Chapter 1

GLOBAL ECONOMIC PERFORMANCE AND PROSPECTS: MODERATING GROWTH, HEIGHTENED UNCERTAINTY

The rapidly changing dynamics of the world economy, accompanied by escalating geopolitical tensions, worsen the economic outlook and increase the uncertainty on global financial markets. This is characterized by five challenges, discussed below, that have generally dimmed the prospects for the world economy and increased investment; they also encourage trade divergences between developed and emerging countries and increase global financial market uncertainty. Such challenges demand the strengthening of international cooperation, both on a multilateral and regional scale, to mitigate the risks as early as possible; to minimize their spillover effects on economic resilience; and to bolster the global economic recovery.

Global economic dynamics are changing rapidly with high uncertainty. Recovery optimism, which was apparent at the beginning of 2023, has faded gradually. Rising demand, particularly in the services sector after the post-pandemic recovery of people's mobility, faced supply-side constraints due to scarring effects in the corporate sector, coupled with public policy to curtail immigration into several Advanced Economies (AEs). Geopolitical-economic fragmentation has increased with the prolonged Russian war in Ukraine, thereby hampering supply and inflating global food and energy prices. Similarly, unresolved trade tensions between the United States (US) and China have undermined export-import activity in both countries and impacted world trade volumes. The recent tensions between Israel and Palestine have added to geopolitical tensions in the Middle East region and the world. As a result, the global economic recovery has slowed, accompanied by continued inflationary pressures stemming from global energy and food prices, as well as labor market tightness in several AEs. The sluggish global economic recovery also stems from monetary policy tightening, which central banks had to undertake to rein in soaring inflation through interest rate hikes, particularly in the US. Expansionary fiscal policy in AEs, especially in the US, is driving up interest rates attracting international capital flows and strengthening the US dollar in global financial markets. In Emerging Markets and Developing Economies (EMDEs), monetary authorities have been required to strengthen their policy response to protect external stability from the negative impact of global spillovers, including the reversal of portfolio investment flows, accompanied by intense currency pressures induced by global economic uncertainty.

The global economic recovery process has also been affected by looming threats posed by climate change, the demographic transition and digitalization. Extreme cold weather in Europe at the beginning of the year exacerbated the impact of food and energy supply constraints caused by the war between Russia and Ukraine on economic recovery in the region. Meanwhile, Asia has been hit by severe drought due to the El Niño weather phenomenon, requiring authorities to safeguard food security and supply to mitigate the impact on inflation and economic recovery. Demands from AEs to reduce carbon emissions immediately through a transition to the green economy and finance have also reduced the space available for EMDEs to revive financing and economic growth. The demographic transition of an aging population experienced in many AEs is placing a heavy burden on the government's fiscal budget, while private savings are increasing more slowly. EMDE countries, which are currently enjoying the demographic bonus of a dominant productive age population, may be unable to take full advantage due to limited employment opportunities and technical capabilities. Meanwhile, rapid digitalization is providing various opportunities to drive economic growth, including: MSMEs digitalization; digital banking and Financial Technology (FinTech); cross-border payment linkages; blockchain technology in international trade; and the use of Artificial Intelligence (AI) in various economic and financial activities. However, rapid digitalization is also creating issues with the emergence of crypto asset trading, the use of AI in financial market trading and the rapid proliferation of cyber-attacks.

Global economic performance and the outlook are distinguished by the following five characteristics that demand vigilance, anticipation and an optimal response by strengthening national economic policy synergies. First, global economic moderation is projected, accompanied by wider growth divergence (divergent slow growth). The global economic recovery is now expected to require more time, with greater difficulty to fully recover to pre-pandemic levels. Second, increasing geopolitical tensions perpetuate high energy prices and higher food prices, leading to a slow global disinflation process (gradual disinflation). Third, to control persistently high inflation, policy rates in AEs, including the Federal Funds Rate (FFR), are expected to remain higher for a longer period (higher for longer). Higher policy interest rates will be followed at long-term tenors, including higher government bond yields in AEs, particularly US Treasury Bonds, due to a greater need for government debt financing and an increase in long-term risk premiums. Fourth, such developments could trigger a reversal of capital flows from EMDEs to AEs and more liquid assets (cash is the king) due to high interest rates in AEs and uncertain global financial markets. And fifth, the strong US dollar is intensifying broad-based depreciation pressures on global currencies, including EMDEs. Global economic and financial uncertainty is increasing due to the simultaneous escalation of geopolitical tensions, thus requiring a strong policy response to mitigate the adverse impact of global spillovers on domestic economic resilience in EMDE countries, including Indonesia.|

1.1. Global Economic Growth Weakens Amid Wider Divergence

Global economic growth is projected to weaken, accompanied by a wider growth divergence between countries. After a high pace of 3.5% in 2022, global economic growth in 2023 is projected to slow to 3.0% and then to 2.8% in 2024, with the risk of a further downgrade Table 1.1). If geopolitical tensions ease, however, the world economy is expected to rebound to 3.0% in 2025. Growth divergence is occurring between AEs, specifically the US, where relatively high growth contrasts with moderation and stagnation in EMDEs. Economic growth in AEs is projected to decelerate from 1.6% in 2023 to 1.4% in 2024 before increasing to 1.7% in 2025. On the other hand, economic growth in EMDEs will retreat from 4.0% in 2023 to 3.8% in 2024 before stagnating at 3.8% in 2025. In AEs, economic growth is driven by the US, where relatively strong growth of 2.3% was recorded in 2023 on the back of household consumption and the domestic-oriented services sector. Growth would decline to 1.3% in 2024 before rising again to 1.8% in 2025. In the EMDE countries, growth in China will moderate from 5.2% in 2023 to 4.3% in 2024 and 4.1% in 2025, undermined by weak consumption and issues plaguing the property sector. As one of centers of the global economy, growth in India would decline from 6.7% in 2023 to 5.8% in 2024, before rebounding to 6.0% in 2025. ASEAN-5 countries are also expected to perform well, with growth projected at 4.4% in 2023 and 2024 before picking up to 4.6% in 2025. In addition to solid domestic demand, growth in India and ASEAN-5

Table 1.1. Global Economic Performance and Prospects (%)

Country	2021	2022	2023*	2024*	2025*
World	**6.3**	**3.5**	**3.0**	**2.8**	**3.0**
Advanced Economies	**5.6**	**2.6**	**1.6**	**1.4**	**1.7**
United States	5.9	2.1	2.3	1.3	1.8
Euro Area	5.6	3.3	0.6	0.8	1.3
Japan	2.2	1.0	1.5	1.3	1.1
Emerging Economies	**6.9**	**4.1**	**4.0**	**3.8**	**3.8**
China	8.4	3.0	5.2	4.3	4.1
India[1]	8.3	6.8	6.7	5.8	6.0
ASEAN-5	4.0	5.5	4.4	4.4	4.6
Latin America	7.4	4.1	2.0	2.0	2.1

Note: *Bank Indonesia's Projection
Source: WEO-IMF, Bank Indonesia

1 India GDP assumption adjusted to Calendar Year (Bank Indonesia estimate)

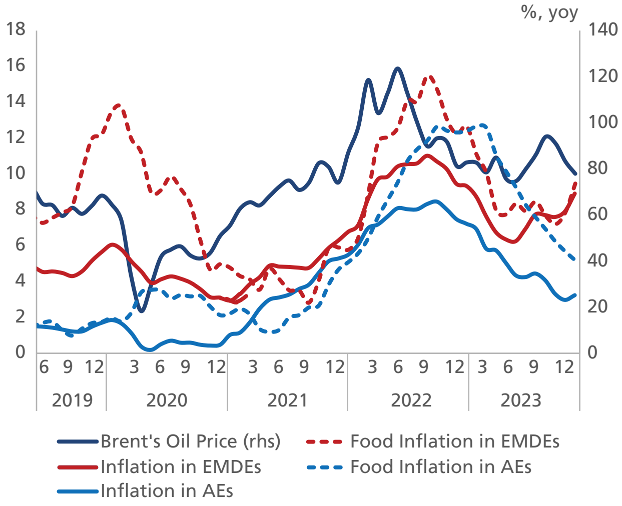
"Global economic growth is projected to weaken, accompanied by a wider growth divergence between countries."

countries is also supported by open trade and investment policies, despite ongoing geopolitical fragmentation. Global economic growth faces the risk of a correction if widespread political and economic fragmentation persists, including through its impact on rising food and energy prices, and if monetary policy tightening, specifically in AEs, requires much more time to bring inflation back under control in each respective jurisdiction.

1.2. Slow Disinflation

The global disinflation process is progressing slowly amid monetary policy tightening by central banks in many countries. After peaking at 11.6% in the second quarter of 2022, global inflation decreased to 6.8% in December 2023, with inflation in AEs recorded at 3.3% and inflation in EMDEs recorded at 9.3% (Graph 1.1). Inflation has fallen in line with lower energy and food prices (Graph 1.2) and the impact

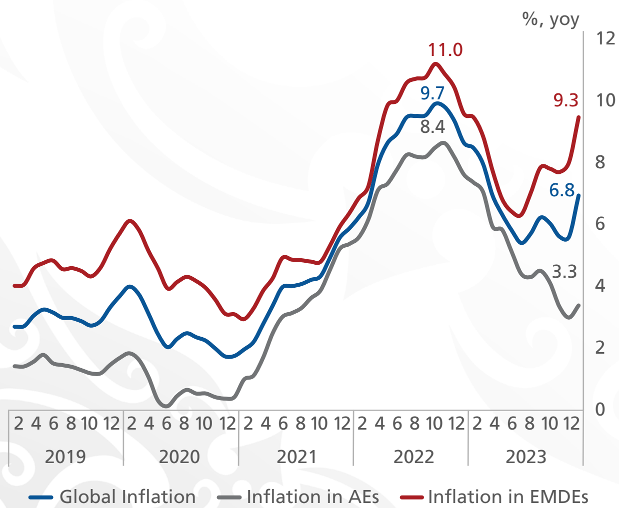
Graph 1.2. Inflation, Food Inflation, Oil Price



Source: Bloomberg and IMF, processed   Dec'23: preliminary figure

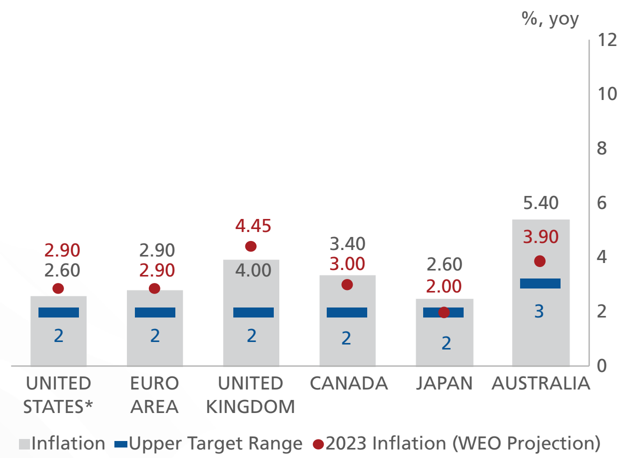
of monetary policy tightening. Nevertheless, inflation in AEs remains well above the 2% target (Graph 1.3). By contrast, inflation in EMDEs has often been below its target (Graph 1.4). In the US, for example, inflation is still expected to remain elevated, namely around 3.4% at the end of 2023, and declining to 2.3% by the end of 2024. Similarly, in the European Union and UK, inflation stood at 2.9% and 4% respectively, and is projected at approximately 2.3% and 2.4%. In EMDEs, countries with inflation above target include Brazil and Mexico in Latin America as well as the Philippines in Asia. Other EMDE countries have been able to bring inflation back to its target, including Indonesia. Such developments demonstrate that monetary tightening by central

Graph 1.1. Global Inflation, AEs, EMDEs



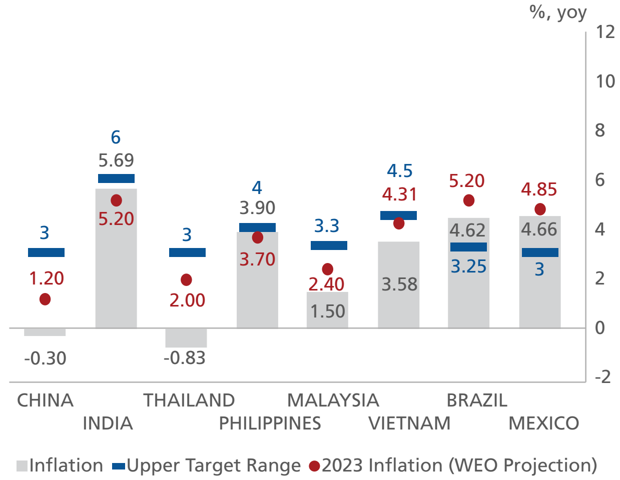
Source: Bloomberg and IMF, processed   Dec'23: preliminary figure

Graph 1.3. Inflation in AEs vs Target



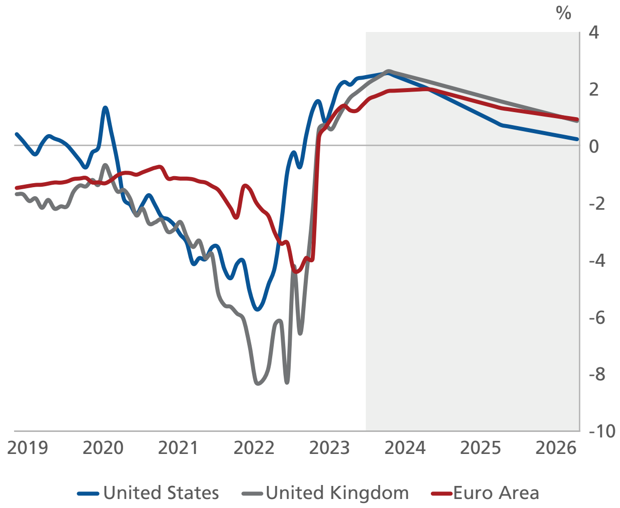
*Realization and Target of PCE Inflation
Data as of Dec'23
Source: CEIC, Country's Central Bank, Bloomberg (calculated)

Graph 1.4. Inflation in EMDEs vs Target



Data as of Dec'23
Source: CEIC, Country's Central Bank, Bloomberg (calculated)

Graph 1.5. Monetary Tightening in Advanced Economies



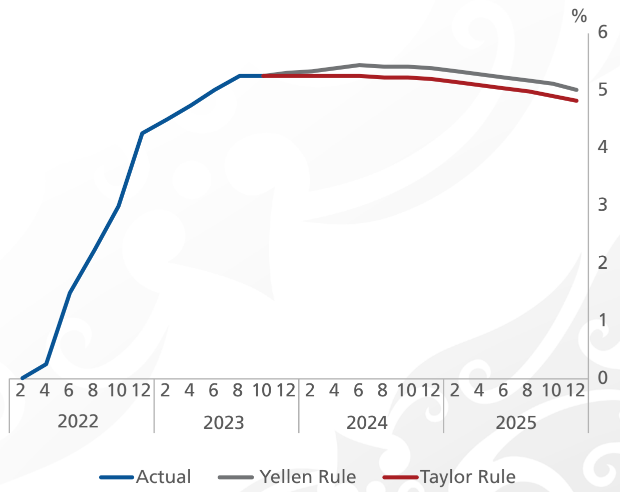
Source: IMF, World Economic Outlook (WEO) October 2023

banks in AEs will continue in 2024 to ensure inflation returns to the target of 2%. This will make it difficult for central banks in EMDEs to orient their monetary policy towards domestic economic goals, specifically price stability and growth, because of the need to protect external stability in the face of high global interest rates.

1.3. High Interest Rates for Longer

Persistently high inflationary pressures triggered monetary policy tightening in AEs with high for longer interest rates. Central banks in AEs are expected to maintain their policy rates in the upcoming months before potentially lowering rates in the latter half of 2024 (Graph 1.5). In the US, the FFR currently stands at 5.50%, and it is expected to remain steady in the first half of 2024 before decreasing to 4.75% in the second half of the year (Graph 1.6). A similar pattern is expected in Europe, where the current policy rates of the European Central Bank (ECB) and Bank of England (BoE), at 4.50% and 5.25% respectively, are projected to hold steady during the first half of 2024, before declining to 3.75% and 4.50% in the second semester of 2024. In Latin America, central banks that had earlier and aggressively tightened monetary policy, have begun to lower interest rates. Banco Central do Brasil (BCB), for instance, lowered its policy rate from a peak of 13.75% in the second quarter of 2023 to 11.75% at the end of 2023, and it is expected to hit 9.75% in the second quarter of 2024 and 9.25% by the end of 2024. El Banco de México (Banxico), which has hiked its monetary policy rate to 11.25%, is expected to reduce the policy rate to 10.50% in the second quarter of 2024 and to 9.00% in the fourth quarter of 2024. Meanwhile, policy rate hikes in Asian EMDEs, which have remained considerably lower, are expected to hold steady in 2024 to mitigate the spillover effects of high policy rates in AEs. The monetary policy rate in India, for example, has increased to 6.50%, which is expected to be held at this level for some time, possibly only lowered in the second half of 2024. The phenomenon of

Graph 1.6. Federal Funds Rate (FFR) Projection



Source: FRED, Bank Indonesia's Calculation high and longer interest rates in AEs limits the space for central banks in EMDEs to lower their monetary policy interest rates to encourage economic growth, even though domestic inflation is below the target. Policy responses to strengthen external stability from global impacts are still a concern for central banks in EMDE countries, including their impact on controlling inflation and domestic financial system stability.

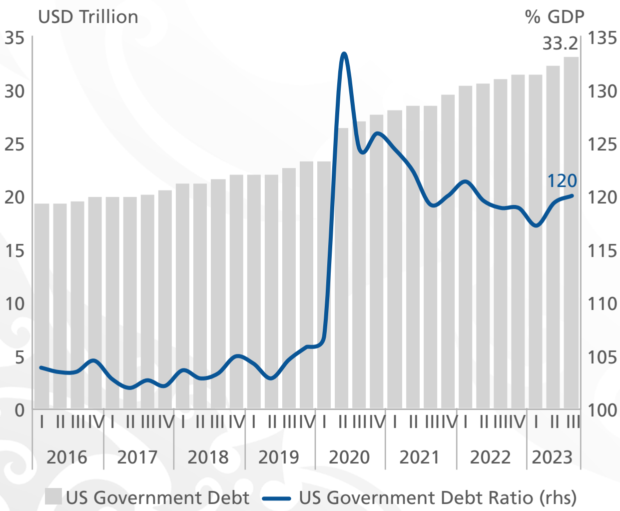
1.4. Reversal of Capital Flows from EMDEs

Heavy fiscal burdens and government debt in AEs are increasing long-term interest rates. Dealing with the Covid-19 pandemic, nearly all countries worldwide incurred large fiscal deficits to meet the costs of vaccination, health, social assistance and business subsidy programs, particularly targeting small businesses. In contrast to Indonesia, where funding for the fiscal burden of dealing with Covid-19 in the 2020-2022 State Revenue and Expenditure Budget (APBN) was partially met by Bank Indonesia to the tune of Rp1,104.85 trillion, AEs financed their large fiscal deficits by issuing bonds to global financial markets. As consequences, government debt in AEs spiked in terms of value and percentage of GDP, which experienced a simultaneous contraction due to the economic impact of the pandemic. For example, US government debt skyrocketed from approximately USD23 trillion (106% of GDP) at the end of 2019 to USD33.2 trillion (120.1% of GDP) in the third quarter of 2023 (Graph 1.7). Government debt in AEs is expected to continue growing as a corollary of government policies to expand social programs, finance wars and a transition towards a green economy. Increasing government debt in AEs, particularly the US, is pushing up short-term interest rates because monetary policy tightening is accompanied by higher long-term bond yields. For example, US Treasury bond yields for 30-year tenors increased from around 4.00% at the end of 2022 to 4.50% in September 2023 and close to 5.00% in October 2023 (Graph 1.8). US Treasury yields are projected to remain high at around 3.7% in 2024 and 3.8% in 2025. This phenomenon of increasing long-term bond yields has exacerbated the outflow of portfolio investment from EMDEs to AEs, particularly the US, and encouraged a strong US dollar.

1.5. US Dollar Remains Strong

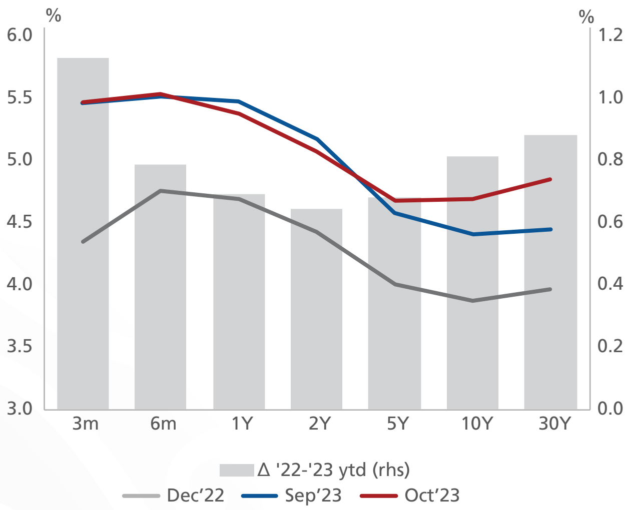
Aggressive FFR hikes, coupled with higher long-term US Treasury yields, have encouraged the surge of portfolio investment outflows from EMDEs to liquid assets in the US (cash is the king) and prompted a strong US dollar (strong dollar) against other global currencies. Since central banks hiked policy rates in AEs, portfolio investment outflows from EMDEs have increased. In 2023, portfolio investment inflows to AEs have reached USD1.7 trillion, rebounding from the

Graph 1.7. US Government Debt



Source: FRED

Graph 1.8. Term-Structure of US Treasury

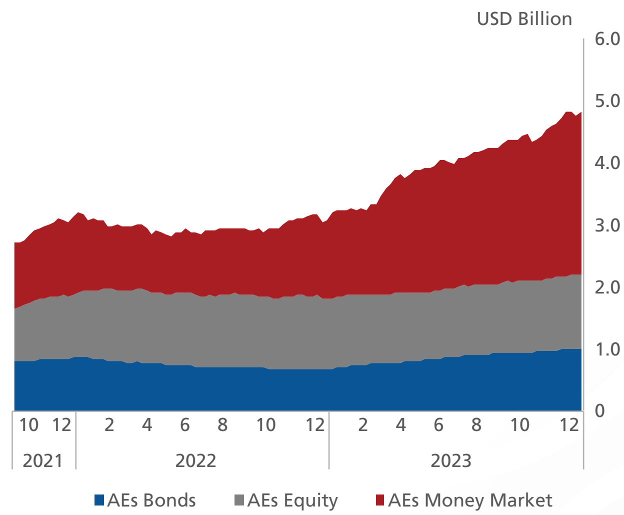


Source: Bloomberg (calculated)

outflow. These inflows are dominated by liquid assets, namely money market assets of USD1.3 trillion (around 77% of the total), the rest went to stock assets of USD78 billion (around 4%) and bond assets of USD317 billion (around 18%) – (Graph 1.9). Overall, the share of portfolio investment in AEs has increased from around 90% to 95% of global portfolio investment. Most of the portfolio investment outflow from EMDEs has been attracted to US financial markets by high US Treasury yields and the US dollar as the dominant global currency. The "cash is the king" phenomenon has again induced broad-based US dollar appreciation against global currencies (Graph 1.10). The US dollar index against world currencies (DXY) reached 106.7 at the end of October 2023, appreciating by roughly 15.4% (yoy) from June 2021 and 3.0% (yoy) from December 2022.

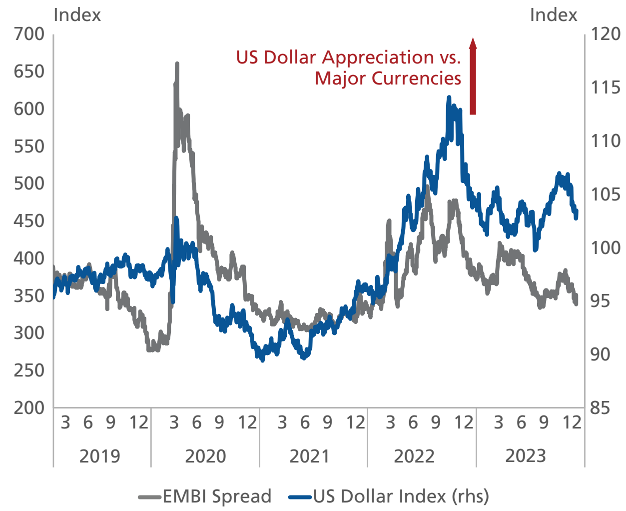
The phenomenon of the strong US dollar is mirrored in currency pressures for depreciation in various countries. In AEs, the British pound sterling and Japanese yen have depreciated by roughly 5% and 7%, respectively, to around GBP1.27 and JPY141 per US dollar in 2023. In terms of EMDEs, the currencies experiencing the greatest weakness were the Argentine peso (78%); Turkish lira (30%); Russian ruble (23%); South African rand (8%); and Chilean peso (4%).

Graph 1.9. Capital Flows to Advanced Economies



Source: EPFR (calculated)

Graph 1.10. US Dollar Appreciation



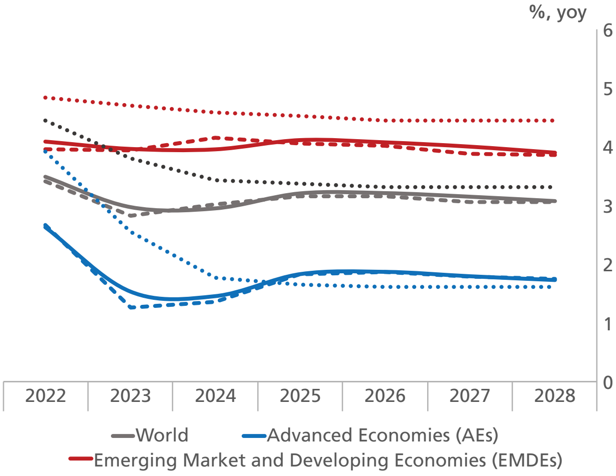
Source: Bloomberg *Data as of 29 December 2023

Broad-based US dollar appreciation against various world currencies and foreign portfolio outflows calls for extra vigilance and a strong policy response to mitigate contagion effects on stability of domestic economies, especially via imported goods inflation, liquidity in the money market and banking and, potentially, financial system stability.

1.6. Medium-Term Global Economic Prospects

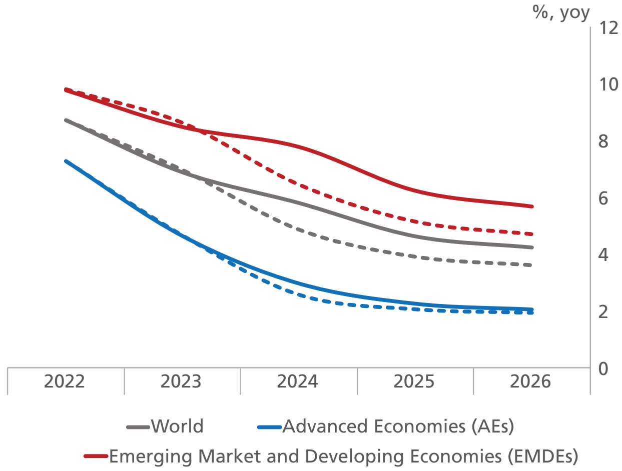
Over the medium term, the global economic recovery is expected to require more time to reach convergence across countries and may even fail to achieve pre-pandemic levels. The five factors detrimental to the global economic outlook, explained above, will not only have a negative impact in 2024, but they will also influence the medium-term prospects. In the World Economic Outlook (WEO) October 2023, the International Monetary Fund (IMF) projects global economic growth to reach only 3.1% in 2028, which is lower than the 3.6% projected before Covid-19 in 2020 and lower than the 4.9% projected before the Global Financial Crisis (GFC) in 2008 (Graph 1.11). Around 80% of the decline in growth is attributable to lower per capita income and productivity growth, stemming from factors of production in the

Graph 1.11. Medium-Term Global GDP



Dashed = WEO April 2023, Dashed = WEO January 2022
Source: IMF World Economic Outlook (WEO) October 2023

Graph 1.12. Medium-Term Global Inflation

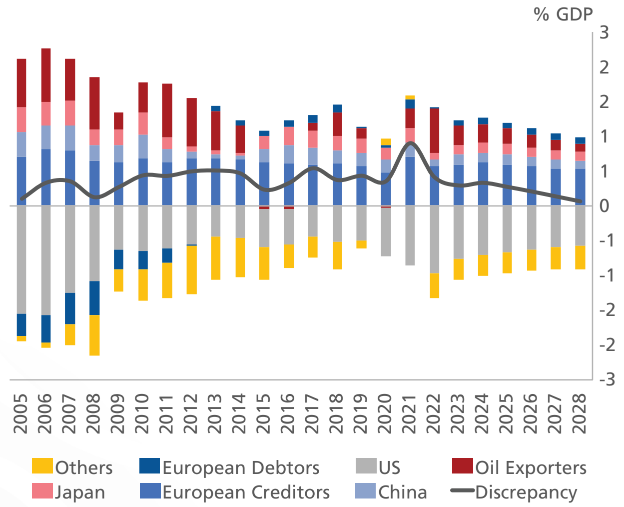


Dashed = WEO April 2023
Source: IMF World Economic Outlook (WEO) October 2023

form of capital and labor. In AEs, approximately one-third of the decline in income will be caused by lower labor force participation rates, owing to the aging population. In EMDEs, lower per capita income will extend the timeframe required to close the gap on AEs. Overall, global output is not expected to return to pre-pandemic levels. The IMF expects the Covid-19 pandemic to wipe out approximately 5.0% of global output, worth about USD6.4 trillion based on 2023 prices. Meanwhile, geopolitical and economic fragmentation will prolong the global disinflation process (Graph 1.12). In 2023, approximately 72 countries, comprising 34 AEs and 38 EMDEs, are experiencing inflation above target. Similarly, around 89% of countries worldwide will record inflation above target in 2024. Inflation in most countries is not expected to stabilise on target until 2025.

Geopolitical and geoeconomic fragmentation has also influenced trade and investment divergence, which has benefited AEs, particularly the US. World trade volume growth is expected to fall precipitously from 5.1% in 2022 to just 0.9% in 2023 before rebounding to 3.5% in 2024, which is still significantly below the 4.9% averaged during the decade before Covid-19. Apart from differences between countries in terms of rising demand, as explained above, the decrease in world trade volume is also attributable to the strong US dollar and the tendency of AEs to implement trade restrictions and barriers from EMDEs, especially from China. However, for the US economy, the strengthening of the US dollar has had a negative impact on trade in goods and services, causing the current account deficit to widen to almost 1.5% of GDP in 2022 and 2023, and it will persist until 2028 (Graph 1.13). Furthermore, the strong US dollar and higher interest rates in the US have and will continue to attract global capital and financial flows that significantly outweigh the requirements

Graph 1.13. Global Current Account Balance



Source: IMF World Economic Outlook (WEO) October 2023

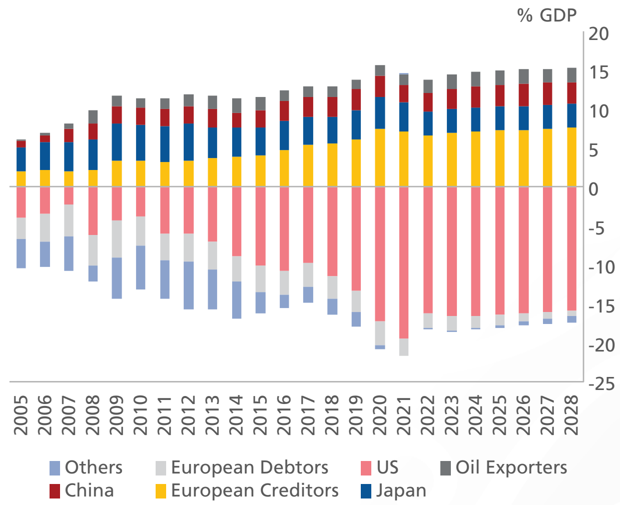
"Geopolitical and geoeconomic fragmentation has also influenced trade and investment divergence, which has benefited AEs."

to finance the current account deficit. This is clearly evident in the US International Investment Position (IIP, which compares US assets abroad with US liabilities to non-residents) where the deficit has ballooned to almost 20% of GDP and will remain around 15% of GDP until 2028, which is notably higher than the position before Covid-19 (Graph 1.14). Imbalances in global investment flows that benefit the US economy demand greater vigilance concerning their impact on the external economic balance of EMDEs, particularly in terms of capital flows and US dollar developments moving forward.

1.7. International Cooperation to Respond to Global Challenges

Seeking to overcome the severe adverse impact of global economic fragmentation and uncertainty, Indonesia continues communicating the need for stronger coordination and policy mix in various international fora. Within the G20 and IMF forums, Indonesia regularly expresses the need to strengthen coordination between central bank policy and government fiscal policy. With high energy and food prices, accompanied by monetary policy tightening to control inflation, fiscal policy must focus on reviving economic growth, providing subsidies for the poor and controlling excessive fiscal spending based on populism. Structural policies in the real sector must be pursued to nurture growth, including open trade and investment policies by avoiding barriers and restrictions between countries. Meanwhile, green economic policies must be pursued with an adequate transition period to prepare projects and financing, especially for EMDEs, that avoid any adverse impact on growth. As a measure to help Low Income Countries (LICs), Indonesia welcomes the IMF's initiative through international cooperation to reduce poverty and the LIC debt burden with a Special Drawing Rights (SDR) 60 million participation to fund the Poverty Reduction and Growth Trust (PRGT) program. In the financial sector, through the Financial Stability Board (FSB) and Bank for International Settlements (BIS), Bank Indonesia continues voicing the need to strengthen the supervision and regulation of crypto assets by implementing the principle of 'same activities, same risks, same regulations'. Indonesia also supports initiatives to develop Central Bank Digital Currency (CBDC) and strengthen payment system linkages between countries, including digitalization to support economic and financial inclusion.

Graph 1.14. Global International Investment Position



Source: IMF World Economic Outlook (WEO) October 2023

Within the purview of ASEAN, Indonesia's Chairmanship in 2023 has achieved a number of successes in transforming important agendas to strengthen the region's economy and finance, not only to be more resilient in the face of global shocks but also to become an epicentrum of global growth. Under the theme 'ASEAN Matters: Epicentrum of Growth', several important achievements under the strong leadership of President Joko Widodo, have laid a solid foundation for ASEAN in facing the challenges moving forward, thus ensuring the ASEAN region becomes an epicentrum of global growth, while realising the Indo-Pacific region as a safe and peaceful area. At the 43rd ASEAN

Summit held in Jakarta on 7th September 2023, members reiterated that ASEAN remains an axis of peace in the region with the ability to manage differences and overcome rivalries by prioritising collaboration. A new phase of regional digital economic integration was achieved with the establishment of the Digital Economy Framework Agreement (DEFA). At the 43rd ASEAN Summit, the leaders also agreed to advance the implementation of Chiang Mai Initiatives Multilateralization and the Local Currency Transaction (LCT) framework. Furthermore, all members in attendance at the 43rd Summit in Jakarta agreed that sustainable economic growth requires broader stability in the region, namely by strengthening Indo-Pacific stability. To that end, implementation of the ASEAN Indo-Pacific Forum (AIPF) successfully produced cooperation commitments for 93 projects with a value of USD38.2 billion, comprising: 81 projects worth USD34.53 billion in the green infrastructure and resilient supply chain subtheme; 4 projects worth USD736.36 million in the sustainable and innovative finance subtheme; and 8 projects worth USD2.94 billion in the inclusive digital transformation subtheme. In addition, there are another 73 potential projects worth USD17.8 billion. Other significant outcomes include agreements between ASEAN members and partners in terms of food security cooperation to mitigate natural disasters and ongoing climate change issues.

Bank Indonesia played an important role and contributed to five concrete achievements during Indonesia's successful ASEAN Chairmanship in 2023. First, an agreement to strengthen the macroeconomic policy mix as an important policy framework for implementation, particularly during the current global challenges and uncertainty. Second, expansion of the LCT framework in the ASEAN region covering three salient aspects as follows: (i) transactions in local currencies to facilitate trade and investment; (ii) LCT in the cross-border payment system, and (iii) LCT for financial assets. Third, expanding Regional Payment Connectivity (RPC) in the ASEAN region by facilitating smooth and secure cross-border payments by agreeing the RPC Roadmap that contains a timeframe for ASEAN members targeted to join the RPC. Fourth, strengthening inclusion and digital financial literacy. Fifth, an agreement to strengthen ASEAN work processes, particularly in the finance channels, to ensure ASEAN can respond to the latest dynamic global economic conditions. This included reviewing the mandate and work processes of each Working Committee (WC) to welcome the vision of the ASEAN Economic Community (MEA) in 2025 and beyond. Various commitments and agreements during Indonesia's Chairmanship of ASEAN in 2023 will further strengthen the region's economic resilience and revival to remain the "Epicentrum of Growth" amidst the ongoing global turmoil.