raw material prices and delays in capital expenditure projects in some emerging economies (such as Russia, Saudi Arabia and Turkey).

According to recent papers on the development of the global economy from the IMF, the Organisation for Economic Co-operation and Development (OECD) and Asian Development Bank (ADB),[17] uncertainty continues to cloud the global growth outlook, including: (1) sovereign debt crisis in the euro area periphery may spread to the core European economies; (2) the absence of progress in formulating medium-term fiscal consolidation plans in key advanced economies; (3) soaring raw material prices exert upward pressure on inflation; (4) favorable trade conditions and strong capital inflows in emerging economies raise concerns about overheating the economy, mounting inflation and asset price bubbles; and (5) global imbalances, rising trade protectionism, and renewed turbulence in foreign exchange markets

[17] IMF, “World Economic Outlook,” October 2010 and April 2011; IMF, “World Economic Outlook Update,” January 2011; OECD, “Economic Outlook,” Volume 2010/2, November 2010; ADB, “Asia Economic Monitor,” December 2010.

stemming from government interventions.

In order to ensure that the global recovery is moving on a sustainable path, the IMF offered the following recommendations to address global imbalances:

- Advanced economies should: (1) resume credit supply by speeding up the restructuring of their financial systems; (2) implement well-specified fiscal consolidation plans; (3) overhaul financial regulations and financial supervisory regimes; and (4) enhance the potential for output growth, so as to restore internal balances.

- Emerging economies should: (1) initiate fiscal consolidations and policy rate rises; and (2) adopt macroprudential instruments and incorporate capital flow management measures where necessary, so as to restore external balances.

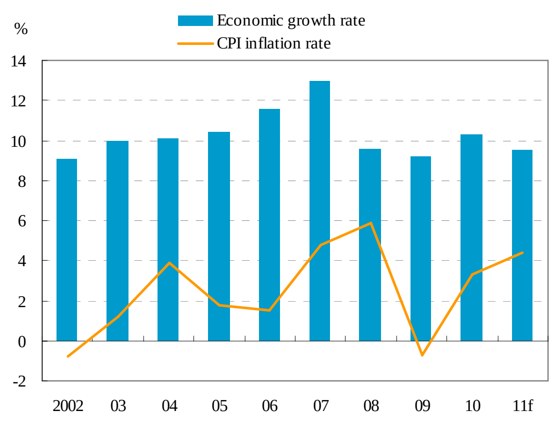
In addition, the OECD also suggests that: (1) macroeconomic policies should be met with fiscal consolidations, the implementation of accommodative policy rates should be adjusted with the pace of economic recovery, and financial reform should be ongoing; (2) structural reform is needed to heighten the efficiency of fiscal consolidations, to improve labor markets, and to reduce the impact of global imbalances on savings and investments.

Mainland China's economic growth accelerated and inflationary pressure built up, but credit expansion slowed down

Mainland China's economic growth accelerated and pressure on consumer prices built up

Underpinned by a series of economic stimulus measures, Mainland China's private consumption and investment continuously increased. Economic growth increased to 11.9% in 2010 Q1 from 11.4% in 2009 Q4. In response to rapid credit expansion and an overheated housing market, the China State Council adjusted macro-control measures and the People's Bank of China (PBC) tightened money supply. Together with contracted exports that resulted from a slowdown in the global economic recovery, Mainland China's economic growth started to cool down in the

Chart 2.6 Economic growth rate and CPI inflation rate in Mainland China



Note: Figures for 2011 are Global Insight projection.
Sources: National Bureau of Statistics of China, Thomson DataStream and Global Insight.

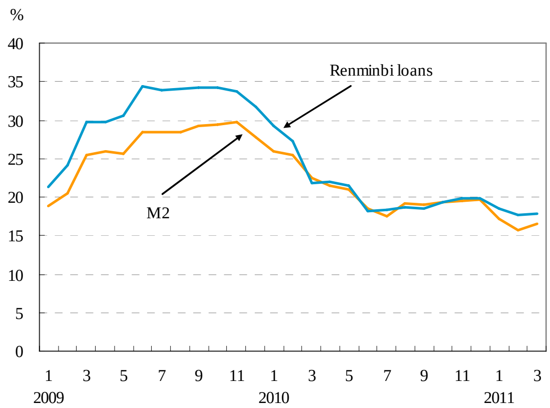
second quarter and registered rates of 10.3% and 9.6% in Q2 and Q3 2010, respectively. Nevertheless, economic growth for the whole of 2010 still reached 10.3%. Global Insight projects Mainland China's economic growth rate through 2011 to slightly decrease to 9.3%[18] (Chart 2.6).

Regarding consumer prices, the CPI inflation rate showed an upward trend in 2010 due to increased consumption demand and rising food prices. In May, the CPI inflation rate reached 3.1%, exceeding the official annual target of 3% for the first time. Subsequently, the flood that hit major agricultural regions pushed up grain prices further and made the China State Council take seven measures in August to stabilize the prices of agricultural products. However, the CPI inflation rate still surged to an annual peak of 5.1% in November, a new high in 28 months. To contain price inflation, the China State Council further announced sixteen measures in November to stabilize prices and the China Banking Regulatory Commission (CBRC) asked commercial banks to prevent loans from being diverted to bid up agricultural products via hoarding and speculation. The CPI inflation rate dramatically increased from -0.7% in 2009 to 3.3% in 2010 and reached a new high of 5.4% in March 2011. Global Insight projects Mainland China's inflation rate to register 4.5%[19] in 2011, indicating a buildup in inflationary pressure (Chart 2.6).

Monetary policy tightened, and bank credit and property price growth slowed

In 2009, due to extremely easy monetary policy, Mainland China's bank credit boomed as the annual growth rates of renminbi loans and M2 all reached historical highs of 34.4% and 29.7%, respectively. As a large amount of newly granted loan funds poured into the property market, the annual growth rate of building sales prices in Mainland China's 70 medium-large cities reached a five-year high of 12.8% in April 2010, suggesting an overheating property market. In order to prevent a property bubble and alleviate inflationary pressure, the PBC substantially contracted market liquidity by raising the reserve requirement ratio (RRR) for depository financial institutions six times by a

Chart 2.7 Annual growth rates of M2 and renminbi loans in Mainland China

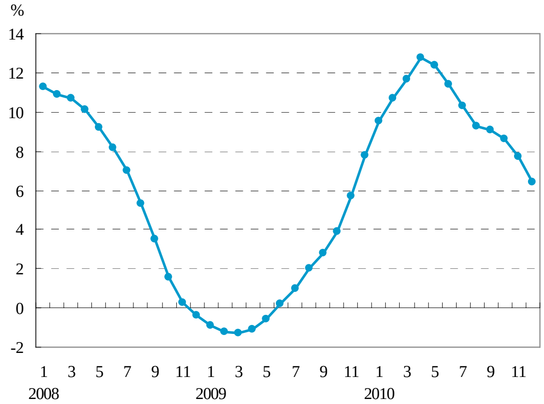


Source: PBC.

18 Global Insight Estimate in April 2011.
19 See Note 18.

total of three percentage points, raising 1-year renminbi benchmark deposit and lending rates of financial institutions two times to 2.75% and 5.81%, respectively, and conducting open market operations several times. Other official institutions, including the China State Council, successively implemented measures to curb property price rises (Table 2.1). The growth of bank credit and property prices therefore slowed down, and in December the annual growth rates of renminbi loans and M2 decreased to 19.9% and 19.7%, respectively, and the annual growth rate of building sales prices in 70 medium-large cities settled down to 6.4% (Chart 2.7 & Chart 2.8).

Chart 2.8 Annual growth rates of building sales prices in 70 medium-large cities of Mainland China



Note: From 2011 onwards, the National Bureau of Statistics of China stopped publishing a national total sales price index of building in 70 medium-large cites.
Source: National Bureau of Statistics of China.

Starting 2011, in response to increased inflationary pressure, the PBC continuously tightened the money supply by raising the RRR rate and the benchmark deposit and lending rates.[20] The General Office of the China State Council further took measures to curb property prices (Table 2.1). Consequently, the annual growth rates of renminbi loans and M2 decreased to 17.9% and 16.6% (Chart 2.7), and the number of cities with inflated building sales prices also gradually decreased.[21] However, building price adjustment may weigh on the real estate industry and the loan quality of banks, and thus warrants close attention.

Meanwhile, according to Mainland China's economic stimulus plan that was rolled out during the financial crisis, fixed capital formation, which was the key engine of economic growth, was attributed to enormous infrastructure investments from all levels of government. Local governments, facing fiscal constraints and legal restrictions on bank borrowing and bond issuance, established local government financing platforms (LGFPs)[22] to fund investments. Some banks relaxed lending terms for LGFPs for their implicit local

[20] During January to April 2011, the PBC again raised the RRR rate by a total of 1.5 percentage points and 1-year deposit and loan rates to 3.25% and 6.31%, respectively.

[21] Starting 2011, the National Bureau of Statistics of China stopped publishing the national total sales price index of building in 70 medium-large cites and only published a sales price index of building for individual cities. In Q1 2011, the building prices of most medium-large cities kept increasing but the number of cities with inflated building prices gradually decreased. In January 2011, more than 80% of medium-large cities registered inflated building prices, but the proportion decreased to 70% and 60% in February and March, respectively.

[22] The local government financing platforms are independent legal entities set up by local governments via financial grants, injection of land or shares.

government guarantee.[23] The number and borrowing scale of LGFPs therefore have grown rapidly in the last two years, which has raised doubts about the fiscal health of local governments and the debt servicing capacity of LGFPs. Therefore, Mainland China's official authorities began to implement a series of measures in order to strengthen the management of LGFPs starting mid-2010 so as to decrease fiscal risk and strengthen the health of banks.

Table 2.1 Measures adopted by Mainland China to curb property prices in 2010 and 2011 Q1

Date	Announced by	Measures
2010.1.7	The General Office of the State Council	The down payment ratio for second-time homebuyers should not be less than 40%.
2010.4.17	The State Council	1. The down payment ratio for first-time homebuyers should not be less than 30%. 2. The down payment ratio for second-time homebuyers should not be less than 50% and the lending rate is not allowed to be less than 1.1 times the PBC benchmark lending rate. 3. Banks in areas with excessively rising house prices could suspend mortgage lending to third-time homebuyers. 4. Banks could suspend mortgage lending to non-resident citizens who fail to offer certificates which evidence payment of taxes or social insurance for one year or more.
2010.5.25	The Ministry of Finance of Mainland China	1. Strengthen the collection of land value appreciation tax. 2. Raise pre-levy rate of land value appreciation tax. 3. The assessment-based levy rate of land value appreciation tax should not be lower than 5%, and forbid tax authorities taking assessment as major means for collection of land value appreciation tax.
2010.9.29	The People's Bank of China (PBC) The China Banking Regulatory Commission (CBRC)	1. Suspend mortgage lending to third-time homebuyers. 2. Suspend mortgage lending to non-resident citizens who fail to offer certificates which evidence payment of taxes or social insurance for one year or more. 3. Restate that the down payment ratio for first-time homebuyers should not be less than 30%, for second-time homebuyers should not be less than 50% and the lending rate should not be less than 1.1 times the PBC benchmark lending rate.
2010.9.29	The Ministry of Finance of Mainland China	Starting 1 October 2010, cancel the personal income tax exemption for home-sellers who purchase another house within one year.
2010.11.4	The Ministry of Housing and Urban-Rural Development of Mainland China The State Administration of Foreign Exchange	1. Offshore individuals are allowed to purchase only one residence to live in. 2. Offshore institutions that have branch or representative offices in Mainland China are only permitted to purchase properties for business use in cities where they are registered.
2011.1.26	The General Office of the State Council	1. Homeowners who sell homes within five years of acquisition will be charged full transaction taxes. 2. Raise minimum down payment ratio for second-time homebuyers to 60% and restate that the lending rate should not be less than 1.1 times the PBC benchmark lending rate. The branches of the PBC may raise the aforementioned ratio and

[23] Some local governments guaranteed the debts of LGFPs. If such debts are not self-liquidating, their insolvency may impair the fiscal health of local governments.

		floor rate according to local government policy. 3. Impose fines and withdraw land use rights from developers if they fail to obtain building construction licenses within two years. Real estate developers are not allowed to transfer underlying land or development items if their paid-in construction investments are less than 25% of the amount (excluding land price) of the project planned. 4. Cities with surging or high house prices and large cities, such as municipalities, should implement house purchase limit policies. Suspend selling houses to residents who already owned two or more houses, nonresidents who already owned one or more houses or nonresidents who fail to offer certificates which evidence payment of taxes or social insurance.

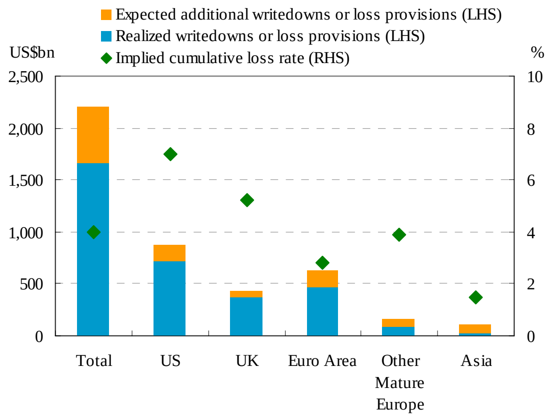
Source: CBC staff summary.

The global financial system has improved but fragilities remain

Driven by the improving economic climate, ample liquidity and greater risk appetite, global financial market performance turned favorable in 2010. At the same time, global equity prices rose broadly, while the capital levels of banks improved. In October 2010, the IMF revised downward its forecast for global asset writedowns and loan provisions to US$2.2 trillion (Chart 2.9). More than three-quarters of them had already been realized or recognized, leaving a residual amount of about US$550 billion.

The vulnerabilities threatening global financial stability subdued, but the global financial system remained fragile. The two-track global recovery[24] continued to pose considerable challenges to policy making. In advanced economies, the slowdown in economic growth alongside fiscal imbalances raised concerns about sovereign debt sustainability. The intensified interaction between sovereign and banking sector risks led to renewed pressures in funding markets in the euro area, and, as a result, induced a pronounced rise in funding costs to governments and banks. Meanwhile, the household debt burden followed an upward trend, while credit risks in the banking sector

Chart 2.9 Global bank writedowns or loss provisions



Notes: 1. Figure for realized writedowns or loss provisions are based on 2007 Q2-2010 Q2 data, while for expected additional writedowns or loss provisions is 2010 Q3-2010 Q4 data.
2. "Other Mature Europe" includes Denmark, Norway, Iceland, Sweden and Switzerland. "Asia" includes Australia, Hong Kong, Japan, New Zealand and Singapore.

Source: IMF, "Global Financial Stability Report," October 2010.

[24] Advanced economies grew slowly, while emerging economies grew rapidly.

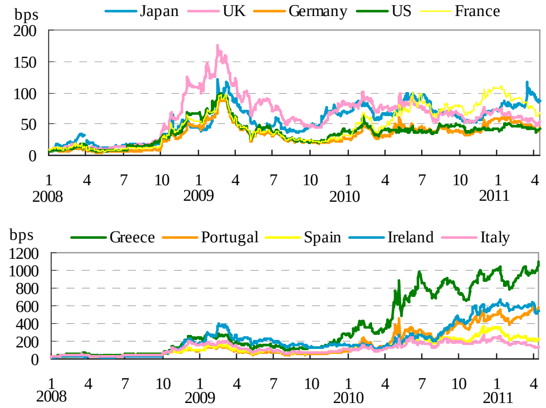
heightened. Stronger economic growth in emerging economies, coupled with accommodative monetary policy in advanced economies, spurred massive capital flows into emerging economies, in turn contributing to higher leverage ratios in financial markets. This not only raised concerns about asset price bubbles but also created upward pressure on inflation.

The financial systems in advanced economies were still at risk

In the second quarter of 2010, the Greek sovereign debt problem once again spurred a recurrence of financial turbulence in the euro area, but the financial system gradually resumed stability in the wake of a range of measures, such as financial support from the European Union (EU) and the IMF as well as the announcement of fiscal adjustment plans by Greece. In November, however, the sovereign debt crisis resurged as lingering concerns about fiscal sustainability and the banking system in Ireland resurfaced. Deteriorating European sovereign debt risks spilled over to other economies and financial systems. The correlation of sovereign bond spreads in Portugal, Italy, Ireland, Greece and Spain (PIIGS) increased markedly with intensifying financial tensions. The credit default swap (CDS) spreads for sovereign bonds of the PIIGS nations also elevated dramatically and even influenced those of France and Germany (Chart 2.10). In the euro area, some banks faced substantial selling pressure on their equities and bonds, while many banks became mired in difficulties of rising funding costs, shortening financing terms and the inability to access funding markets. The confluence of funding pressures and weak balance sheets in the banking sector led to financial system fragility in the euro area and exposed it as highly vulnerable to further market turmoil.

In the US, the financial system improved but financial vulnerabilities persisted, including: (1) the financial system needed to raise more capital to keep on tackling the impact stemming from ongoing deleveraging and financial supervisory reform; (2) a lackluster real estate market and a backlog of foreclosures hindered credit extension and the return to a normally functioning mortgage market; (3) the focus of market concern on credit risks in government-sponsored enterprises (GSEs) shifted to fiscal balances, and how the government sector might deal

Chart 2.10 Sovereign CDS spreads in major advanced economies



Note: Figures are based on 5-year credit default swap.
Source: Bloomberg.

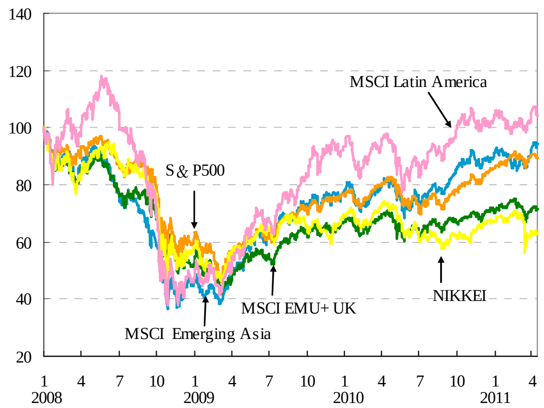
with excessive debt burdens is still an open question. In Japan, banks have been facing low capital levels and depressed profitability. This, together with a stock market downturn, exacerbated pressures on Japanese banks' capitalization and profitability. The banking system was also vulnerable to weakening sovereign funding access. Moreover, an earthquake in Japan exacted a terrible human toll and asset damage, leading to a further deterioration in the banking sector.

Over the past years, several economies have been phasing out their emergency supports. Meanwhile, the effects of low-interest-rate policies have gradually subsided and fiscal stimulus packages have met considerable political criticism. Against this backdrop, the IMF supposes that the monetary and fiscal support policies instituted merely had near-term effects and more structural reforms are needed in the long run. These recommendations include: (1) advanced economies with higher foreign debts (such as euro area economies, the US and Japan) should further combine credible medium-term fiscal consolidation plans with better public debt management; and (2) an ongoing financial supervisory reform agenda to overhaul the financial system is required.[25]

Strong capital inflows into emerging economies raised concerns over the gradual buildup of macrofinancial risks

Relatively favorable fundamentals and stronger growth potential in some emerging economies, together with lower interest rate levels in advanced economies, evoked the resurgence of massive global capital inflows to emerging economies, particularly to Asia and Latin America. According to IMF statistics, international capital movements, which were moderate during the financial crisis, rebounded in 2010 bolstered by asset reallocation by institutional investors, the carry-trade, and expectations of foreign exchange rate appreciation incentives. The international capital flows into emerging economies were estimated to register about 4% of GDP in those economies.

Chart 2.11 Performance of key international equity indices



Note: 1 January 2008 = 100.
Source: Bloomberg.

Abrupt increases in capital inflows into emerging economies have pushed up their

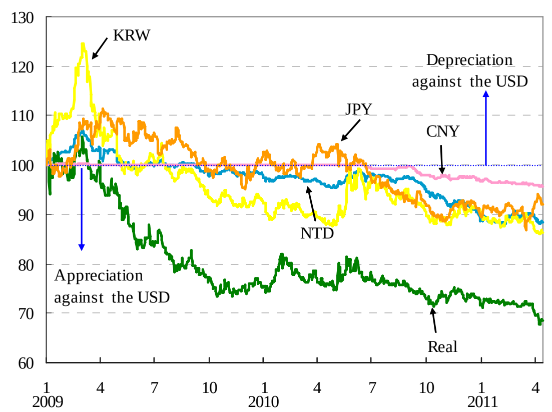
25 IMF, "Global Financial Stability Report," April 2011.

equity prices. From 2010 onwards, equities indices in emerging markets have been generally buoyant, particularly in Latin America and some emerging Asian economies (Chart 2.11). Capital inflows also triggered excessive credit expansion in emerging economies, reflecting a sharp rise in non-financial sector debt-to-GDP ratios. In some economies (for example, Brazil, Chile, Mainland China, India and South Korea), these ratios have become close to historical highs for the past 15 years. Furthermore, heavy capital inflows have enabled weaker enterprises to easily access funds by issuing bonds, resulting in a further deterioration in the credit quality of assets held by investors. If interest rates unexpectedly rise in advanced economies, economic prospects worsen in emerging markets, or investor appetites change, it could lead to sudden reversals of capital inflows and compromise the soundness of the financial system.

Sizable capital inflows also put upward pressure on currency appreciation in emerging economies, for example, the NT dollar, renminbi, real and won all faced such problems (Chart 2.12). To prevent exchange rates from being disrupted by international capital inflows and undermine the stability of financial markets and commodity prices, some emerging economies successively initiated a number of capital flow management measures aimed at containing short-term capital inflows (Box 1). In addition, some central banks and financial supervisors (such as in Taiwan, South Korea, Singapore and Hong Kong) also introduced targeted credit control measures for real estate-related loans by financial institutions to prevent domestic asset prices from being disrupted by speculative demand.

In response to strong capital inflows, the IMF suggests that emerging economies need to rely on macroprudential polices (such as more stringent loan-to-value ratios and limits on the combination of funding sources) to reduce overheating and financial imbalance risks, in addition to the implementation of macroeconomic policies (for example, more flexible exchange rates, accumulating foreign exchange reserves and fiscal tightening). Capital flow management measures could be resorted to when the above-mentioned approaches fail to effectively mitigate risks. The IMF supposes that the signs point to the fact that these capital inflows to emerging economies were driven by increased structural changes in global asset allocation.

Chart 2.12 Movements of various currencies against the US dollar



Note: 1 January 2009 = 100.
Source: Bloomberg.

Emerging economies should deploy policies aimed at strengthening local financial market deepening to enhance their capacity to absorb inflows. These policies could entail the streamlining of corporate bond issuance procedures, removal of barriers for securities issuance and improvement of financial regulations and infrastructure.

International financial regulatory reforms have made greater progress

From 2010 onwards, international financial regulatory reforms have made striking progress. In December 2010, the Basel Committee on Banking Supervision (BCBS) announced a comprehensive framework presenting the details of global regulatory standards on bank capital adequacy and liquidity (also known as Basel III). The framework set up standards covering both microprudential and macroprudential elements. From the microprudential perspective, regulations aimed at enhancing the resilience of individual banks have put in place explicit criteria and are expected to be abided by national supervisors. These approaches entail better capital quality and higher capital levels, the expansion of the coverage of risk-weighted assets, the introduction of a leverage ratio and the formulation of two global minimum liquidity standards. The macroprudential policies could entail creating counter-cyclical capital buffers as well as imposing a capital surcharge or establishing stricter limits on large exposures for systemic risks and linkages. These policies, which aim to ensure the stability of the financial system as a whole, are emerging issues and their implementation could pose significant challenges to policymakers. More details about Basel III are summarized in Box 2, while the implications of systemic risks and macroprudential supervision are listed in Box 3.

In addition, the deliberation or discussion of some initiatives are under way and still await further action. These include guidance for identifying systemically important financial institutions and measuring their systemic risk contributions, macroprudential policies to mitigate systemic risks as well as the establishment of an effective cross-border bank resolution mechanism. Nevertheless, the European economies and the US have successively set up an independent body responsible for the oversight of systemic risks in hopes of better monitoring systemic risks as follows that warrant close attention.

- The European Systemic Risk Board (ESRB), which came into force in December 2010 and started operation in January 2011, is mainly composed of the governors of national central banks in the European Union (EU). It is in charge of macroprudential supervision which indentifies, measures and monitors threats to the financial stability of the EU, and the establishment of an early warning mechanism. The ESRB shall suggest policy responses, where necessary, to mitigate various risks.

- Under the US Dodd-Frank Wall Street Reform and Consumer Protection Act of July 2010, the Financial Stability Oversight Council (FSOC), composed of the head of supervisory agencies in the US, is charged with monitoring and addressing systemic risks arising from large financial institutions, financial instruments and financial activities.

- In the UK, the Financial Policy Committee (FPC) was set up under the Bank of England to monitor the macroeconomic and financial issues that may threaten the resilience of the financial system, and to adopt macroprudential tools.

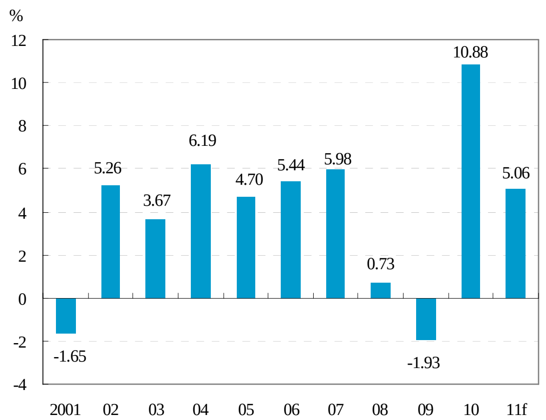
2.2 Domestic economic and financial conditions

Taiwan's economy saw solid growth through 2010 with stable commodity prices. Short-term external debt servicing ability remained strong on the back of a continued surplus in the current account and ample foreign exchange reserves. The scale of external debt continued to expand but at a moderate pace, and overall external debt servicing ability stayed robust. The government's fiscal deficits shrank, whereas government debt elevated.

Domestic economy expanded at a robust pace

In the first quarter of 2010, economic growth rebounded to 13.59%, a record-high since 1978 Q4 and sustained a high level of 12.86% in the following quarter. These high growth rates mainly were underpinned by sharp growth in exports which resulted from brisk foreign demand due to gathering momentum in the global economic recovery, upward momentum in private investment, mild growth in private consumption, and a lower base compared to a year earlier. In the second half of the year, private investment continued to expand alongside rising private consumption. But meanwhile economic growth turned to moderate, registering 10.69% and 7.3% in the last two quarters of 2010, respectively, on the back of slowing growth momentum alongside the continued influence of a high base in the previous year.

Chart 2.13 Economic growth rates in Taiwan



Note: Figure for 2011 is forecast by DGBAS.
Source: DGBAS.