

A close-up photograph of a human hand, palm up, holding a small, vibrant green seedling with four leaves. The seedling is growing out of a mound of dark, rich soil. The background is a blurred forest scene with large trees and dappled sunlight filtering through the canopy.

Keep growing because of being taken care

Rainy or sunny day, can only be predicted. Seedlings began to grow with the roots and stems that are still fragile, may be affected. But one that certain is, to deal with whatever happens is to keep vigilant.

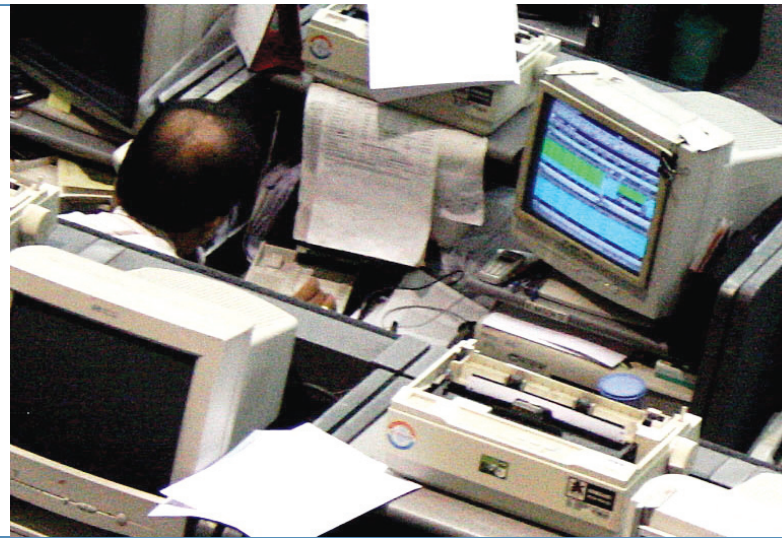
CHAPTER II

MULTI-SPEED GLOBAL
ECONOMIC RECOVERY
AND ITS IMPLICATION ON
THE EMERGING MARKET
ECONOMIES



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Multi-Speed Global Economic Recovery and Its Implication on the Emerging Market Economies



Global economic recovery intensified in 2010 indicated by the return of positive economic growth. However, this post 2008 crisis recovery process occurred at a fairly uneven pace. Economic recovery in emerging market economies (emerging economies) was faster yet followed by increased inflationary pressure. Increased inflationary pressure subsequently led these countries to tighten monetary policies. On the other hand, advanced economies continued their easy monetary policy, accordingly global liquidity continues to be abundant. The uneven global economic recovery and abundant global liquidity encouraged capital flow into emerging economies. This massive capital inflows had negatively affected emerging economies' economy, including increasing monetary management complexity. Various policies were issued in response to this, ranging from moderate policies to some kinds of capital control. The continuing global economic recovery will once again face substantial challenges that require policy cooperation or coordination among countries in order to optimally revive the economy.

The rapid economic recovery enjoyed by emerging economies was largely attributed to the robust economic performance of the emerging Asia. These emerging economies were supported by strong domestic demand and increased trade among emerging economies, which compensated for the decline in exports destined for advanced economies. However, this strong domestic demand and the sharp increase in commodity prices resulted in high inflationary pressures. This condition pushed central banks in this region to tighten their monetary policy.

On the other hand, the pace of economic recovery in advanced economies was slower, particularly following the public debt crisis that occurred in the midst of lingering weak domestic demand. The public debt crisis that began in Greece affected the European financial markets and subsequently spread to other financial markets around the world. This crisis revived uncertainty in regards to the prospects for a global economic recovery. In addition, advanced economies' economic recovery was also constrained by disruptions to export performance. In their attempt to push their economic performance, advanced economies extended their extra loose monetary policy coupled with aggressive fiscal stimulus.

Emerging economies' economic performance, which was substantially superior, led to a massive inflow of global capital to these countries, especially in view of the abundant liquidity. This intensive flow of foreign capital to emerging economies led to domestic currency appreciation, substantial increase in asset prices, as well as increasing complexity of monetary management. To overcome the negative impact of capital inflow, various policies were introduced in accordance to the size of capital inflow, such as foreign exchange market intervention and the implementation of macro prudential policies for moderate foreign capital inflow, the introduction of various restrictions to reduce the sizable capital inflow, as well as policies that induced foreign capital outflow to balance the massive capital inflow.

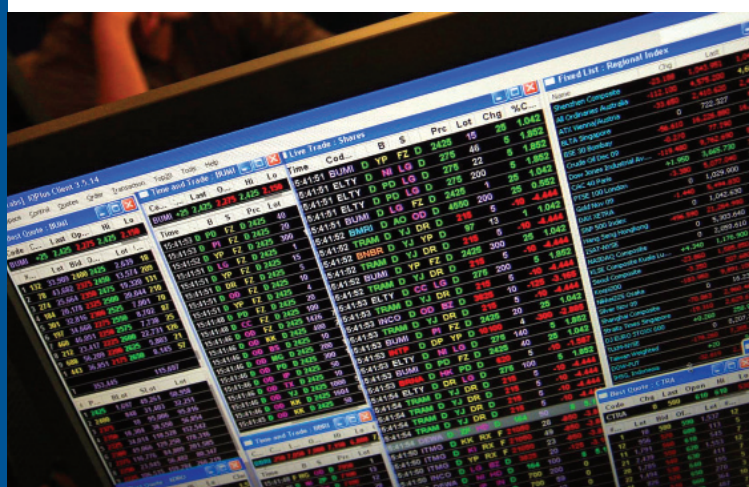
Experience from the global economic recovery process shows that a country's policy does affect



other countries; whereby steps are needed to align policies in the future. This is in line with global economic conditions that have become increasingly integrated. Therefore, policy coordination is required to achieve this collective goal for global economic recovery, while ensuring that a country's specific policies will not negatively affect other countries and that it should facilitate the achievement of its objectives.

2.1

Global Economic Performance and Policy Responses

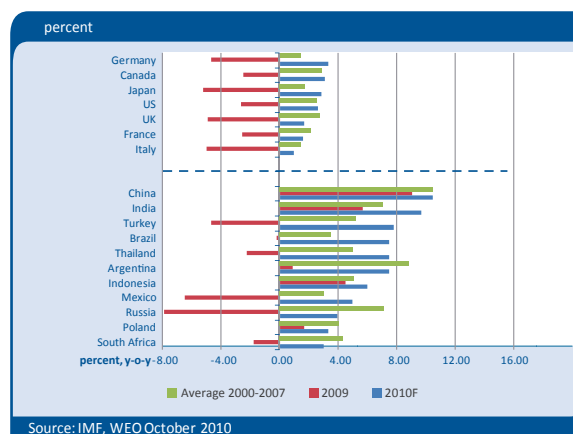


Global Economic Performance

The global economy continued its endeavor to recover from the 2008 global financial crisis. Clear indications of a recovery occurred in the second half of 2009 and became increasingly evident in 2010 with the return of positive economic growth levels of 5.0%.⁴¹ Despite this, the global economic recovery did not evenly happen in all countries (multi-speed economic recovery). Emerging economies recovered relatively faster, with 7.1% GDP growth, compared with that achieved by advanced economies of only 3.0% (Chart 2.1). The fast economic recovery in emerging economies were followed by mounting inflationary pressure that subsequently led these countries to tighten monetary policy much earlier than advanced economies. On the other hand, the central banks in the advanced economies generally maintained loose monetary policy in their attempt to revive weak domestic

demand. Meanwhile, the governments launched fiscal stimulus packages that were more aggressive than those of implemented by the governments of the emerging economies.

Apart from uneven pace, the global economic recovery also slowed in the second half of 2010, weakening the recovery's momentum. The economic recovery, which was substantially stronger earlier in the year, was affected by the advent of the Greek's public debt crisis occurred in the second quarter of 2010. This crisis led obstructed economic recovery for Greece as well as other countries within the European Union. In fact, the crisis might spread to other countries, such as Ireland, Italy, Portugal, and Spain, that also encountered significant fiscal issues. Ireland also experienced a fiscal crisis at the end of 2010. The public debt crisis within the Euro zone also affected the global recovery process both in terms of finance as well as trade. As a result, recovery in many countries, including emerging economies, slowed in the second half of 2010.



Source: IMF, WEO October 2010

Chart 2.1 Economic Growth in Some Countries

41 IMF's estimates in the World Economic Outlook Update, January 2011

The uneven economic recovery between advanced and emerging economies was particularly due to the level of exposure to the source of the crisis. The US was the epicenter of the global financial crisis in 2008, which was triggered by the subprime mortgage crisis. Accordingly, nearly all elements of the US economy were affected by this crisis, including consumers (particularly property owners and mortgage borrowers), producers or business players dealt with subprime mortgages (such as contractors and developers), the financial institutions that provided housing loans, conducted securitization process and provided guarantees for mortgage lending (banks, financial institutions, insurance, and the capital markets), investors (individual and institutional), as well as the government. Other advanced economies, particularly those within the Euro zone, were also largely exposed to the subprime mortgage crisis in view of the sizeable investments placed by banks, financial institutions and also individual investors on subprime mortgage products. In fact, the subprime mortgage crisis also led to the collapse of numerous banks and financial institutions in advanced economies.

Excessive exposure to the subprime mortgage led advanced economies to experience serious ‘damages’ to their economies, specifically resulting in the weakening domestic demand. The collapse of asset prices, particularly housing price (property) and financial asset prices, decreased consumers’ wealth, hence reduced domestic demand. The crisis also resulted in the closure of numerous companies thereby pushing unemployment rate up (Chart 2.2). The increase of unemployment rate also contributed to the decline in consumption. Furthermore, the collapse of a number of companies forced the Government to implement bailouts to prevent

even bigger losses. As a result, fiscal burden increased and reduced the capacity of the fiscal stimulus to revive economic activity and reduced government spending. Overall, the crisis resulted in weakening domestic demand. On the supply side, the decline in household and government consumption caused the decline in the level of sales, production, and investment. For the advanced economies in the Euro area, the slow recovery process were not merely due to the impact of the subprime mortgage crisis, but also as a result of the subsequent impact of the Greek public debt crisis. These contributing factors have delayed the economic recovery in advanced economies in Europe.

In contrast to advanced economies, emerging economies’ exposure to the subprime mortgage was somewhat limited in which the losses incurred were not as large as those in advanced economies. The crisis affected emerging economies mainly through the weakening demand from advanced economies. However, strong domestic demand compensated for the drop in exports destined for advanced economies thereby ensuring high economic growth. Moreover, increasing intra-trade among emerging economies also enhanced overall export performance. On the fiscal side, emerging economies’ governments contributed in helping the economy out of the crisis by introducing fiscal stimulus, even though at a fairly limited intensity. The private sector’s strength also allows for a fairly limited fiscal role. A combination of strong fundamentals and economic performance, as well as limited losses from the crisis, helped these countries to recover quickly from the crisis. In fact, the emerging Asian served as the engine of the global economic growth.

Aside from the disparity, global economic recovery was also constrained by the declining momentum in the second half of 2010. Following the advent of the global economic recovery within the second half of 2009, the economic recovery process continued to strengthen in early 2010 thereby providing optimism for a quick economic recovery. Consumption and production activities intensified as reflected by improvements in some economic indicators, such as retail sales, consumer confidence, manufacturing production and business confidence. As a result, export performance improved significantly. Regarding employment, there were also moderate improvements in employment rate.

Just as when the economy was heading for a recovery, the advent of the Greek’s public debt crisis seemed to revive

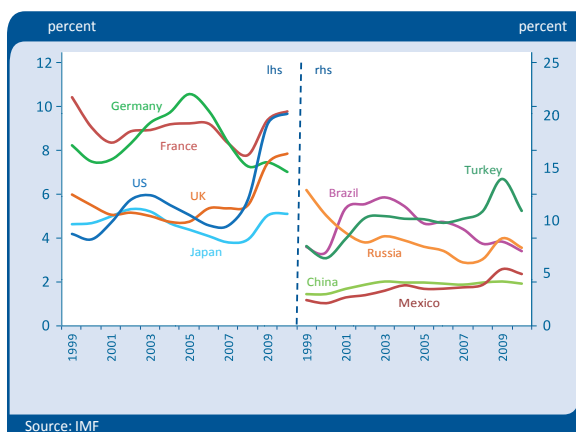


Chart 2.2 Unemployment Rate in Some Countries

uncertainty in the global economic recovery. This also brought concerns of the likelihood of the crisis spreading throughout the Euro area since a number of countries, such as Ireland, Italy, Portugal, and Spain, also experienced deep fiscal problems. For governments of other countries, particularly those that vigorously applied fiscal stimulus to promote economic activities, this crisis served as a warning to immediately conduct fiscal consolidation. The potential for the crisis to spread to other countries within the Euro area was also caused by strong interconnection among countries in fiscal financing. However, stabilization measures coordinated by the European Central Bank (ECB), the European Commission (EC), and the IMF and supported by the Federal Reserve (Fed) were able to prevent the crisis from spreading further with the exception of Ireland.

The financial market upheaval was a direct impact of the Greek crisis that not only affected European financial markets, but also other financial markets around the world. As the crisis unfolded, global investors switched their portfolio investments into safe haven instruments, such as US Treasury Bonds (flight to quality), therefore the impact spread to other financial markets across the globe. In the meantime, the impact on the real sector was reflected in the weakening of domestic demand in line with the decline in the fiscal stimulus and private consumption. The decline in private consumption, partially as a result of the decline in financial asset prices, was also due to an increase of saving as consumer response to of the crisis. Moreover, the weakening domestic demand in advanced economies, caused exports from their trading partner countries to decline. This constellation eventually caused global economic growth trend to shift downwards and slow the recovery process within the second half of 2010.

Although the pace of economic recovery in advanced economies was in general slower, it was caused by different factors within each respective country. In the US, high unemployment rate and declining household wealth caused private sector consumption to grow moderately, thereby hampering the economic recovery process. In Japan, export performance, which served as the driver of economic growth, deteriorated as yen appreciation hurt export competitiveness, while demand from other advanced economies also declined. In Euro area, economic recovery was hampered by the public debt crisis as mentioned previously.

The US economic recovery was mainly supported by heavy economic stimulus and measures to stabilize the

financial sector. In the first half of 2010, manufacturing production, which served as a pillar of the US economic recovery, moved in line with the recovery in external demand. Output levels had once again reached levels similar to those achieved prior to the crisis, however, with a slower growth trend and decelerated economic activities since the Q2 2010. On the household side, expanded consumption continued on from the Q3 2009, but with a low growth trend.

The weakening consumption was due to the decline in household wealth as a result of the decline in housing prices (around 25%-30% in the last three years) and financial asset prices, as well as the continuing high level of unemployment, which reached above 9.0%. Consumption that relied on financing from financial institutions (credit) was also affected by the credit market, which had not yet to recover, as well as the banking sector that was in the midst of a financial consolidation process (which includes reducing its leverage). The households began to apply prudent spending practices as a result of the decline in the value of wealth and income sources, as well as the high level of uncertainty. This also led to the growth in household savings. The appetite for savings in the US prior to the crisis was relatively quite low.

Despite the slow economic recovery, the US economy continued to grow by 2.8% throughout 2010. Economic growth, which continued to be weak, also affected inflation levels that, despite its increase, remained within a fairly low level of 1.5%.

Economic performance of the Euro area in 2010 seemed to improve with growth levels of 1.7%. However, this region was affected by the public debt crisis that weakened the economic growth. Economic recovery within the Euro area was driven by the German economy's favorable performance, which was in line with the depreciation trend of euro that had a positive impact on exports. However, contribution of export was also fairly limited in view of still weak economic performance of trading partner countries. In the meantime, domestic demand was relatively weak due to the high dependence on credit amid the banking sector tendency to take an extra cautious approach in extending new loans. Meanwhile, contribution from the fiscal side became more and more limited as most countries in the Euro area undertook fiscal consolidation. In fact, this fiscal consolidation resulted in an economic contracted for several countries.

Economic growth within the Euro zone slowed within the second half of 2010 as a result of the Greek crisis. This economic slowdown was reflected in the weakening of consumption and production. The fiscal austerity programs and tight lending activities by banks constrained household spending. In the meantime, the resurgent trend of euro against USD caused export and the industrial sector performance, the main drivers of economic recovery, to experience a slowdown. Some economic indicators, such as consumer confidence and business confidence indexes showed that the momentum for a European economic recovery seems to weaken. Despite of the weak economic conditions, inflationary pressure within the Euro zone increased to 2.2%.

Economic recovery in Japan also showed improvement despite the decline in exports since the second quarter of 2010. The economy improved in the Q1 driven by increased export orders (particularly from China) and fiscal stimulus that boosted domestic demand. However, export performance began to decline after the first quarter as global demands receded due to the worsening conditions in advanced economies and yen appreciation, which weakened export competitiveness. In the meantime, domestic demand remained relatively strong thereby contributed larger to the economic growth. Overall, the Japanese economy grew by 4.3% in 2010. Positive development in domestic demand was accompanied by rising inflation that grew by 0.5% following the deflation period since early 2009.

Despite the relatively slow economic recovery in advanced economies, a number of advanced economies registered positive performances such as those of Australia, Canada, and the Newly Industrialized Economies (NIEs⁴²). Australia's and the NIE's economic performance was driven by a favorable export performance. Australia's export performance was supported by a consistent strong demand for agricultural commodities, as well as high commodity prices. In contrast with Australia, the NIEs' export performance was driven by increased trade among the Asian nations, particularly as a result of increased orders from China. Meanwhile, Canada's economy was largely driven by domestic demand as a result of its fiscal stimulus.

As advanced economies were struggling to recover from the crisis, emerging economies, particularly the emerging Asia, had once again become the locomotive for the global economic growth. Emerging economies generally

grew faster – with growth levels of 7.1% – than advanced economies. Driven by China and India, the emerging Asia had once again registered the highest growth of 9.3%. Strong domestic demand and improved export performance supported economic growth in emerging economies. Strong domestic demand itself was driven by, among others, increased household spending (improved welfare or the wealth effect), increased investment, as well as fiscal stimulus. Meanwhile, improved export performance, particularly within the Asian countries, was driven by increased intra-regional trade among the Asian countries. Solid domestic demand and increased intra-Asian trade were able to compensate for export deterioration to advanced economies. As a result of the rapid recovery, inflationary pressure in emerging economies also increased significantly, particularly as a result of the rising trend in global commodity prices.

China's economy once again registered high GDP growth in 2010 amounting to 10.3%, which was driven by domestic demand. Private sector demand grew significantly thereby compensating for the drop in export performance. In addition to this, government expenditure also contributed significantly to economic growth. Sustaining China strong economic growth supported export performance of commodity exporting countries, such as Australia, Indonesia, and New Zealand, as well as capital exporting countries, such as Germany, Japan, and the NIE's. Consequently, inflationary pressure also increased and was largely due to rising food prices. China's economic activities, which increased significantly in the first half of 2010, moderated in the second half, in line with the decline of the fiscal stimulus, tightening of credit limits, the implementation of policies to stem booming in the housing market, as well as the impact of fiscal consolidation in advanced economies.

India's economy also grew significantly to 9.7% and was driven by the expansion of domestic demand. Accommodative policies and an influx of foreign capital led to the improvement in domestic demand. Increasing consumption drove up investment which is also supported with increasing business profit and ease in business financing. In turn, this investment growth contributed to domestic demand.

The emerging economies in Latin America also registered high GDP growth, which was driven by Brazil. Prudent macroeconomic policies along with sizeable stimulus policies served as the strong basis for economic recovery within the region. Conducive external financing conditions

42 Hong Kong (SAR), Korea, Singapore and Taiwan (Province of China).

and improved export performance along with high commodity prices were crucial factors behind this economic recovery. These developments strengthened domestic demand thereby enabling this region to post economic growth of 5.9% in 2010. However, increased economic activities also drove inflation higher. In the meantime, the emerging economies in other regions also posted favorable economic growth. Emerging economies in Europe, Africa and the Middle East, once again enjoyed benefits of improved global trade performance and rising commodity prices, including oil prices.

■ Policy Responses

Divergent economic recovery between advanced and emerging economies produced different policy responses from authorities of these two groups of countries. Global economic policies generally focused on efforts to strengthen momentum of economic recovery, to stabilize the banking and financial systems, as well as to manage inflationary pressure. These policies were reflected through monetary and fiscal policies.

In the backdrop of weakening private demand, the economic recovery in advanced economies largely relied on the role of fiscal stimulus. In fact, the fiscal burden that resulted from the crisis was rather daunting, including the bailouts of a number of companies and the unemployment benefit that seem to be on the rise. The aggressive fiscal stimulus resulted in multiple fiscal deficits and rising government debt. Chart 2.3 shows the size of the fiscal deficit of some countries, including those within the Euro area that experienced problems pertaining to fiscal sustainability.

Despite its effectiveness in driving economic growth, this policy threatened the fiscal sustainability. This fiscal stimulus is basically expected to drive and revive economic activity, particularly within the private sector. The government can, with the private sector's recovery, reduce the fiscal stimulus (consolidation) required to revive and maintain fiscal sustainability. However, this transition process had not functioned the way it was expected to. The public debt crisis, particularly in Greece and Ireland, occurred prior to the private sector's revival to take more active role in economic recovery.

Efforts to bolster economic activities were also carried out through the implementation of loose monetary policies throughout 2010. Central Banks in advanced economies, such as the Fed, ECB, Bank of Japan (BOJ), and the Bank

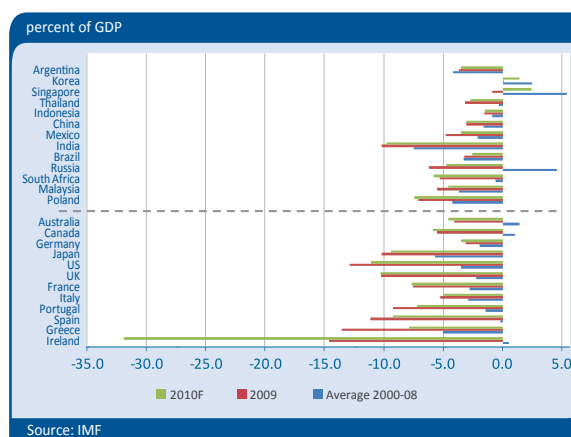


Chart 2.3 Fiscal Deficit in Some Countries

of England (BOE), kept the policy rates low despite rising inflation. This decision was made on the basis of inflation, which was perceived to be within a manageable level, while domestic demand remained weak and limited fiscal stimulus following the Greek's public debt crisis.

The Greek crisis was also due to the role of the sizeable fiscal stimulus whereby the government's debt grew and subsequently defaulted. This crisis shook the global financial markets, especially the European government bond market. The ECB loosened monetary policy in its effort to overcome the financial market upheaval. Given that the policy rate already at its lowest level, monetary relaxation was carried out by virtue of quantitative easing by injecting additional liquidity into the money market and ECB acquiring specific securities in return.

The ECB also bought government bonds to stabilize bond prices while simultaneously securing the effectiveness of the monetary policy transmission. The Government bond purchases, which were valued at 60 billion euro, were able to stabilize government bond prices and to bring it back to the normal level. The ECB also continued the securities market program by acquiring government bonds of Greece, Ireland, and Portugal, amounting to 40 billion euro (approximately 10% of the 3 countries total debt).

Besides ECB, the European Commission and the IMF also stepped in to resolve the Greek crisis by providing a rescue package for Greece amounting to 110 billion euro, as well as a commitment valued at 750 billion euro under the European Financial Stabilization Mechanism (EFSM) scheme. Meanwhile, the Fed reactivated the emergency

currency-swap facility for the ECB and other central banks (such as the BOJ, BOE, and the Swiss National Bank) to assist in providing USD liquidity and deter the Greek crisis from spreading. These various measures successfully stabilized the financial market turbulence triggered by the Greek crisis. However, this crisis brought about risks of uncertainty within the financial market as well as weakened the economic performance of the Euro area.

Despite maintaining a loose monetary policy to support economic recovery, several quantitative easing measures were ceased in 2010. The term auction facility issued by the Fed during the 2008 global financial crisis as part of the emergency liquidity provision facility expired in March 2010. Other facilities provided by the Fed, the term asset-backed securities and the asset purchase programs, also expired on 30th June 2010. The ECB also terminated the limited purchase programs for specific marketable securities and long-term refinancing. In the meantime, the BOE also terminated the reserve-financed government bond purchases on February 2010. As a result, the quantitative easing policy in 2010 was substantially moderate compared to those of previous years and only a number of policies continued to be implemented, including the securities purchase program amounting to USD 200 billion by the BOE and the Japanese authorities (the BOJ and the Government) policies to inject liquidity and provide an assistance package to promote lending and economic growth.

Although the monetary policy stance of the advanced economies were generally more loose, a number of advanced economies whose economies quickly recovered, such as Canada, Australia and the NIEs, applied tight monetary policies similar to those applied by the emerging economies. These tight monetary policies were carried out in response to the inflationary pressures, which increased quite significant in line with improved economic performance. Australia, which began tightening its monetary policy stance since 2009, increased its policy rate by as much as 100 basis points whereby at the end of 2010 reached 4.75%. Canada and Korea increased their policy rates by 75 basis points, which by the end of 2010 respectively stood at 1.00% and 2.75%. Hong Kong (SAR) introduced regulations that hamper property loan disbursements to deter the impact of property sector boom. These regulations sought to increase the minimum down payment for mortgages to 40% of the property's price. In addition to this, the authorities also increased tax for housing purchases that are valued above HKD 20 million (equivalent to USD 2.6 million).

The combination of a sizeable fiscal deficit and loose monetary policy increased economic liquidity, as well as global liquidity since the policy was carried out by countries whose currencies were broadly used for international transactions. This increased liquidity in general could enhanced economic activity, including financial market activities. However, with the fairly limited capacity in advanced economies to absorb this ample liquidity, it subsequently flowed out of these countries.

In contrast, the economic recovery in emerging economies occurred at an accelerated pace. Due to solid domestic demand, emerging economies required fairly limited fiscal stimulus, which in turn it ensured and maintained fiscal sustainability. Despite this, the rapid recovery triggered growing inflationary pressures. Monetary authorities in the emerging economies were, in contrast with advanced economies, largely focused their efforts on fighting the growing inflationary pressure. Tight monetary policies were applied by most central banks in emerging economies through either increasing the policy rate or tightening other monetary instruments, such as reserve requirement and credit limits.

In general, the tight monetary policy adopted by emerging economies was preceded by increasing the reserve requirements or imposing credit limits before increasing the policy. Countries that increased their reserve requirements included China, India, Brazil, and Peru. In China, the People's Bank of China (PBoC) increased bank reserves requirement 4 times throughout 2010, from 16% to 17.5%. The PBoC initially increased the reserves requirement in January 2010 and gradually increased it further in February, May, and finally in November 2010. The Reserve Bank of India (RBI), India's central bank, increased the reserve requirement (cash reserve ratio) twice (in January and April 2010) with total increase of 100 basis points, raising reserve requirement to 6.0%. Brazil's central bank (Banco Central do Brazil) raised the reserve requirement (unremunerated) for time deposits from 13.5% to 20%, and raised the marginal requirement (remunerated) for deposits from 4% to 12%. Brazil increased the reserve requirements in February and December 2010. In the meantime, Peru's central bank (the Central Reserve Bank of Peru) raised the reserve requirement in September 2010 from 8.5% to 9.0%, and marginal requirement from 15% to 25%.

The implementation of tight monetary policy through credit limit was carried out by China. In addition to increasing the reserve requirement, the PBoC sought to

limit credit growth by imposing limits as part of its effort to offset an overheated economy. The quota for bank lending, which in 2009 amounted to 10 trillion yuan, was reduced to 7.5 trillion yuan for 2010. In addition, banks also required to carry out a stress test to assess the impact of shocks in the property sector on bank's balance sheet, with the scenario that property price fell to 60% of initial price. This focus on the property sector influences the bank's policy to reduce mortgages thereby hampering credit growth.

In the meantime, the policy response to the increasing inflationary pressure through increasing the policy rate was carried out by most emerging economies. China that aggressively raised the reserve requirement and impose credit limits to stem the inflationary trend, finally raised the reference rates. The PBoC raised its reference rates by 25 basis points in October 2010 to reach 5.56%. In contrast with China, India did not explore the reserve requirement to control inflation pressure, but aggressively increased its policy rate. Throughout 2010, RBI had raised its policy rate 6 times with a total increase of 150 basis points, and reached 6.25% (repo rate). Apart from China and India, other emerging economies in Asia that

also raised the policy rates were Malaysia, Thailand, and Vietnam.

A number of emerging economies in Latin America, such as Brazil, Peru, and Chile, also adjusted their policy rate throughout 2010. Brazil increased its policy rate (SELIC overnight rate) by as much as 3 times from 8.75% to 10.75%. Peru registered increased its policy rate on 5 separate occasions from 1.25% to 3.00%. In the meantime, Chile took a more aggressive stance by adjusting its discount rate upwards 7 times, from 0.50% to 3.25%.

Influenced by advanced economies in the Euro area that continues to be weak, the economic conditions of the emerging Europe were generally not as strong as those in Asia or Latin America. As a result, most of the emerging Europe continued to apply loose monetary policies by maintaining or reducing the policy rates.

As the tight monetary policy stance in position, inflationary pressure in most emerging economies were contained. The inflation still rose, however, in fairly moderate manner. India's inflation, as a matter of fact, even declined once again.

2.2

Capital Inflows to the Emerging Market Economies

■ Capital Flows to the Emerging Market Economies

Easy monetary condition in advanced economies, coupled with expansive fiscal policy, significantly increased global liquidity. Given incomplete economic recovery, advanced economies could not, in particular the real sector, absorb this ample liquidity. Some of this liquidity was devoted to the financial market to ensure that it remains productive or generate revenues. This in turn push investment returns in advanced economies' financial market down. Decreasing returns and lingering risk in major financial markets sent liquidity out of the advanced economies. On the other hand, emerging economies possess almost all factors that attract foreign investment, such as good economic performance, prudent macroeconomic policy (including a relatively low government debt that reflects fiscal sustainability), higher investment returns, and improving risk factors. Accordingly, global investors' capital flowed to emerging economies.

Capital inflows surged to emerging economies throughout 2010, either in Asia, Latin America, Europe, or in Africa and the Middle East. In fact, capital inflows to emerging economies significantly increased compared to the previous years. Capital outflow from emerging economies, on the other hand, was also increased, particularly with those pertaining to foreign exchange reserves management.

The emerging Asia remained the leading destination for foreign capital. High rate of return and manageable risk were the main factors that attract global capital to this region. Capital inflows to emerging Asia increased by USD 85.2 billion compared to the previous year, or totaling USD 446.9 billion throughout 2010 (Chart 2.4).

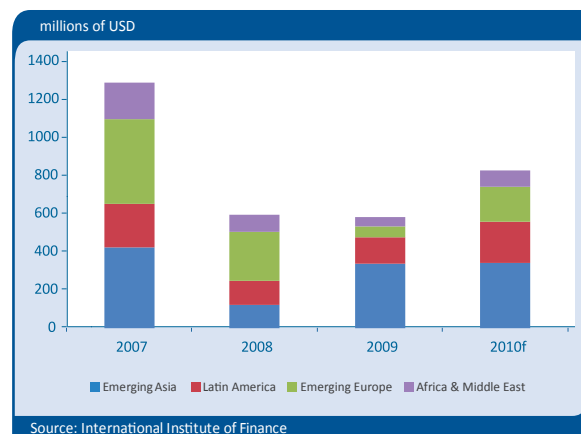


Chart 2.4 Global Capital Flow to Emerging Markets based on Region

Some of this capital inflows (USD 152.6 billion) was direct investments of which the majority was absorbed by China (approximately USD 90 billion) and India (USD 40 billion). Portfolio investment flows to emerging Asia also increased and amounted to USD 127.2 billion. Other type of capital inflows, specifically bank and non-bank loans, also grew respectively to USD 104.8 billion and USD 62.4 billion.

Capital inflows to emerging Latin America increased from USD 167.6 billion (2009) to USD 240.1 billion (2010). This increase occurred evenly across all investment types that included direct investments, portfolio investments, and loans. The largest portion of capital inflows to this region was the direct investments (USD 79.7 billion), followed by non-bank loans (USD 60.9 billion), portfolio investment (USD 52.9 billion), and bank loans (USD 26.7 billion).

The emerging Europe witnessed a steeper growth of capital inflows. Capital inflows increased over two-fold from around USD 79.5 billion in 2009 to USD 172.7 billion in

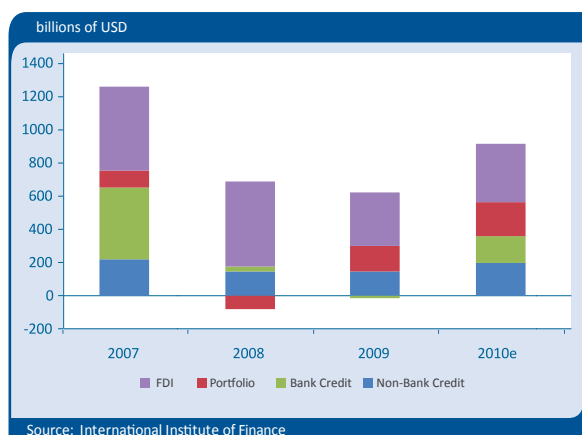


Chart 2.5 Global Capital Flow to Emerging Markets by Type

2010. It, however, had not reach its pre-crisis levels of over USD 200 billion yet, and the capital inflows in 2009 was the lowest level as an impact of the 2008 global financial crisis. In the meantime, capital inflows to emerging Africa and Middle East also witnessed growth. Capital inflows to this region was largely dominated by direct investments.

Capital inflows to emerging economies was largely dominated by private capital. Private capital inflows accounted for 94% of total capital inflows to emerging economies, and only 6% comprise of capital inflows derived from government and international financial institutions (or official inflows). Apart from its small portion, the amount of official inflows destined for the emerging economies was lower compared to previous years. Fiscal consolidation in advanced economies contributed to the decline of official inflows.

In terms of the type, most of the private capital destined towards the emerging economies comprised of investments in shares, both in the form of direct investments and portfolio investments. Direct investments increased slightly compared to the previous year while, at the same time, portfolio investment increased significantly. The most significant increase of capital inflows was in the form of loans. The inflow of loans have, since the drastic decline in 2009 due to the shrinking credit market, increased three-fold in 2010, from around USD 127 billion in 2009 to USD 358 billion in 2010 (Chart 2.5).

■ Dynamics of Capital Flows to Emerging Economies

Capital inflow to emerging economies, in the form of bonds and shares, continued to increase in the first

quarter of 2010. However, negative market sentiment attributed to the Greek crisis in April 2010 resulted in a flight to quality as global investors shifted their investments from emerging economies to hard currency denominated assets. This capital outflow weakened emerging economies' currencies. However, capital inflows to emerging economies increased once again in the second half of 2010, as the ECB's and IMF's rescue package to resolve the Greek crisis successfully restored investors' confidence to invest in emerging economies.

In the third quarter of 2010, the continuing capital inflows to emerging economies since August 2010 was characterized by market sentiment that the second quantitative easing policy would likely be implemented by the Fed. However, as this policy was implemented in November 2010, investors' risk appetite for emerging market assets had in fact deteriorated, and investors shifted their investment to safe haven assets. This was triggered by the growing intensity of the crisis in the European financial markets, particularly as a result of the Irish banking crisis. The dynamics of the capital flows to emerging economies described above is reflected in Chart 2.6.

■ Impact of the Capital Inflows

The surge of capital inflows to emerging economies had significant impacts on the domestic financial markets. Capital inflows instantaneously affected on the growing demand for local currencies – on the other hand, increased foreign currency supply in the domestic foreign exchange market – thereby appreciating domestic currencies. Although temporary capital reversal occurred during the heightening Greek crisis in the second quarter of 2010,

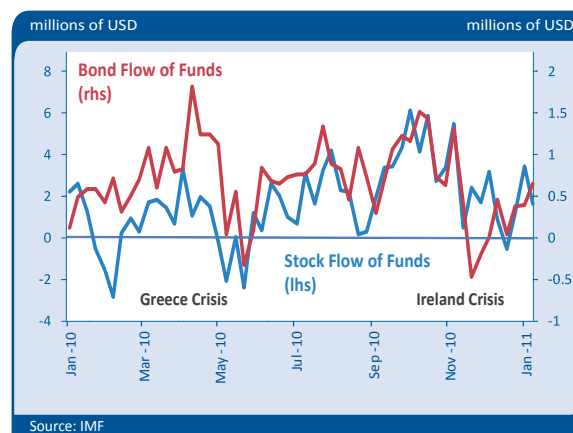


Chart 2.6 Global Capital Flow to Emerging Markets Countries in 2010

foreign capital returned and once again led to the domestic currency appreciation. In general, the emerging economies' currencies were appreciated in 2010 (refer to Chart 2.7).

Nevertheless, the impact of capital inflows was not entirely reflected in the exchange rate movements, due to the foreign exchange market intervention carried out by central banks, particularly in most emerging economies. This intervention sought to support export performance or maintain exchange rate stability. To support export performance, central bank purchased foreign currencies (accumulating foreign exchange reserves) against local currencies to depreciate domestic currency or to avoid sharp appreciation of domestic currency, which lead to a decline in export competitiveness. This measure was largely carried out by highly export dependent countries, and so arose a currency war phenomenon. In the meantime, efforts aimed at maintaining exchange rate stability amid the enormous capital inflows was also carried out by purchasing foreign currencies against local currencies, and resulted in reserves accumulation.

The foreign exchange reserves of emerging economies rose significantly in 2010 (refer to Chart 2.8). China was one of the countries whose foreign exchange reserves increased significantly by over USD 400 billion, and the reserves reached USD 2.57 trillion by the end of 2010. The reserve accumulation by emerging economies also serves as self-insurance regarding rapid capital inflows and rising vulnerability of the financial sector.

The impact of capital inflows on the real sector was mainly through the real exchange rate (exchange rate index that takes into account the price level different between the related countries). The real exchange rate, which tend

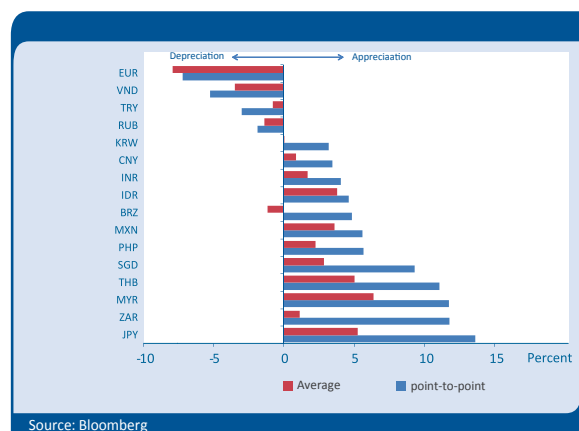
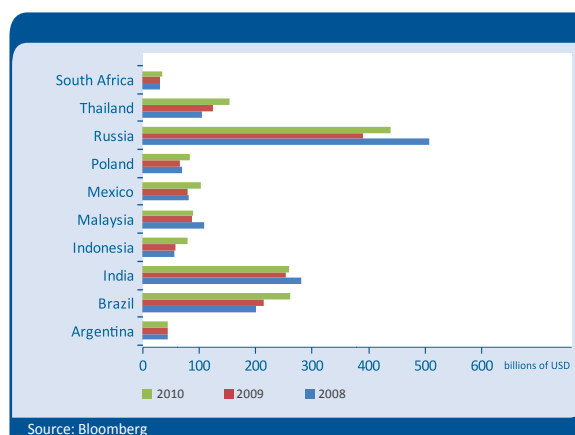


Chart 2.7 Currency Appreciation/Depreciation
(2010 relative to the end of 2009)



Grafik 2.8 International Reserves in Emerging Markets Countries

to appreciate, negatively affected export performance (weakening export competitiveness in terms of relative price), as well as increased imports.

In regards to capital outflows, most emerging economies generally registered an increase in capital outflows. This was mainly related to the central banks' reserve management. The increase in reserves preceded the increase in assets placed overseas. In the meantime, private sector capital outflows generally declined, with the exception of the emerging Europe.

Portfolio inflows to emerging economies were placed in various investment outlets, particularly financial assets, which in turn drove asset prices higher. Stock prices in emerging economies generally recorded significant increase (refer to Chart 2.9). Despite the stock price hikes, stock prices experienced price correction due to flight to quality during the Greek crisis. As various rescue policies introduced by the ECB, IMF and the Fed, which successfully eased the impact of this crisis, foreign capital returned to emerging economies and restored up-trending stock prices until the end of 2010. Foreign investments in government bonds also drove bond prices higher (as reflected in the declining bonds' yield reflected in Chart 2.10). These asset price hikes can potentially inflate asset prices above its fair value (asset price bubble). This increased financial market vulnerability to a sharp correction of these asset prices.

Emerging Economies' Policy Responses

In general, capital inflows provide benefits to receiving countries, particularly emerging economies. Capital

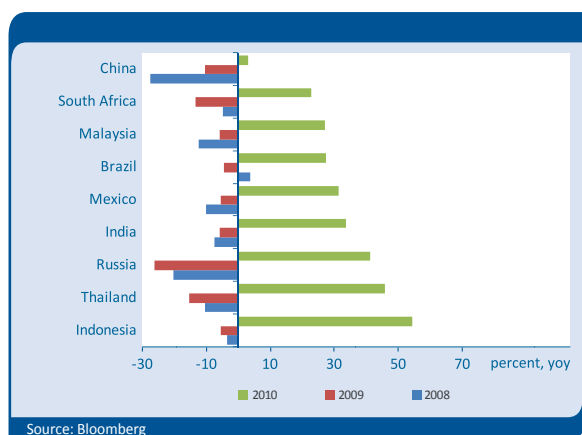


Chart 2.9 Change of Stock Price in Emerging Markets Countries

inflows can serve as a source of financing for economic development, as well as supports financial market development. It, however, can also have negative impacts on economy if the inflows become quite sizeable and cannot be fully absorbed by the economy. Various negative effects of massive capital inflows has previously mentioned, which includes weakening export competitiveness (as domestic currency experienced significant real appreciation), creating asset price bubble, increasing financial market vulnerability, as well as intensifying monetary management complexity. Authorities in emerging economies implemented various policies – in general conducting foreign exchange market intervention – to stem or deter these negative effects. Some emerging economies also implemented macroprudential measures, capital control, capital outflow liberalization.

China was one of the countries that received substantial amounts of capital inflows. This capital inflows, in general, had a significant impact on money supply which in turn increased inflationary pressure. With managed floating and capital control regime, foreign exchange market intervention was automatically carried out. At the same time, the PBoC also absorbed additional liquidity resulted by the intervention to sterilized it's the impact on money supply. To reduce pressure on the domestic economy, China gave more flexibility that allowed the yuan to appreciate further. Meanwhile, to reduce enormous capital inflows, China cut quota on external loans provided to residents. The reduction of the quota was accompanied by a more stringent monitoring system. On the other hand, China introduced a partial liberalization to induce capital outflows by relaxing regulations concerning investment abroad by residents and allowing specific exporters

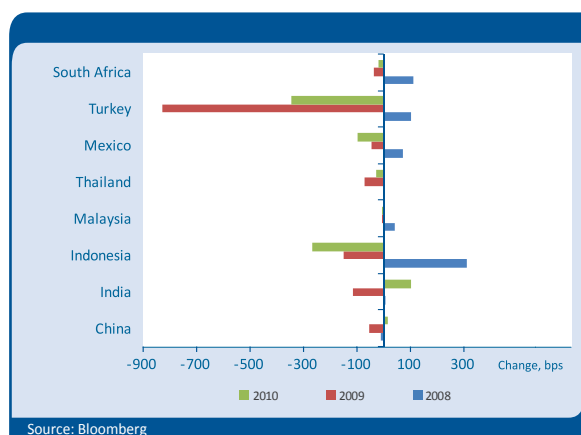


Chart 2.10 Government Bond Yield in Emerging Markets Countries

to manage export proceeds abroad. Aside from these policies, China also implemented macro prudential policy related to capital inflows to property sector, including requirement for banks to perform stress tests to measure the impact of property price fall to bank's balance sheet.

India issued a unique macro prudential policy to handle the capital inflow. India's authority increased the maximum limits for government and corporate bond purchases by foreign institutional investors (FII) to USD 10 billion and USD 20 billion dollars respectively. Investment by FII above those limits is only permitted for securities with a tenor of above 5 years, which were issued by companies involved in infrastructure development projects. This measure did not absolutely limit capital inflow, but redirected it to specific areas that generate or boosted economic productivity.

In dealing with capital inflows, Thailand chose to balance the inflows with capital outflow liberalization. Efforts to reduce capital inflows were conducted through the application of a 15% withholding tax for interest income and capital gains from investments in fixed income instruments. On the other hand, Thailand permitted domestic investors to invest outside of Thailand, both in term of direct investments and portfolio investments. This policy served as part of the capital outflow liberalization process implemented in previous years, and had become increasingly relevant with the rapid capital inflows. The Bank of Thailand (BoT) also relaxed foreign exchange regulations related to investment abroad by residents, foreign exchange hedging, and corporate treasury center.

Intensified capital inflows to Brazil and its negative impacts on the economy, had forced the Brazilian authorities to

constraint capital inflows. For that purpose, the Brazilian government increased tax rates on foreign investments on fixed income instruments and equity funds from 2% to 4%. Tax rate applied on fixed income investments was even increased, once again, to 6%. In addition to this, the tax increases were also expanded to margin deposits for derivative transactions (also increased to 6% from 0.38%).

Capital inflows to Peru has resulted in a sharp appreciation of the domestic currency with increasing volatility. To overcome this problem without affecting money supply, the Central Bank of Peru conducted sterilized intervention. This policy also helped stem the currency mismatch for various currencies. The Peruvian central bank also introduced various macro prudential policies, such as increasing the reserve requirement for foreign currencies by 50 basis points to 9.0% and increasing the marginal requirement for foreign currency denominated deposits to 55% from a previous of 50%. Meanwhile, the Turkish central bank carried out similar measures, which was to increase reserve requirement for foreign currencies by 50 basis points to 9.5%.

Despite capital inflows to emerging economies, foreign capital also flowed to the NIEs, such as Korea. To deal with the drastic capital inflows, Korea implemented a series of macro prudential policies to avoid increasing financial market vulnerability. The Bank of Korea (BoK) issued regulations that (i) reduced foreign exchange derivative transaction limits to 50% for local banks and 250% for foreign banks from previously 300% for all banks, (ii) reduced the maximum limits for foreign currency hedging (forward contract) facilities with exporters to 100% of the underlying transaction's value (previously at 125%), (iii) increased the minimum limit for foreign currency credits or securities (with a tenor of 1 year or more) that must be funded by foreign exchange borrowings with maturity of over 1 year to 100% (previously at 90%), and (iv) required the use of foreign currency loans for overseas activities. In addition, the Korean government also tried to constrain capital inflows by imposing a 14% withholding tax on government bond and monetary stabilization bond purchases, as well as a 20% tax on capital gains derived from the stock market.

2.3

Global Recovery Path and the Implications on the Emerging Economies

The conclusion from the above descriptions is that advanced economies have not fully recovered from the 2008 global financial crisis and the global economic performance is largely dependent on the emerging economies. As the advanced economies faced daunting challenges to recover, still weak domestic demand, limited room for fiscal stimulus, and rising inflationary pressure, global economic performance going forward, will continue to depend on the emerging economies' economic performance, particularly those in Asia. This is not a sustainable condition in the long term since emerging economies began to show signs of economic overheating. Moreover, emerging economies are expected to continue to face problems with massive capital inflows, provided that the future recovery process will be quite similar to this year. Efforts to continually spur growth within emerging economies will, in fact, bring forth a new crisis that will prove to be very costly for these economies, as well as the global economy.

Synergy between advanced and emerging economies is required to achieve superior and sustainable global economic growth. The synergy can be initiated from intergovernmental and central bank policy coordination of these countries. In an increasingly integrated global economy, coordination becomes increasingly crucial, as a policy introduced by one country will affect, not only the country itself, but other countries as well.

Effort to implement policy coordination has basically arose through a bilateral dialogue between two countries or multilateral dialogue, such as the G20 forum (Group of 20 nations)⁴³. The G20 represents both the advanced

and the emerging economies, which in term of GDP size represents majority of the global economy. Policy coordination under the G20 forum is carried out through a framework to achieve a strong, sustainable, and balanced growth (see Box 2.1 The G-20's role in the Global Economic Recovery). Through this framework, each member country's commitments to implementing various policies (including monetary and fiscal policies) is coordinated. Monetary policy is generally directed towards controlling inflation, and accordingly it flexibly adjusts to economic condition and inflationary pressure (monetary policy stance was not previously determined). Monetary policy in some of G20 countries is also directed towards driving economic growth.

On fiscal policy front, majority of the G20 countries plan to implement fiscal consolidation to reduce deficit, to achieve balanced budget, or even surplus government budget. Aside from the budget's target, fiscal consolidation is also carried out to reduce government debt. In general, this target seeks to be achieved within the medium term (1-5 years) through budgetary expenditure cuts, including reducing the fiscal stimulus package. These countries direct fiscal stimulus towards activities that spur economic growth (growth friendly), such as infrastructure development, technological innovation projects, and the development of free trade zones, in order to ensure effectiveness of this limited fiscal stimulus. Fiscal consolidation, which nearly all of the G20 member countries are committed to, was also influenced by the Greek and Irish fiscal crisis that serves as a 'reminder' to be more prudent in managing domestic economy.

43 The G-20 consists of 20 countries, i.e. Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan,

Mexico, Russia, Saudi Arabia, Spain, South Africa, South Korea, Turkey, UK, and US.

Other crucial commitments, particularly in determining the future direction of global economic development, are structural reform, infrastructure development, and financial sector policies. The G20's commitment to implement structural reforms varies from one country to another and covers various areas. Regarding employment issue, some countries intend to carry out efficiency measures in labor market, improve workers' benefits and increase the retirement age. In the manufacture sector, reforms are implemented to drive investment in infrastructures, to promote research and development activities, as well as to improve business environment. Reforms are also introduced for taxes, education, and health services. Meanwhile, financial sector policies were directed towards providing access to various source of financing (banks and capital market) for small and medium enterprises, in addition to regulating high risk transactions that may potentially disrupt the financial system stability and lead to a repeat of the 2008 financial crisis.

In regards to the coordination process, the G-20 works closely with the IMF and other international institutions to assess all of the action plans of its member states. Based on IMF's assessment, recommendations are provided to synchronize conflicting policies, as well as provide recommendations for additional policies that are required (but are not reflected in the action plan). The IMF also formulates standards to evaluate the accomplishments or implementation of the commitments made by the G20 member countries.

Implementation of the G20 commitments is expected to positively contribute to efforts to boost domestic demand. Improving domestic demand can be achieved through, among others, infrastructure development that is expected to generate employments, as well as opening access to source of financing for small and medium enterprises. In addition to this, the G20 forum can serve as a medium for strengthening fiscal consolidation, particularly for advanced economies. The G-20's commitment to conduct financial sector reforms and to strengthen the global financial safety net also alleviates financial market vulnerability in its effort towards global economic recovery.

Policy coordination in the G20 forum will be formulated to meet the challenges associated with excessive global liquidity and massive capital flows. This coordination will be carried out under the framework of the International Monetary System. It is expected that, through this coordination, issues pertaining to excessive capital flows can be resolved.

The global economic recovery can indeed be solidified, balanced (not solely dependent on the emerging economies) and superior by virtue of strong and effective policy coordination, despite the need for some tough adjustments and sacrifices ahead.

2.4

Conclusion

From the experience of the global economic recovery to date, there were number of lessons that Indonesia's economy can learn. First, the global economic recovery process generally had some positive impacts, despite the various tough challenges. Global economic growth has reached a positive growth that was followed by an increase in the world trade volume, which was positive to Indonesia's economy. Indonesia's exports significantly grew, with even better export structure that increasing intra-trade among Asian countries had reduced dependency on the advanced economies as Indonesia's major export destination. Indonesia's export performance was also driven by the high global commodity prices that affected by global economic recovery. Details on the improving export performance and investment are presented in Chapter 5.

Secondly, foreign capital inflows had both positive and negative impacts on the domestic economy. The positive impacts of capital inflows were reflected in the investment growth, particularly those associated with the increase in FDI and IPO in the stock market. Capital inflow also led to the rupiah appreciation, which indirectly reduced inflationary pressure. On the other hand, the massive capital inflows weakened export competitiveness, increased financial market vulnerability, and increased monetary management complexity. There were several policy options available to overcome this

problem such as those implemented by other countries. Bank Indonesia strived to balance between the benefit and the negative impact of the capital inflows with a policy mixed of foreign exchange market intervention and implementing macroprudential regulations. These policy mixed allowed capital inflows to persist (not implement capital controls), even though at smaller volume, hence the benefits were obtained, while the negative effects were also controlled. Bank Indonesia's policies in dealing with rapid capital inflows are explained in Chapter 4.

Thirdly, the Greek and Irish crisis stresses the need for prudent macroeconomic management, despite the presence of crisis conditions. Indonesia's fiscal policies were deemed prudent in view of relatively low fiscal deficit, even as the government debt remains within sound limit. This ensures fiscal sustainability and provided the government with ample room to implement a fiscal stimulus if required.

Fourth, the experience from the crisis also showed the importance of policy coordination to achieve solid economic recovery. Indonesia, as a member of the G20 forum, needed to actively take part in dialogue or policy coordination, therefore was able to positively contribute towards global economic recovery while simultaneously, reaping the benefits from this coordination.

BOX 2.1: The G-20's Role in the Global Economic Recovery

Following its declaration as ‘the forum for international economic cooperation’ at the meeting held in Pittsburgh on 24-25th September 2009, the G20 had actively sought to maintain and strengthen efforts towards global economic recovery. In view of the need to systematically and continually implement international cooperation and policy coordination to revive the global economy, the leaders of the G-20 countries agreed to coordinate each country policies based on the framework of strong, balanced, and sustainable global economic growth. To achieve this, the G-20 countries implemented the Mutual Assessment Process (MAP). The MAP seeks to evaluate the alignment of member’s policies, collective consistency of these policies, as well as identify steps that needed to be implemented. This MAP was divided into two phases.

In the first phase, the G-20 members submit their policy plans and medium term target or projection (3-5 years), which consisted of: (i) fiscal policy, (ii) monetary and exchange rate policy, (iii) financial sector regulation, (iv) structural reforms and national development policy (covering policies on labor market, investment, and trade), (v) external policies (such as Official Development Assistance commitments), and (vi) future growth projections, and related indicators. G-20 was supported by a number of related international institutions, such as IMF, World Bank, FSB, OECD, ILO and WTO, in analyzing all G-20 member countries’ policies, as well as assessing the impact of those policies on development and poverty alleviation.

Based on the analysis of the member’s policies, it was projected that the global economy will, by 2014, recover to levels close to that achieved in the pre-crisis period with a declining unemployment rate, along with a manageable inflation rate. However, based on the risk identification of this baseline scenario, there is possibility that the economic growth will be lower compared to that initially projected, concerning high fiscal deficit and debt level in advanced economies, as well as decreasing production capacity in some countries as a result of the crisis.

During the Toronto Summit (June 2010), the G-20 leaders had agreed to implement policies aimed at achieving a more optimistic scenario. Accordingly, the member countries had identified policies and subsequent steps in line with the policy guidelines as follows:

- Developed countries: pursued fiscal stimulus as well as formulate a fiscal consolidation plan that was conducive for growth and is deemed credible.
- Developed countries with current account deficit: increased national savings.
- Developing countries: improved social safety net, accelerated corporate governance reforms, enhance financial market deepening, increase infrastructure spending, and Increase exchange rate flexibility.
- Current Account surplus countries: reduce economic dependency on exports.
- All members: implemented structural reforms, e.g. developed countries should carry out goods and services market reforms and labor market reforms, while the developing nations should enhance foreign investment opportunities (such as infrastructure investment), as well as simplify regulations governing the goods market. In addition, all members should also avoid protection measures and accelerate financial sector reforms and global demand balancing.

During the second phase, the G-20 member countries at its meeting in Gyeongju in October 2010, agreed on the need to coordinate joint actions. Amid the ongoing global multi speed economic recovery between countries and regions, and accompanied by various downside risks, as well as high interdependency among countries and financial markets, the G-20 members agreed to collaborate and coordinate efforts to overcome global imbalances and implement structural reforms. Moreover, the members also agreed to complete revisions and reforms to financial market regulations, as well as to plan for a medium-term fiscal consolidation that was both credible and conducive for growth. Other topics that were discussed at this forum included policies to address unemployment issues, monetary policy to achieve price stability, more

flexible exchange rate system and avoiding competitive devaluation, formation a stable and effective international monetary system, as well as the rejection of all forms of protectionism.

The spirit of the G-20 members mentioned above reinstated at the Leaders' summit held in Seoul on 11-12th November 2010. The outcome of the meeting was incorporated in the Seoul Action Plan, which contents included the following commitments:

- Implementing macroeconomic policies, including fiscal consolidation, a market-oriented exchange rate system, enhancing exchange rate flexibility that reflects economic fundamentals, as well as avoiding competitive devaluation.

- Implementing structural reforms that promote employment and enhance potential growth.
- Implementing series of policies to overcome external imbalances and maintaining current account balances at sustainable level. Agreement was reached to evaluate external imbalances based on the indicative guidelines¹ in order to ascertain the characteristics and constraints in the adjustment process, in accordance with the domestic and regional conditions.

1 The indicative guidelines consists of a series of indicators, which enables early identification in the event of significant imbalance that require preventive and corrective actions. The drafting of the indicative guidelines will be conducted by the G-20 and assisted by IMF and other international organizations in the first half of 2011.