



THE GLOBAL ECONOMY

Part I

THE GLOBAL ECONOMY

In a departure from widespread optimism surrounding improvements at the beginning of the year, global economic performance in 2013 did not live up to expectations and even slipped further compared to the previous year. Global economic growth slumped from 3.1% to 3.0%, commodity prices corrected downwards and uncertainty propagated across financial markets. Such conditions were on account of a shift in the global economic cycle and landscape that persisted throughout the year. Notwithstanding, a range of economic challenges was addressed through appropriate policy responses in various countries, thereby halting further economic declines. Through the policies instituted global economic performance improved towards year end, which is expected to garner optimism for further economic improvements looking ahead.

A shift in the global economic cycle and order represented the most binding global economic challenge faced in 2013. The associated challenges were onerous considering the shift in the economic cycle occurred in three different areas that are all interconnected with one another. The first shift occurred in the global economic landscape, marked by gradual improvement of economic growth in advanced countries and weaker growth in emerging market countries. The second shift related to a continuation of sliding international commodity prices. The final change was global capital flows reversal prompted by indication of a possible cut back on the Federal Reserve's asset purchase program in May 2013 (tapering off policy).

The array of changes that befell the global economy undermined global optimism and economic performance. The year 2013 began on an optimistic note following upbeat forecast on emerging markets' economic growth. Entering the second quarter, however, a shift began to take hold primarily in emerging market countries as the economies of China and India slowed. The economic decline persisted into the third quarter, which in

turn triggered a contagion effect that spread to other emerging markets.

Optimism in advanced countries, meanwhile, also ebbed away as reflected by corresponding growth projections. Nevertheless, the economic slowdowns taking place in advanced countries were not as deep as the economic deceleration affecting emerging markets. This signalled a shift in the economic growth cycle has been accompanied by a change in the global economic landscape, as the key drivers of economic growth began to swing from emerging markets countries to advanced countries.

An implication of the global economic downturn was lower international commodity prices. The impact on lower commodity prices was relatively significant in 2013 as it was linked to slower economic growth in China and India, which represent the largest importers in the world.

The change in the global economic landscape also impacted global financial market performance. Economic recoveries in advanced countries, coupled with weak economic performance in emerging market countries, precipitated capital outflows from emerging markets towards advanced countries. The intensity of capital outflows increased towards the third quarter of 2013, triggered by tapering off policy. The tapering off policy of the Federal Reserve sparked widespread uncertainty and bearish sentiment on global financial markets, including in emerging market countries. Ultimately, uncertainty drove capital to flow out of emerging markets, triggered shocks on financial markets and compounded pressures on the currencies of emerging market countries, including Indonesia.

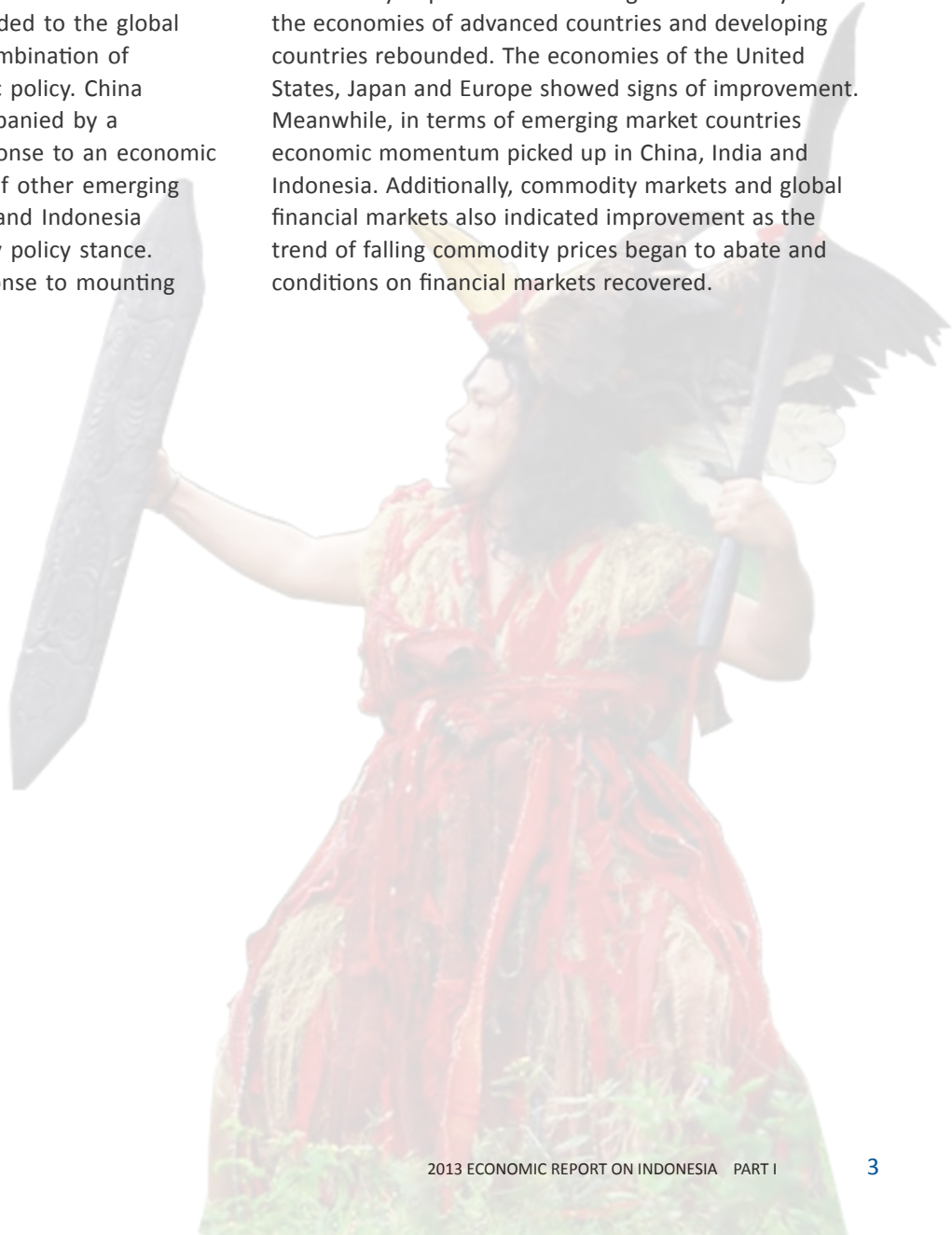
The arduous global economic challenges elicited an accommodative macroeconomic policy response from advanced countries. Meanwhile, emerging market countries responded to the challenges through more diverse policy responses. A plethora of international

forums helped buttress international cooperation concerning the policy responses taken in various countries. The United States persisted with its stimulus policy, held interest rates low and continued the policy of quantitative easing. Japan introduced economic stimuli through a policy package known as *Abenomics*. Countries in the Euro zone maintained their loose monetary and fiscal policy stance to bolster economic growth during the ongoing recession.

Emerging market countries responded to the global economic challenges through a combination of loosening and tightening economic policy. China launched a “mini stimulus” accompanied by a structural reforms package in response to an economic slowdown. Conversely, a number of other emerging market countries like Brazil, India and Indonesia began to adopt a tighter monetary policy stance. Such policy was instituted in response to mounting

inflationary pressures and external sector imbalances stemming from burgeoning current account deficits and the impact of planned tapering by the Federal Reserve. Furthermore, emerging market countries began introducing structural policy in order to reinforce economic resilience.

The auspicious impact of the aforementioned policies, however, was only felt in the final quarter of 2013, as reflected by improvements in the global economy as the economies of advanced countries and developing countries rebounded. The economies of the United States, Japan and Europe showed signs of improvement. Meanwhile, in terms of emerging market countries economic momentum picked up in China, India and Indonesia. Additionally, commodity markets and global financial markets also indicated improvement as the trend of falling commodity prices began to abate and conditions on financial markets recovered.





Global Economic Dynamics

A shift in the global economic cycle triggered uncertainty in the global economy during 2013. First was a change in the global economic constellation, denoted by improvement of economic growth in advanced countries and weaker growth in emerging market countries that were previously the drivers of the global economy. Second was the continuation of down-trending international commodity prices. Third was a capital reversal due to the tapering off policy of the Federal Reserve that signified the end of abundant liquidity on global financial markets. The three changes to the global economic cycle led to weaker-than-expected global economic performance in 2013.

A change in the economic cycle and landscape severely affected global economic performance in 2013. The first shift was a change in the global economic landscape, marked by stronger economic growth in advanced countries and weaker growth in emerging market countries that were previously drivers of the global economy. The second change was the continuation of declining international commodity prices. The final change was the onset of capital outflows from emerging markets into advanced countries as the era of loose monetary policy in the United States (US) came to an end.

The changes that plagued the global economy in 2013 resulted in weaker performance than initially projected. The global economy expanded by 3.0% in the reporting year, which is lower than the 3.5% projected at the beginning of the year as well as the 3.1% achieved in 2012. The economic slowdown, notably in emerging market economies, coupled with abundant supply helped perpetuate the trend of sliding international commodity prices. The slump in prices mainly affected non-oil and gas commodities, amounting to 1.2%. Furthermore, the average price of oil also dropped moderately compared to the average price in 2012 despite spiking a number of times during the year due to geopolitical tensions in the Middle East.

Likewise, the global shift in international capital flow triggered uncertainty on global financial markets. The capital flow turnaround was largely influenced by the monetary policy adopted by the Federal Reserve in the United States which plan to taper off its monetary stimuli. The tapering off policy sparked uncertainty and triggered negative sentiment on global financial markets, including in emerging market countries. Widespread uncertainty subsequently induced a capital reversal in emerging market countries as capital flowed back to advanced countries and touched off shocks on financial markets, while exacerbating pressures on the currencies of several emerging market countries, including Indonesia.

Pressures in the global economy began to subside during the final quarter of 2013 in line with the policy responses taken in advanced and emerging market countries alike. The response adopted in advanced countries tended to consist of a looser policy stance compared to emerging market countries. Sound policy responses contributed to improvements in the global economy driven by the US and Japan, coupled with signs of recovery in Europe, China and India. Such improvements subsequently hastened recoveries on global financial markets.

1.1. Global Economic Growth

Economic performance in a number of countries demonstrated a weak global economic growth throughout 2013. The global economy achieved just 3.0% growth in 2013, down from 3.1% in the previous year of 2012. Moreover, economic growth in the reporting year was lower than previous projections. At the beginning of 2013, the International Monetary Fund (IMF) projected economic growth in the range of 3.5%. Nevertheless, weaker-than-expected performance forced the IMF to revise down its projections several times during the year to just 2.9% in October 2013 (Table 1.1).

The global economic downturn was also accompanied by a change in the global economic landscape. The global economy was characterized by a slowdown in emerging market countries coupled with signs of recovery in advanced countries. Economic growth in emerging market countries, which had hitherto propped up the global economy, began to decelerate due to economic downturns in China and India. Meanwhile, the economies of advanced countries have showed a growing trend since the second quarter of 2013 but remain unable to fully support the global economy as a whole (Chart 1.1). The upward growth trend was most pronounced in the United States and Japan, while economic corrections began to ease in Europe. The change of global economic setting affected the performance of emerging market countries, including Indonesia, as there were a number of differences between commodities exported to advanced countries and to emerging market countries. (see Box 1.1. The Impact of Changes in the Global Economic Landscape).

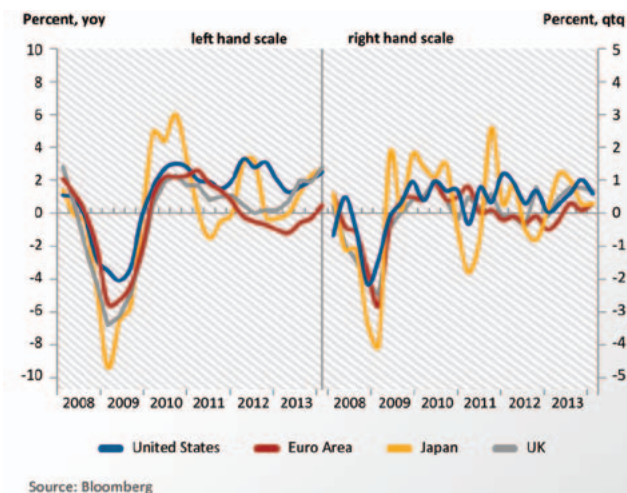


Chart 1.1. Economic Growth of Advanced Economies

Table 1.1. Global Economic Indicators

Percent, yoy

	2010	2011	2012	2013*				
				Jan'13	Apr'13	Jul'13	Oct'13	Jan'14
World GDP	5.2	3.9	3.1	3.5	3.3	3.1	2.9	3.0
Advanced Economies	3.0	1.7	1.4	1.4	1.2	1.2	1.2	1.3
United States	2.5	1.8	2.8	2.0	1.9	1.7	1.6	1.9
Euro Area	2.0	1.5	-0.7	-0.2	-0.3	-0.6	-0.4	-0.4
Japan	4.7	-0.6	1.4	1.2	1.6	2.0	2.0	1.7
Emerging Economies	7.5	6.2	4.9	5.5	5.3	5.0	4.5	4.7
Asia	9.8	7.8	6.4	7.1	7.1	6.9	6.3	6.5
China	10.4	9.3	7.7	8.2	8.0	7.8	7.6	7.7
India	10.5	6.3	3.2	5.9	5.7	5.6	3.8	4.4
India, at factor cost	9.7	7.5	5.1					4.6
ASEAN-5	7.0	4.5	6.2	5.5	5.9	5.6	5.0	5.0
World Trade Volume (goods and services)	12.8	6.1	2.7	3.8	3.6	3.1	2.9	2.7
CPI Inflation								
Advanced Economies	1.5	2.7	2.0	1.6	1.7	1.5	1.4	1.4
Emerging Economies	5.9	7.1	6.0	6.1	5.9	6.0	6.2	6.1

Note: India's GDP were based on the fiscal year; analysis were based on at factor cost

Source: World Economic Outlook (WEO) International Monetary Fund (IMF)

*IMF Projection based on WEO Projection within the month

Economic Performance of Advanced Countries

Economic growth in advanced countries recorded an upward trend in 2013 although somewhat lower compared to that achieved in 2012. The growth of advanced countries showed a growing trend since the second quarter of 2013 on the back of more intense production activities in the US and Japan. Indications of a recovery in the Euro zone were also noted but remain overshadowed by uncertainty.

For the full year, the upward trend among advanced economies was insufficient to successfully achieve stronger growth in 2013 compared to the preceding year. The advanced economies achieved just 1.3% growth, down on the 1.4% posted in the previous year (Table 1.1). The economic slowdown in advanced countries was primarily attributable to a downturn in the US economy, achieving just 1.9%, and the ongoing contraction in the Euro zone of -0.4%. Meanwhile, the economy of Japan posted 1.6% growth, exceeding that documented in the previous year. Apart from some signs of economic recovery in advanced countries, there is a need to be cautious and vigilant as a number of macroeconomic indicators, like fiscal deficit to GDP, government debt to GDP and unemployment, remain tepid at best (Table 1.2).

The gradually strengthening of economic growth in advanced countries was also driven by the US economy. During the first half of 2013, the US still recorded a moderate growth of 1.5% despite the setback resulting from uncertainty on fiscal consolidation (budget sequestration) as well as provisions for a debt ceiling. Sequestration policy in the form of raising taxes and cutting government spending has eroded consumer confidence and household consumption. Furthermore, a protracted recovery in the housing sector and stagnant level of labour absorption also undermined consumer confidence. Such circumstances placed additional pressures on industrial activity in line with moderating domestic demand and lowered the new order indicator. A decline in production activity was also buffeted by weaker external demand following weaker-than-expected GDP realisation in China during the first quarter of 2013. Nonetheless, private consumption subsequently rebounded due to the wealth effect as bullish sentiment took over the stock exchange and the housing sector rallied, as reflected by gains in consumer confidence and stronger retail sales figures.

In the second half of 2013, US economic indicators improved significantly on the back of gains in the manufacturing sector. Activity in the manufacturing sector continued to improve, as demonstrated by the Purchasing

Table 1.2. Macroeconomic Indicators of Advanced Economies

Percent

	Fiscal Deficit / GDP				Government Debt / GDP				Unemployment			
	2010	2011	2012	2013*	2010	2011	2012	2013*	2010	2011	2012	2013*
United States	-10.8	-9.7	-8.3	-5.8	95.2	99.4	102.7	106.0	9.6	8.9	8.1	7.6
Japan	-9.3	-9.9	-10.1	-9.5	216.0	230.3	238.0	243.5	5.1	5.1	4.4	4.2
Euro Area	-6.2	-4.2	-3.7	-3.1	85.7	88.2	93.0	95.7	10.1	10.1	11.4	12.3
Ireland	-30.5	-13.1	-7.6	-7.6	91.2	104.1	117.4	123.3	13.9	13.9	14.7	13.7
Italy	-4.3	-3.7	-2.9	-3.2	119.3	120.8	127.0	132.3	8.4	8.4	10.7	12.5
Portugal	-9.9	-4.4	-6.4	-5.5	94.0	108.4	123.8	123.6	10.8	10.8	15.7	17.4
Spain	-9.7	-9.6	-10.8	-6.7	61.7	70.4	85.9	93.7	20.1	20.1	25.0	26.9
Greece	-10.8	-9.6	-6.3	-4.1	148.3	170.3	156.9	175.7	12.5	12.5	24.2	27.0

Source: WEO Database, October 2013, IMF

* projection

Managers' Index leading indicator (PMI)¹ (Chart 1.2). Such conditions were further supported by a rebound on the housing market and higher net worth of households as an outcome of the wealth effect (Chart 1.3). The balance sheet of US households also recovered as the ratio of household debt to income decreased. In addition, labour absorption continued, bringing the level of unemployment down to 6.7%, although this was also due to a low level of labour participation. Notwithstanding, favourable progress was hindered by tighter financial markets following the indication of tapering off policy coined in May 2013.

The improvement of US exports along with increased energy production bolstered the US recovery and lowered imports thereby narrowing the current account deficit. Private consumption also grew impressively by 2.5% (yoy) in the final quarter of 2013, the highest rate recorded in the past three years. Ultra-accommodative monetary policy further supported such propitious conditions. Economic growth in the US was maintained until the partial government shutdown and debt ceiling debacle that subsequently prompted a fiscal drag in US GDP.

Favourable economic performance in the US had a positive effect on the Euro zone. An accommodative monetary policy response coupled with relaxing austerity measures helped invigorate economic growth and reduced the level of unemployment in Europe, albeit very limitedly. In 2013, economic growth in Europe was observed to improve despite recording a contraction of 0.4%. Contractionary pressures eased in Europe from the second quarter to the

fourth quarter of 2013 and recorded a positive growth of 0.3%, 0.1% and 0.3% respectively. These feature was quite promising as in the preceding year, positive growth was only achieved in the final quarter of 2013 at 0.5%. Such conditions were possible due to stronger consumption as reflected by retail sales and gains in the manufacturing sector (Chart 1.4).

It should be noted that recovery signals in the European region still require vigilance since the recovery did not cover all fundamental sectors yet, as reflected by the large fiscal deficit to GDP, government debt to GDP and the level of unemployment (Table 1.2). Moreover, improvements in the financial sector remain suboptimal, which was evidenced by financial market fragmentation as well as deterioration of the banks' balance sheets, thus impeding the transmission of accommodative monetary policy instituted by the European Central Bank

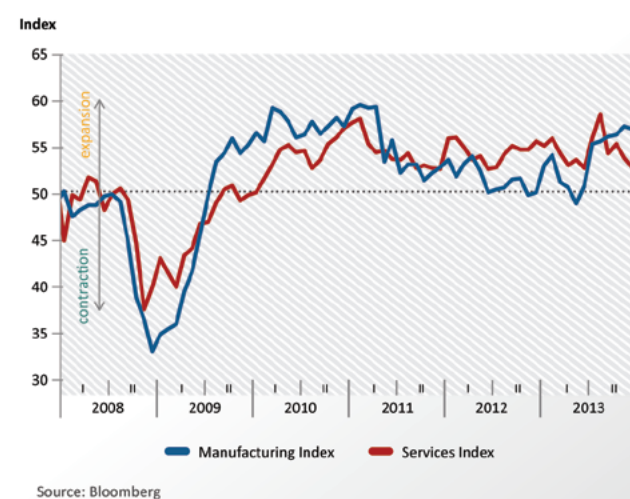


Chart 1.2. US Manufacturing Purchasing Manager's Index

1 The Purchasing Managers' Index (PMI) are economic indicators that monitor conditions in the manufacturing sector, covering output, new orders, stock levels, labour absorption and prices in the manufacturing sector, construction, retail and services sectors. <http://www.markiteconomics.com>

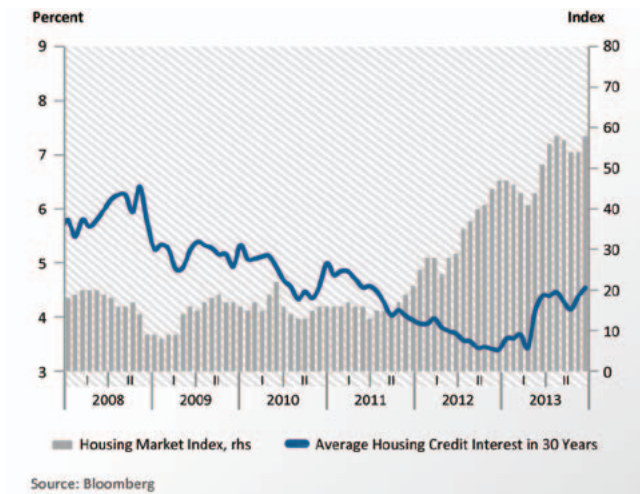


Chart 1.3. US Housing Indicators

(ECB), particularly in periphery countries. Consequently, lending rates remained high and the ability of banks to extend credit was still limited. Regarding competitiveness, periphery countries remained constrained in terms of adjusting their cost of labour, which could make the prices of goods and services more competitive. Accordingly, such conditions have undermined efforts to overcome external imbalances between periphery countries and the major countries of Europe.

Economic growth also picked up in Japan during 2013. During the reporting year, the economy of Japan grew 1.4% as a positive outcome of the Abenomics policy consisting of fiscal stimuli and an expansive monetary stance that successfully boosted private consumption and investment. The loose monetary policy stance of the Bank of Japan (BoJ) was achieved through the

purchase of securities to the tune of US\$ 75 billion per month, primarily Japanese Government Bonds (JGB). The purchases intended to increase the amount of currency in circulation (M2) two-fold in 2014, thereby bringing inflation towards its target of 2%. The magnitude of the monetary stimuli led to a depreciation of the yen, which catalysed Japanese exports and boosted consumer confidence (Chart 1.5).

Economic Performance in Emerging Market Countries

Amid signals of economic recovery in advanced countries, emerging market countries experienced an economic downturn. Economic growth in emerging market countries amounted to 4.7% in the reporting year, down from 4.9% in the previous year. The slowdown was blamed on the economic performance of several countries like China, India, Brazil and South Africa, where slower growth trends were reported (Chart 1.6). The economic slump in emerging market countries stemmed from global economic dynamics and domestic structural issues. On one hand, the downward trend in international commodity prices placed additional pressures on exports from emerging market countries, predominantly in countries reliant on commodity-based exports. On the other hand, however, domestic structural problems resulted in the failure of economic capacity to offset domestic demand, thereby raising imports. The combination of pressures on exports and escalating imports, in turn, widened the current account deficit. In addition, pressure on exports and climbing imports also slowed economic growth. Furthermore, economic performance also tailed off in line with the Fed's tapering

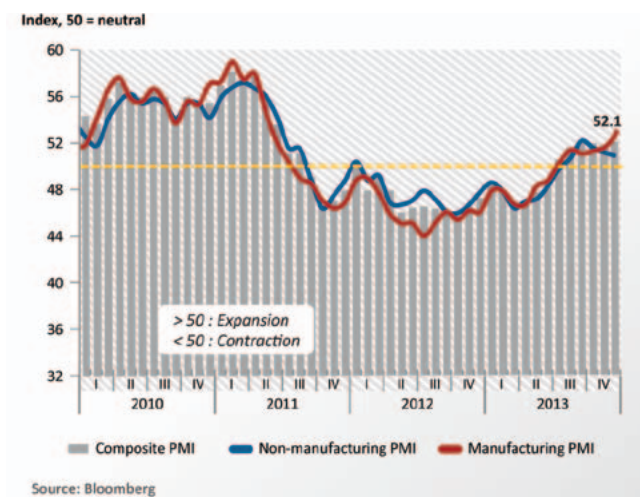


Chart 1.4. Euro Area's Manufacturing Purchasing Managers' Index

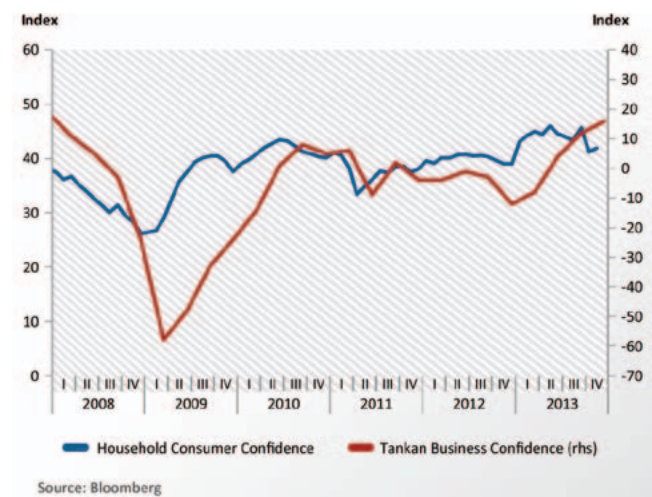


Chart 1.5. Tankan Business Confidence and Consumer Confidence Survey

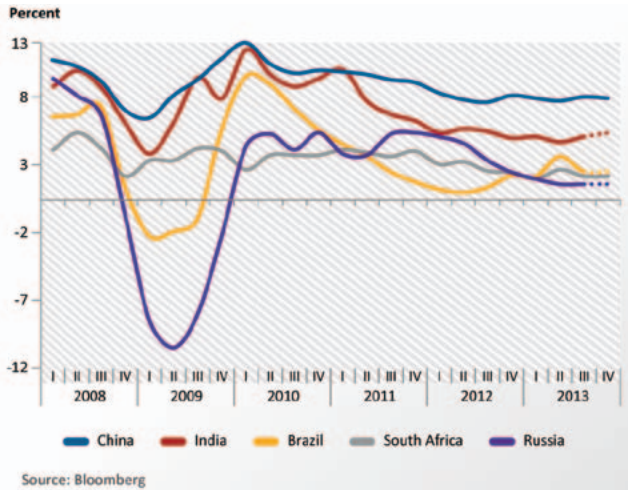


Chart 1.6. Economic Growth in Emerging Economies

off policy which affected economic financing in emerging market countries. Besides, domestic financing also decreased as monetary policy was tightened in a number of countries.

China achieved economic growth in the range of 7.7% in 2013, lower than its historical average (Chart 1.7) as a result of weaker exports in line with the nascent recovery in the US along with less investment, particularly in construction. The decline in investment stemmed from the pass-through effect of policy to tighten credit introduced in 2010. Such policy aimed to dampen the property price bubble that resulted from large-scale fiscal stimuli in the infrastructure and property sectors in response to the global financial crisis in 2008.

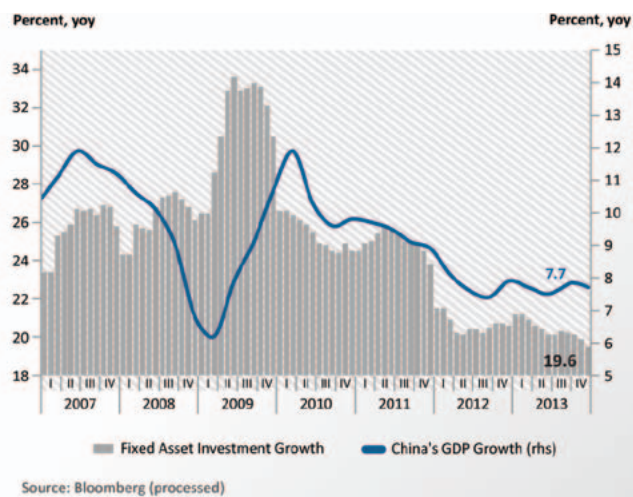


Chart 1.7. China's GDP and Investment Growth

The economy of India also suffered a downturn accompanied by escalating inflationary pressures, a widening current account deficit and a burgeoning fiscal deficit. The Indian economy expanded by 4.4% in 2013 compared to 5.1% posted in 2012. Poor export performance combined with surging imports contributed to the economic slowdown, which ultimately placed additional pressures on the growing current account deficit. India also experienced mounting inflationary pressures as the government raised fuel prices to offset the large fiscal deficit. Inflationary pressures also stemmed from exchange rate depreciation as an effect of capital outflows from India in relation to the Fed's plan to taper off its monetary stimuli. Pressures on the Indian economy eased during the final few months of 2013, as reflected by less intense depreciatory pressures on the exchange rate as well as an upswing in manufacturing activity, indicated by gains in the Purchasing Managers' Index (PMI) and production index (Chart 1.8). Favourable performance towards the end of the year was further accredited to the response of the government and central bank to stabilise the domestic economy.

The economies of other emerging market also slowed, like in Russia and South Africa. Economic growth in the two countries was 1.3% and 1.9% respectively in 2013, down from 3.6% and 2.5% in the previous year. Lacklustre economic performance in both countries was associated with nearly identical factors as those suffered in other countries, like the downward trend in international commodity prices as well as limited capacity on the supply side.

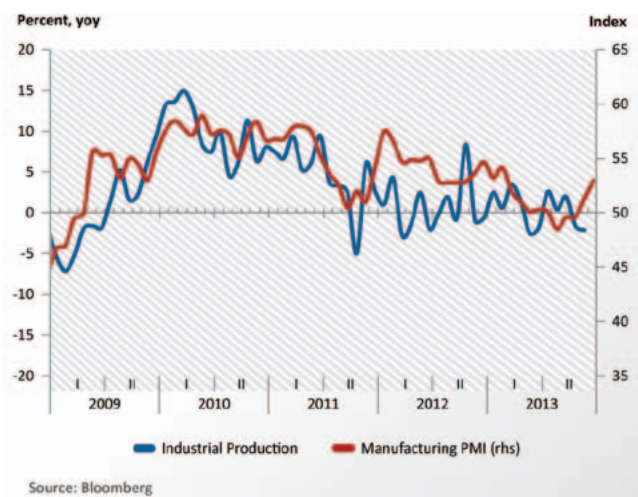


Chart 1.8. India's Purchasing Managers' Index and Industrial Production

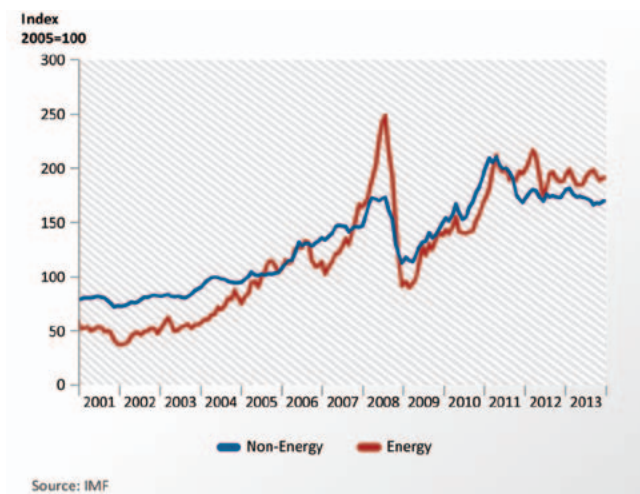


Chart 1.9. Energy and Non Energy Commodity Price Index

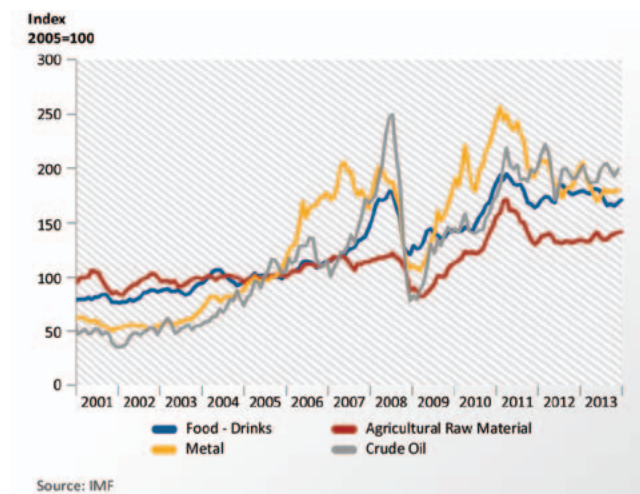


Chart 1.10. Commodity Price Index by Group

1.2. International Commodity Prices and Global Inflation

Another key feature of the global economy in 2013 was the continuing downward trend of international commodity prices. The commodity prices continued to tumble due to weaker global demand, primarily from emerging market countries, along with the increased supply of goods and services². The most pronounced decline in prices affected non-energy commodity prices, amounting to 1.2%, following on from the significant 10.0% slump reported in 2012 (Chart 1.9). The persistent downward trend in non-energy commodity prices was primarily attributable to tumbling prices of metals and foods (Chart 1.10). The drop in metal prices caused non-energy commodity prices, as inputs of the manufacturing sector, also experience a decline during the reporting year of 2013. Congruently, the price of oil also decreased moderately compared to the price in 2012.

The sliding trend of international commodity prices, especially non-energy commodities, was also attributed significantly to the rebalancing strategy of the Chinese Government that diverted sources of economic growth

away from investment and exports towards consumption. The rebalancing strategy reduced total global demand for metals and other non-energy commodities, which ultimately lowered international non-energy commodity prices (Chart 1.11). Weaker demand for leading non-energy commodities from China, particularly during the first half of 2013, precipitated a 4.2% drop in the prices of metals in 2013. Nevertheless, in the second half of 2013, metal prices rebounded as conditions picked up in the manufacturing sector of advanced countries and emerging market countries, mainly China, driven by efforts to accumulate stock.

A different trend was evident in the prices of other leading non-energy commodities. The prices of agricultural produce used as inputs in the manufacturing sector increased 1.4% during 2013. Higher prices were more notable for agricultural products used as raw materials in industry, like cotton, wool, rubber, animal hide and processed wood. Conversely, the prices of foods and beverages generally declined due to over-supply of cereals, cooking oil (edible oil), coffee, tea and chocolate.

Concerning energy commodities, the price of oil in 2013 decreased by only 1.0% compared to the price in the previous year³. The decline in the price of oil was more pronounced in the first half of 2013 due to moderating demand as a consequence of the sluggish global economy and a smaller requirement for refineries during periods of maintenance. The drop in the oil price was also due to greater supply from non-OPEC countries, primarily oil

2 The declines in international non-energy commodity prices also indicate the end of the commodity price supercycle. The commodity supercycle began in the year 2000 as the economies of Brazil, Russia, India and China (otherwise known as BRIC), particularly China, took off. The prices of leading commodities skyrocketed in 2002-2003 and in 2006-2007, peaking during the first semester of 2008 just before the global crisis unfolded. Thereafter, international commodity prices reversed direction as the global economy slumped. The commodity supercycle is cited, among others, by Kaplinsky, R. (2010), "Asian Drivers, Commodities and the Terms of Trade" in M. Nissanke, & G. Movrotas, "Commodities, Governance and Economic Development Under Globalization", Chapter 6, Palgrave/Macmillan.

3 The oil price according to the International Monetary Fund (IMF) is the average price of West Texas Intermediate (WTI), UK Brent and Dubai Fateh.

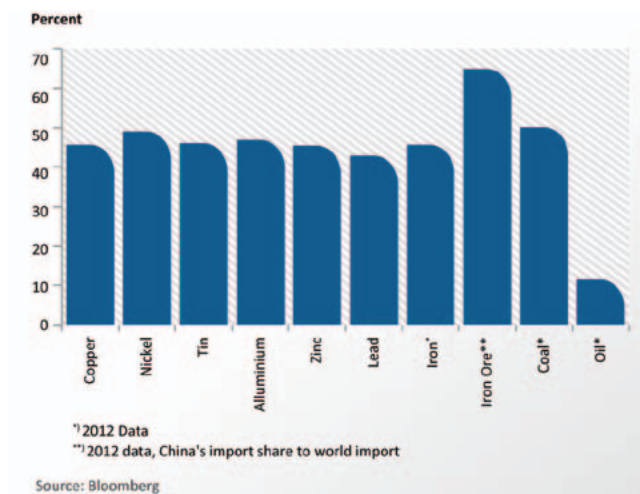


Chart 1.11. China's Metal and Energy Consumption Share to World Consumption

shale in the United States and oil sand in Canada. In the second half of 2013, however, the price of oil increased moderately as production lessened due to mounting geopolitical pressures in the Middle East as well as stronger demand for the driving season and destocking outside of the US. Notwithstanding, the price of oil tailed off again in the final quarter of the reporting year as production recovered in the Middle East, geopolitical tensions eased and the driving season came to an end (Chart 1.12).

A lacklustre global economy, coupled with tumbling international commodity prices, helped to lower the rate of global inflation in 2013. Global inflation during the reporting year of 2013 was just 2.9%, primarily due to persistently low inflation in advanced countries at just 1.4%, while inflation in emerging market countries was 6.1%. The rates of inflation recorded in the US and Japan were 1.5% respectively (Chart 1.13), which was below the corresponding targets of the Federal Reserve and the Bank of Japan at 2% each, although Japan has succeeded in exiting two decades of deflation. The monetary authority of the European Union (the European Central Bank) aired concerns about the current trend of deflation following the exceptionally weak demand. Meanwhile, inflationary pressures in emerging market countries remained intense due to a combination of solid economic growth, disruptions to supply and subsidised fuel hikes. The rate of inflation in Malaysia spiralled from 1.2% in 2012 to 4.1% in 2013, while inflation in India remained high at 9.1% in 2013 (Chart 1.14)⁴.

⁴ The rate of inflation in India is calculated based on the Consumer Price Index (CPI) of industrial workers.

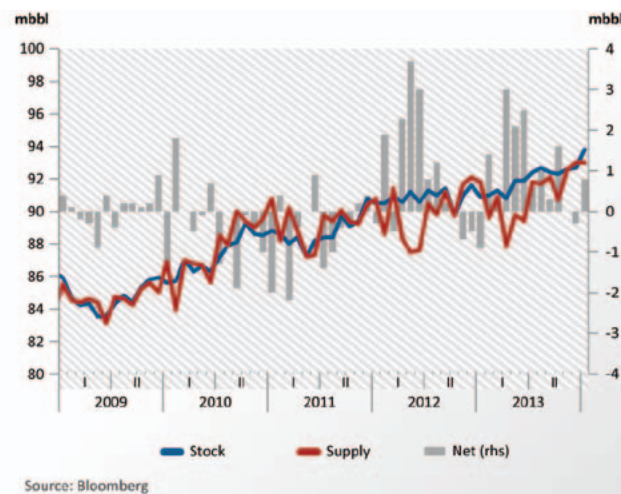


Chart 1.12. World Oil Supply and Demand

1.3. Global Financial Markets

Global financial markets in 2013 were overshadowed by ubiquitous uncertainty as international capital reversed from emerging market countries to advanced countries. Uncertainty was more evident in the first three quarters of 2013 triggered by the ambiguous economic outlook for Europe and the Fed's plan to normalize its monetary policy (see Box 1.2. The Impact of Quantitative Easing in the United States on the Global Economy). During that period, financial market performance, notably in emerging market countries, underperformed following capital reversal from the region (Chart 1.15). During the fourth quarter of 2013, however, financial markets rebounded on the back of asset prices increased in advanced countries' stock exchanges. Conversely, the composite indices of bourses in emerging market countries in Asia remained bearish due to continued negative sentiment pertaining to the Fed's plan to scale back its asset purchase program which prompted capital outflows (Chart 1.16). The continued negative sentiment following the Fed's tapering off policy was also evident in bond markets. The yields of bonds in the majority of countries increased, including 10-year United States Treasury (UST) Bills, as global investors risk appetite shrank (risk-off) and favouring cash holdings.

Uncertainty on global financial markets was also manifested in the performance of capital market. In the first half of 2013, global capital market performance deteriorated due to negative sentiment concerning the downgraded sovereign credit rating of the United Kingdom, the crisis in Cyprus, concerns over the election in Italy, failure to reach a compromise on the debt ceiling along with automatic spending

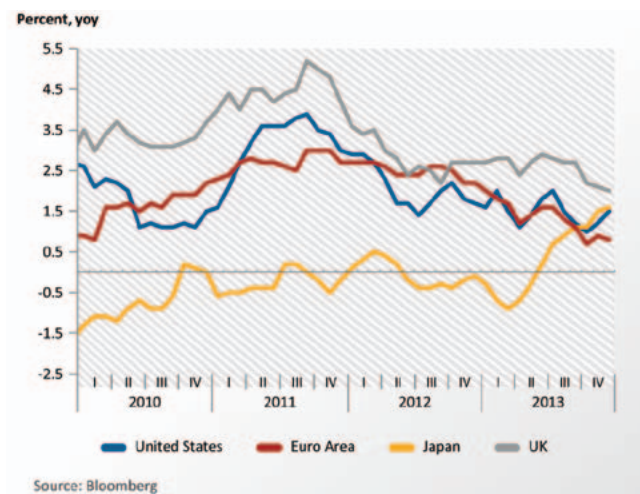


Chart 1.13. Advanced Economies Inflation

cuts (sequestration) in the US as well as speculation regarding the Fed's tapering off policy. Weaker performance was obvious in Europe through stock exchange losses, a wider yield spread of government bonds and an increase in sovereign Credit Default Swaps (CDS) in the region. In Asia, weaker performance was marked by corrections on stock exchanges as indicated by the decline in the Morgan Stanley Composite Index (MSCI) of emerging market countries in Asia, the increase in sovereign credit default swaps and the Emerging Markets Bond Index Global (EMBIG), as well as a weaker regional currency index (Asia Dollar Index) to the US dollar.

Capital market performance did improve in the second half of the year, despite an overall decline. Improvements

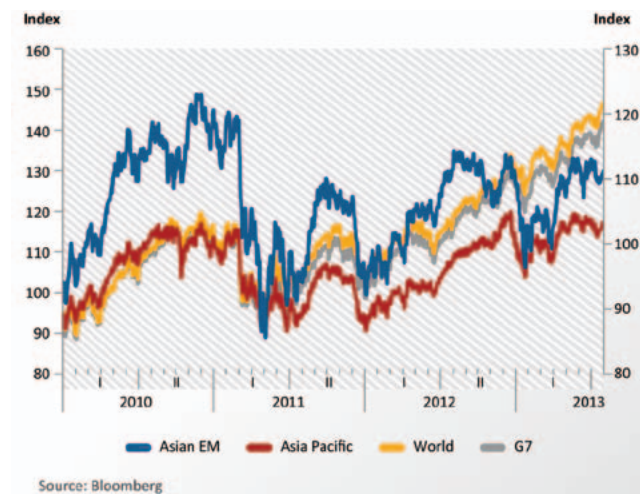


Chart 1.15. Global Stock Price Index

emerged at the beginning of the second half of 2013 in the form of positive sentiment regarding quantitative easing (QE) policy instituted by the BoJ, crisis resolution in Cyprus, Ben Bernanke's statement delaying the tapering off its monetary stimuli as well as commitment from the ECB to maintain the interest rate at a low level. Notwithstanding, global stock exchanges suffered severe corrections again in the wake of new global economic data released that was below previous projections as well as a lack of explanation regarding the structural reforms under the Abenomics program. Improved conditions on the labour market and the expected tenacity of the economic recovery in the US failed to elicit a positive response from market participants, subdued by the Federal Reserve's plan to taper off monetary stimuli, which aroused concerns of less global

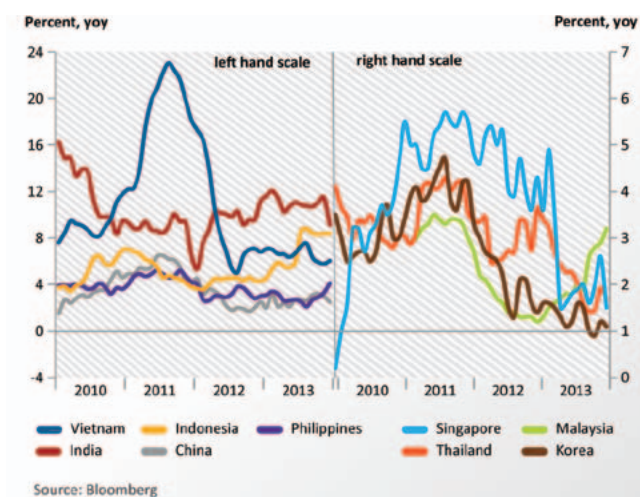


Chart 1.14. Inflation in Asian Emerging Market

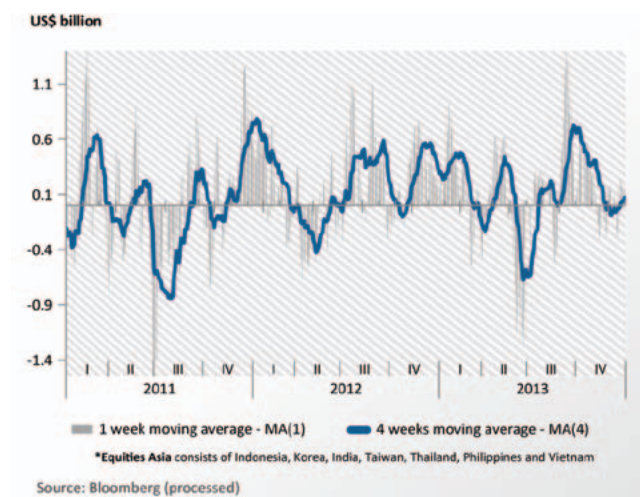


Chart 1.16. Foreign Capital Net Flows to Asian Emerging Markets

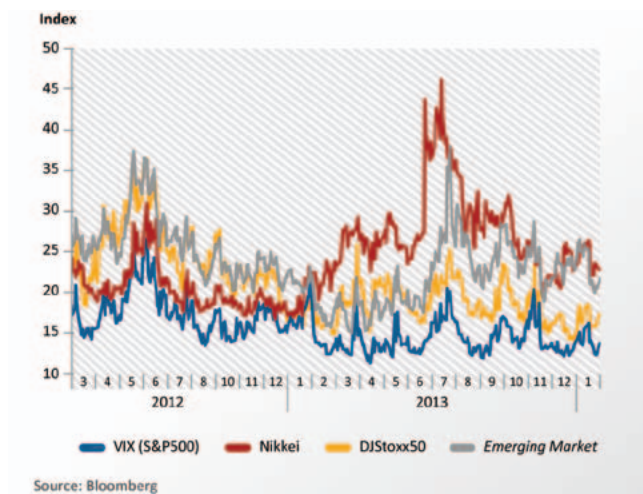


Chart 1.17. Financial Market Volatility

liquidity looking ahead. Risk on global financial markets mounted, evidenced by greater volatility along with deep corrections in the Nikkei index, on stock exchanges in emerging market countries of Asia, in Europe (DJ Stoxx 50) and in the United States (VIX) (Chart 1.17). Deep corrections on various bourses were precipitated by speculation linked to the Fed's tapering off policy, thereby triggering sell off by international investors on the emerging countries' financial markets. This action, in turn, placed additional depreciatory pressures on currencies of emerging market countries in Asia (Asia Dollar Index) including Indonesia.

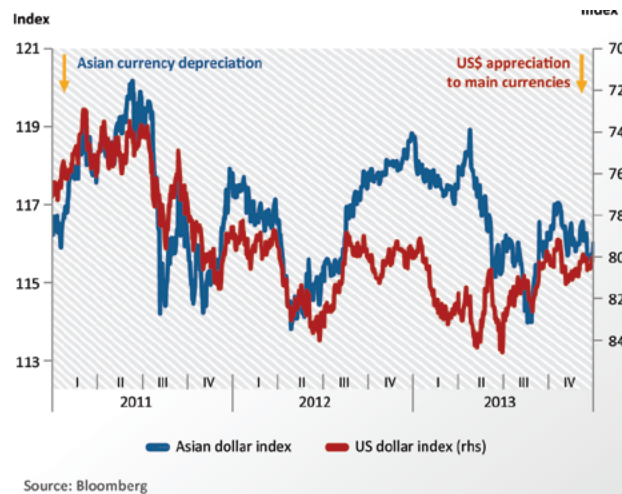


Chart 1.18. US Dollar Index and Asian Dollar Index

Pressures on financial markets in Asia subsided towards the end of 2013, as the manufacturing sector in China improved and subsequently set a better footing for global stock exchanges. Furthermore, financial markets in the Asian region rallied as indicated by the region's bourses which recorded net inflows from non-residents and the yield spread of bonds from emerging market countries and US Treasury Bills narrowed as the partial shutdown of the US Government came to an end. This more favourable backdrop provided sufficient impetus for currencies in the Asian region to strengthen against the US dollar albeit with heightened volatility at year end of 2013 (Chart 1.18).

Box 1.1.

The Impact of Changes in the Global Economic Landscape

The year of 2013 was marked by a distinct change in the global economic landscape, signified by stronger economic growth in advanced countries coupled with weaker economic growth in emerging market countries that had previously acted as the leading drivers of the global economy. Despite hitherto not reaching its normal trajectory, economic growth in advanced countries is picking up. Accelerating economic expansion in advanced countries is primarily driven by a stronger recovery in the US that has persisted since the first quarter of 2013. In contrast, emerging market countries have experienced economic downturns amid signals of economic recovery in advanced economies. The deceleration in terms of economic growth in emerging market countries was predominantly attributable to a slowdown in China.

The change in the global economic setting has had a spillover effect on other economies through the trade channel. As the global economy is now becoming increasingly integrated, the dynamics found in one country are progressively impacting upon other countries, directly and indirectly. Consequently, the dynamics of the global economy, especially the US and China, are spilling over to the domestic economy of Indonesia through the trade channel, among others.

The spillover effect on trade of a particular country, however, depends on the characteristics of the leading commodities traded by the said country. More solid



Chart 2. Indonesia's Export Growth

growth in the US and the slowdown in China are affecting the export performance of their leading trade partners. For example, in the aftermath of the global financial crisis, Singapore suffered a decline in export performance in harmony with torpid domestic demand from the United States (Chart 1). Meanwhile, growth in emerging market countries, driven by China, will affect export performance in countries which rely heavily on commodity exports such as Indonesia (Chart 2).

In relation to the change in the global economic constellation, stronger domestic demand in the US will bolster demand for exports from Indonesia to the

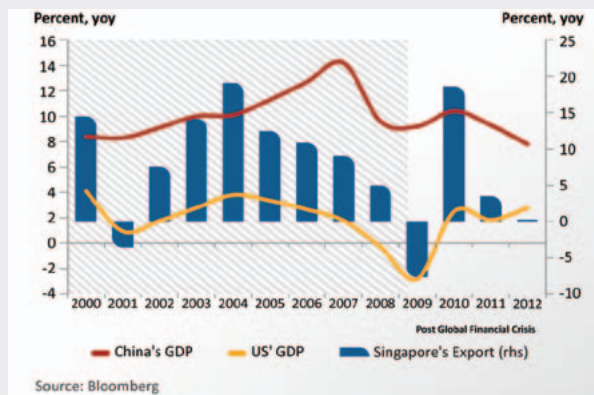


Chart 1. Singapore's Export Growth

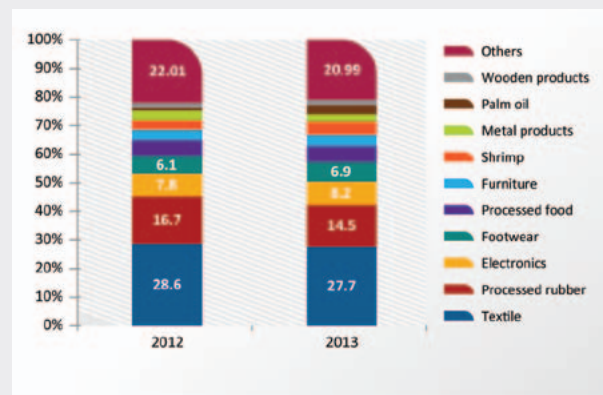


Chart 3. Composition of Indonesia Export to US

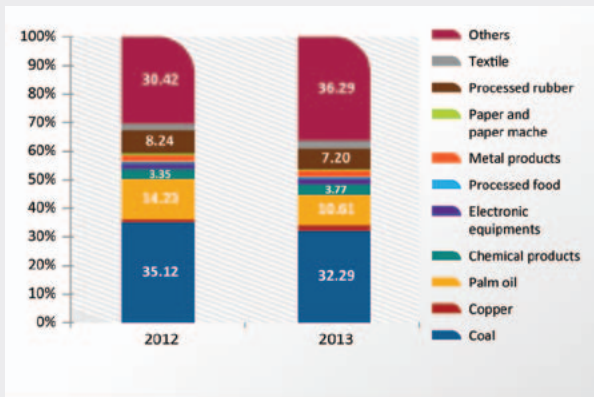


Chart 4. Composition of Indonesia's Export to China

US. Exports of a number of leading commodities to the US, like textiles, processed rubber, electronics and footwear are expected to surge (Chart 3). Meanwhile, the impact of the slowdown in China will be followed by moderating demand from China for primary goods exported from Indonesia like coal, palm oil and processed rubber (Chart 4).

Box 1.2. The Impact of Quantitative Easing in the United States on the Global Economy

In the wake of the global financial crisis 2008, emerging market countries benefited from a deluge of foreign capital inflows as a result of quantitative easing (QE) policy¹. The downturn suffered by the US economy following the global financial crisis compelled the US Government to apply unconventional expansionary monetary policy. In general, the goal of quantitative easing is to bring down interest rates, as reflected in the yield of United States Treasury (UST) Bonds, which is ultimately expected to stimulate the domestic economy. Quantitative easing is exercised by purchasing long-term financial assets like mortgage-backed securities (MBS), bank debt and United States Treasury (UST) Bonds.

Thus far, three periods of quantitative easing and one period of Operation Twist have played out with the amount of long-term financial assets purchased varying between the different periods (Table 1). The policy led to a greater availability of liquidity on global financial markets which subsequently inundated emerging market countries due to the better economic fundamentals found in such countries, coupled with higher yields available in emerging market countries compared to advanced countries.

As the US economy gradually improved, the US Government planned to unwind its quantitative easing measures. The economic improvement buoyed by the economic stimuli had begun to bear fruit, which was reflected by a number of US macroeconomic variables. Consequently, the US economy beat a path towards recovery from the first quarter of 2013 until the plan to taper the Fed's quantitative easing policy coined in the second quarter of the same year. On the other hand, unemployment also followed a downward trend, closing in on the 7% target required to initiate the tapering policy (Chart 1). The tapering off policy will end of the easy money era and potentially trigger another torrent of capital inflows to emerging market countries, including Indonesia. Such a correction in the international flow of funds could spark additional pressures on domestic financial markets.

Global financial markets appeared to over-react to the issue of tapering. The increase in yield of US Treasury Bonds during the third period of quantitative easing while the US economy did recovered was a clear evidence of an over-reaction by global financial markets². The increased of US Treasury Bonds' yield

Table 1. US Quantitative Easing Period

Policy	Period	US Government Action
Quantitative Easing 1	December 2008 to March 2010	Started with the purchase of US\$600 billion Mortgage Backed Securities, the impact of QE-1 peaked at June 2010 when the Fed held US\$2.1 trillion of bank debt, MBS and US treasury.
Quantitative Easing 2	November 2010 to June 2011	Purchase of US\$600 billion UST Bond.
Operating Twist	September 2011 to August 2012	Purchase of US\$400 billion long term bond (6 to 30 years) and sale of overdue short term bond (< 3 years). On June 2013, a plan to add purchase on long term bond, worth US\$267 billion, was announced.
Quantitative Easing 3	Starting September 2012	Purchase of US\$40 billion of MBS per month until the labor market improved. On December 2012, The Fed announced an addition to the QE3, to become US\$83 million per month and US\$45 million of US Treasury Bond.

Source: The Federal Reserve

¹ Quantitative easing (QE) is unconventional monetary policy implemented by a central bank to stimulate the economy when standard monetary policy is ineffective.

² Historically, the yield of United State Treasury Bonds experienced a decline in the periods after QE1 and QE2.

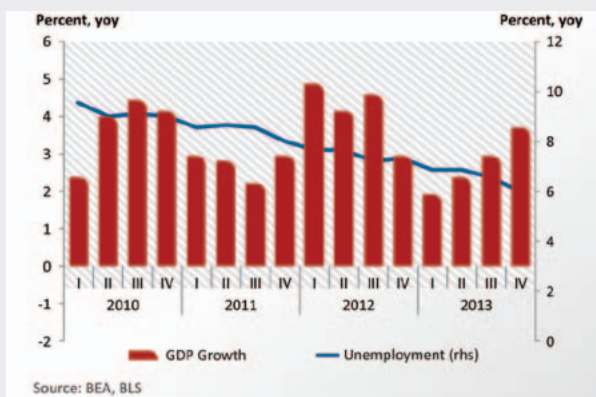


Chart 1. US Macroeconomic Development

put a greater concerns among financial market players on the possible capital reversal in the midst favourable global financial markets. Such concerns were raised following the widening spread between the US interest rate and those in emerging market countries after the issue of tapering off policy was coined (Chart 2). The market over-reaction indicated that they were inclined to ignore the propitious growth achieved in emerging market countries over the past ten years. As a matter of fact, emerging market countries did enjoyed much stronger growth than advanced countries in the wake of the global financial crisis. Moreover, in its report, the International Monetary Fund (IMF) also stated that over the past decade, economic growth in emerging market countries has outpaced that posted in more developed countries³. Such conditions demonstrated that emerging market countries have enjoyed greater resilience to external shocks than their more advanced counterparts.

The impact of possible tapering off policy was quite varied, depending upon domestic economic fundamentals in emerging market countries, including the position of the current account and the management of capital flows. Capital outflows from emerging market countries affected exchange rates and yields of government bonds in those countries. Since the announcement of the plan to unwind monetary stimuli by the Federal Reserve took place in May 2013, the majority of currencies of emerging market countries, including Indonesia, experienced

³ "The Rising Resilience of Emerging Market and Developing Economies", IMF working paper, December 2012.

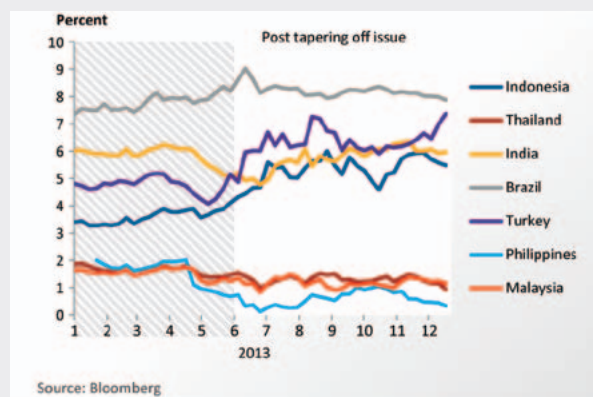


Chart 2. US and EM Government Bond Interest Spread (10 years maturity) in 2013

depreciatory pressures. The rupiah and rupee were more sensitive compared to the ringgit and the baht. Accordingly, the rupiah and rupee experienced intense depreciation, while the ringgit and baht only suffered moderate depreciation.

The unpredictable impact of tapering off policy on emerging market countries related to varied economic fundamentals among those countries. Indonesia and India experienced a wider current account deficit which then put a more intense pressures on their exchange rates, while the current accounts of Malaysia and Thailand were sounder. The importance of current account position was confirmed by the easing of pressures on the rupee in the third quarter of 2013 as India's deficit narrowed. In terms of capital flows management, India, Malaysia and Thailand applied tighter capital flow management compared to Indonesia⁴, which in turn successfully suppressed excessive exchange rate volatility.

On top of exacerbating pressures on the currencies of emerging market countries, the issue of tapering also drove up the yield of government bonds. The yield of government bonds in India experienced the most pronounced increase compare to that recorded in Indonesia, Malaysia and Thailand (Chart 3).

Although the issue of tapering off policy will continue to influence capital outflows from Indonesia in

⁴ AREAER (Annual Report on Exchange Arrangements and Exchange Restrictions), IMF, 2010, stated that Indonesia is a country with the lowest capital control index along with Singapore and South Korea.

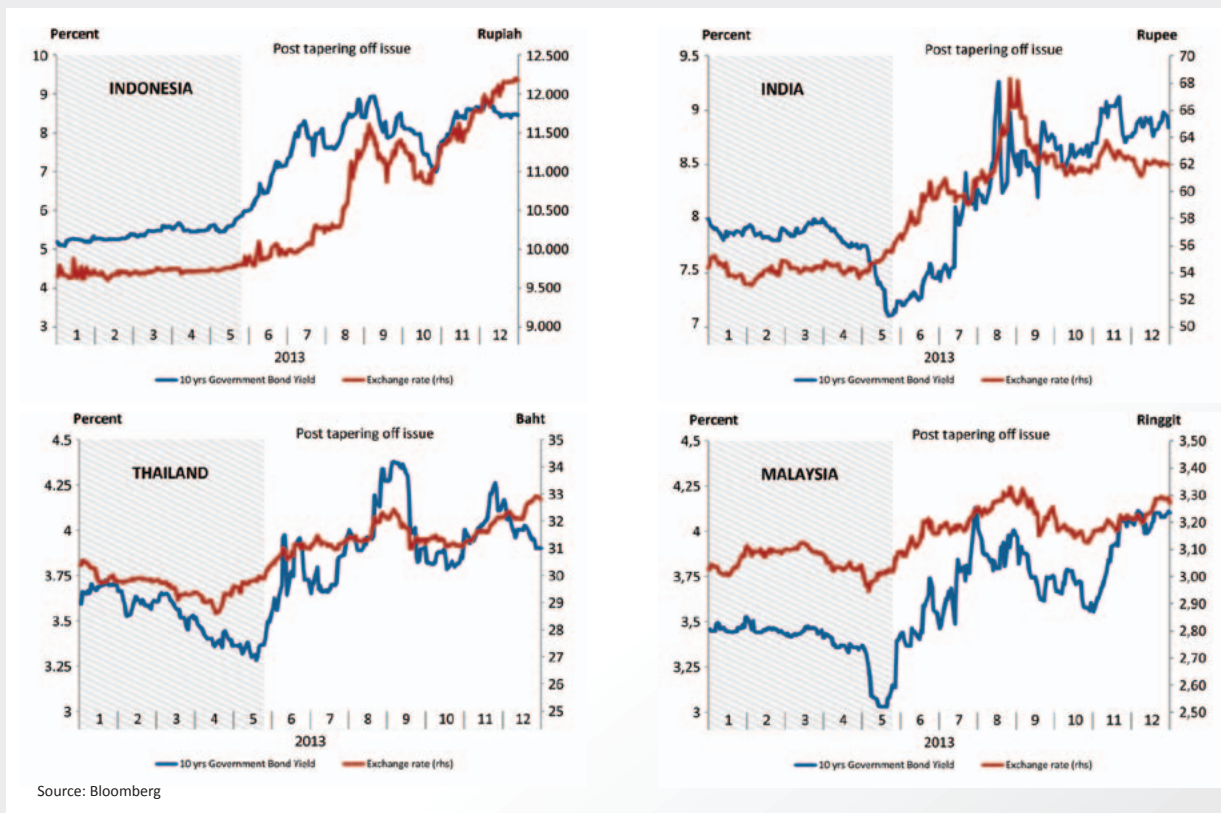


Chart 3. Emerging Markets' Exchange Rate and 10 years Government Bond Yield

2014, the impact will be less prominent than that in 2013. In the near term, the increase in the yield of US Treasury Bonds with a maturity of 10 years (UST Bond 10Y) will be followed by a rising VIX index⁵ and a correction in non-resident holdings of rupiah assets. Following a stronger sentiment regarding the tapering off policy between May and August 2013, the yield of 10-year US Treasury Bonds jumped 111 bps, accompanied by a US\$ 5.2 billion correction in non-resident holdings of rupiah assets. Nevertheless, total capital outflows are expected to be less distinct in 2014 compared to 2013 when outflows were not merely attributable to the shock of tapering off related issues but also due to a domestic shock in the form of fuel price hikes.

In the medium term, an upward trend of the yield of US Treasury Bonds will favourably boost the risk-on behaviour. If the increase in yield of US Treasury Bonds coincides with a further global economic recovery, it will reduce the risk factor and bolster the risk appetite of investors towards financial assets in Asia, including Indonesia. Historically, an uptrending yield of US Treasury Bonds has indicated that the US economy is experiencing an expansionary phase. This will trigger a correction in the VIX index that will be followed by a surge of global investor funds flowing into emerging market countries. On domestic financial markets, a lower VIX index closely correlates to an influx of non-resident funds to rupiah assets like government bonds (SUN) and shares.

⁵ The VIX index is a measure of market expectations of stock market volatility for the upcoming 30 days.



Global Economic Policy Response

An array of policies has been instituted in response to the ubiquitous uncertainty pervading the global economy. Advanced countries continued to implement accommodative policy, despite the Federal Reserve's initial plan to taper off monetary stimuli. Meanwhile, the policies of emerging market countries tended to vary. China had introduced a policy mix to tighten monetary conditions and launched a mini stimulus package along with structural reforms. The range of policies taken was also supported by efforts to strengthen international cooperation.

The contrasting policies applied in advanced and emerging market countries were in response to escalating uncertainty that overshadows the global economy. The response from advanced countries was directed towards garnering recovery momentum in the wake of the global financial crisis in 2008. Conversely, the policy response taken in emerging market countries was to manage and alleviate mounting economic pressures on the back of the shift in the global economic landscape, the downward spiral of international commodity prices and capital reversal from emerging market countries to advanced countries.

In broad terms, the economic policies implemented in advanced countries were expansionary. The Government of the US continued its policy of providing stimuli by keeping the policy rate close to zero percent and maintaining its quantitative easing policy. Furthermore, in harmony with signs of improvement in macroeconomic indicators, on top of fiscal consolidation measures, the Federal Reserve of the US announced its plans to cutback monetary stimuli subject to certain economic criteria as a form of forward guidance. On the other hand, Japan launched a fiscal and monetary stimulus package known as *Abenomics*. Likewise, authorities in Europe adopted a loose monetary policy stance in order to catalyse the floundering economy. In addition to expansive monetary policy, governments in Europe also agreed to relax fiscal consolidation to bolster economic growth during the recession.

Among the group of emerging market countries, the policy response was fairly diverse depending upon prevailing domestic conditions in each respective country. China introduced a policy mix with a tight-bias monetary policy to curb overheating in the property sector combined with a mini stimulus package in the public and infrastructure sectors in response to the ailing economy. China also announced plans for structural reforms in a number of sectors to expedite its rebalancing strategy towards domestic sustainable economic growth based on domestic demand. Meanwhile, a number of other emerging market countries started to tighten their monetary policy stance in order to counter mounting inflationary pressures, burgeoning current account deficits, a surge in capital outflows and exchange rate depreciation. A torrent of capital outflows and exchange rate depreciation were attributed to the over-reaction of investors concerning uncertainty surrounding the Federal Reserve's plan to taper off monetary stimuli, which subsequently undermined financial market performance in emerging market countries. In addition to the near-term response taken to ease inflationary pressures, emerging market

countries like Brazil, India and Indonesia also implemented structural measures to reinforce economic resilience.

The wide range of policy responses adopted in countries around the world was also reinforced by greater international cooperation through a number of international forums. The sluggish global economic recovery, coupled with escalating risk in several emerging market countries, awakened the world to the fact that rebalancing economic growth cannot merely rely on efforts taken in emerging market countries. To this end, the G20 and International Monetary Fund (IMF) agreed to persevere with structural reforms and policy coordination as well as to expedite the realisation of policy commitments. A relatively similar policy direction was adopted on a regional scale, which was necessary considering that stronger domestic demand, if not offset by structural reforms, would exacerbate economic risk in the medium term. On the other hand, growing risk and uncertainty along with global economic imbalances compelled authorities in the region to cement cooperation through a stronger and more refined financial safety net.

2.1. Policy in Advanced Countries

The policies implemented by advanced countries in 2013, in general, remained accommodative in response to decelerating economies. Accommodative monetary policy involved purchasing securities by central banks, a process known as quantitative easing, which was a continuation of policy already implemented for a number of years. Moreover, the policy was underpinned by low policy rates (Chart 2.1). Japan even included qualitative and quantitative easing in its policy program known as *Abenomics*. On the fiscal side, policy in advanced countries remained consolidative during the reporting year in order to ensure long-term fiscal sustainability.

The US Government persisted with stimulus policy implemented in previous years in order to shore up the protracted domestic economic recovery. The Federal Reserve maintained a very low policy rate approaching zero percent at 0.25% per annum. In addition, the Federal Reserve also persisted with its policy of quantitative easing in the form of purchasing securities to the tune of US\$ 85 billion per month. The US Government also continued its policy of fiscal consolidation by raising taxes and implementing automatic spending cuts, or budget sequestration, as announced in the Budget Control Act of 2011 in order to ensure sustainable economic growth in the medium term. Fiscal consolidation was unavoidable as

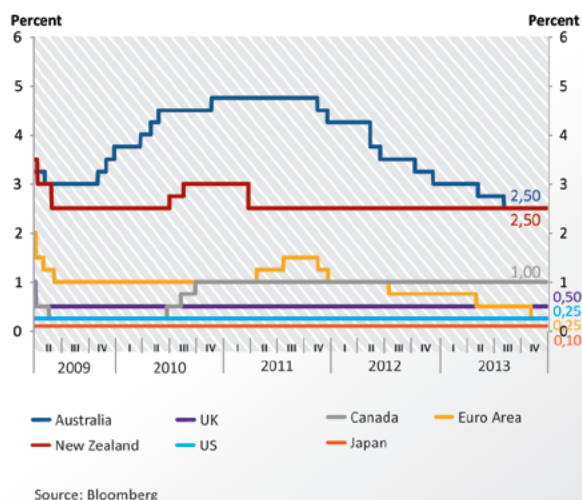


Chart 2.1. Advanced Economies' Policy Rate

it helped to reduce the government sector's contribution to US GDP. Nonetheless, agreement to relax fiscal consolidation at the end of 2013 by US\$60 billion for two consecutive years was expected to restore the fiscal role in the US economy looking ahead.

Corresponding to the improvements in US economic activity, the Federal Reserve announced its plan to expedite the tapering off policy. In order to dampen market reaction over fears of less liquidity on financial markets, the Federal Reserve also provided a forward guidance regarding the timing and magnitude of the tapering process. The forward guidance included the level of unemployment and rate of inflation, which were already approaching the targets set by the Federal Reserve. As macroeconomic indicators improved, through the Federal Open Market Committee (FOMC), the Federal Reserve announced in December 2013 its plan to reduce purchases of securities by US\$10 billion commencing in January 2014. Nevertheless, the Federal Reserve also emphasised that it would maintain a very low policy rate over a longer period of time.

In stark contrast to measures introduced by the Federal Reserve in the US, authorities in Europe actually expanded their accommodative monetary policy to stimulate economic growth. In addition to holding interest rates extremely low, the European Central Bank (ECB) also persisted with quantitative easing in the form of purchasing securities through a program of outright monetary transactions (OMT), for which the total and time period were yet to be determined. The OMT program helped lower borrowing costs (yield) in a number of significantly indebted countries.

The ECB also lowered interest rates in response to further economic deterioration. The ECB slashed its policy rate twice in order to catalyse an economic recovery in Europe. The ECB first cut its policy rate by 25 bps to 0.5% in May 2013 in response to the economic recession that had already endured for six consecutive quarters. In addition to the policy rate cut, the ECB also committed to provide a range of other policies required to reverse lacklustre economic activity. The Governor of the ECB, Mario Draghi, even stated that technically the ECB was ready to apply a negative deposit rate to help alleviate the credit squeeze by encouraging banks, especially in periphery countries, to extend credit to individual and business consumers. The second policy rate cut was implemented by the ECB at the beginning of November 2013 by lowering the refinancing rate 25 bps to 0.25%. This policy response was taken in order to ease concerns that Europe would experience stagnation and deflation.

The policy to lower interest rates was further bolstered by the ECB commitment to prop up the economic recovery, which had stalled on numerous occasions. Such commitment was similar to the forward guidance offered by the Federal Reserve. As a notable example, the yield of 10-year bonds in Portugal and Greece jumped to 8% at the beginning of July 2013, in the midst of their efforts to meet the bailout target set up by the European Union (EU) and International Monetary Fund (IMF). However, both countries could bring down the yield to 7%. Apart from the exceptional efforts of the two countries to meet the bailout target, their achievement to bring the yield down was also attributable to the role of the ECB who clearly stated its commitment to maintain its policy rate at 0.5% or lower for an extended period. Commitment towards a low policy rate was presumably one supporting factor that prompted increased activity in the manufacturing sector of Germany in response to demand from the automotive industry and construction.

In addition to the ECB, finance ministers in Europe also took corrective actions to spur the economic recovery. In relation to the banking crisis in Cyprus, finance ministers in Europe agreed to provide a bailout program on March 25th 2013. A bailout totalling 10 billion euros was provided to the banking sector while at the same time required lenders and account owners with more than 100 thousand Euros to bail-in, thereby preventing contagion from the crisis in Cyprus propagating across Europe. The Cyprus bank crisis resolution scheme was agreed by finance ministers in Europe at the end of June 2013 as a way to settle future bank bankruptcies. Finance ministers from Europe also agreed to relax fiscal consolidation for one or two years in six countries including France, Spain and the Netherlands. This

response was taken in order to better stimulate economic growth in a number of recession-struck countries in Europe.

The variety of responses taken by European authorities thus far contributed favourably to economic growth in the region. On a quarterly basis, economic growth in Europe from the second until the fourth quarter of 2013 remained at a positive trajectory (0.3%, 0.1% and 0.3% in each quarter respectively), although for the full year the growth was still negative 0.4% compared to that posted in 2012. Looking ahead, countries in Europe still require structural policy in order to provide a solid basis for economic recovery, especially relating to fiscal consolidation, bank restructuring, and resolution on credit squeeze problem..

In Japan, Prime Minister Shinjo Abe launched a stimulus package that came to be known as *Abenomics*. That policy spurred optimism amid a sluggish and protracted economic recovery in the aftermath of the global financial crisis, the earthquake and tsunami in Japan, and the flooding in Thailand as one of Japan's production hubs¹. The *Abenomics* program covered fiscal stimuli for public facility projects, disaster recovery programs, as well as project to support small and medium enterprises (SMEs). An ultra-loose monetary policy stance was also adopted in order to combat deflation that had persisted for two decades and achieve the inflation target of 2%. In this context, the Bank of Japan (BOJ) planned to expand base money. Nonetheless, a comprehensive structural reform to boost private investment remained partially deliberated by the Shinjo Abe Government.

In addition to the aforementioned policies, Japan also planned to undertake fiscal consolidation in April 2014 in the form of hiking the sales tax from 5% to 8% in line with signs of an economic recovery buoyed by improved export performance and solid consumption. Furthermore, in anticipation of the proposed sales tax increase, the government decided to add a 5 trillion yen (or US\$51 billion) fiscal stimulus to spur investment in the corporate sector. The BOJ also emphasised that no additional monetary stimuli, excluding those already in the pipeline, would be launched. Although, in general, *Abenomics* has succeeded in catalysing an economic recovery, the policy was constrained in terms of achieving its longer-term targets of raising capital spending in the corporate sector and raising wages.

1 The flooding in Thailand at the end of 2011 affected no less than 320 Japanese businesses, primarily in the automotive and electronics sectors. Refer to <http://www.yomiuri.co.jp/dy/business/T111017004860.htm>, as well as Haraguchi and Lall (2013), "Flood Risks and Impacts: Future Research Questions and Implication to Private Investment Decision-Making for Supply Chain Networks", Global Assessment Report on Disaster Risk Reduction, UNISDR.

2.2. Policy in Emerging Market Countries

The policies adopted in emerging market countries were directed towards controlling mounting economic pressures albeit with different magnitude and timing. The main policy responses taken were to maintain economic stability and sustain long-term economic growth. Some countries responded to weaker economic activities by lowering interest rates. Other countries, however, tightened their monetary policy stance in the face of escalating inflationary pressures along with exchange rate depreciation. Furthermore, emerging market countries also implemented more fundamental approach by structural economic reforms.

China, as an emerging market country, responded to the global economic downturn through the introduction of a "mini stimulus" policy package in the public sector and infrastructure, which was accompanied by more holistic structural reforms amid a tight-bias monetary policy setting. Structural reforms were implemented in a number of economic sectors in order to help smooth the economic rebalancing process towards a more domestic demand driven economic model (Table 2.1).

Notwithstanding, the People's Bank of China (PBOC) had also tightened monetary conditions since 2010 in response to a property price bubble and credit boom, which propagated the practice of shadow banking in the wake of large-scale stimuli after contractive pressures emerged stemming from the 2008 global crisis. The tighter monetary policy stance, however, led to an unfolded credit squeeze in the middle of June 2013, as indicated by the upsurge of overnight interbank rate which peak at 13% before returning to 8.5%. The 7-day interbank repo rate also skyrocketed to 25% before falling sharply the following day. Tighter credit caused widespread panic and triggered a 0.5% correction on the indices of the Shanghai and Hong Kong stock exchanges over the weekend, thereby forcing the PBOC to inject 17 billion yuan (US\$ 2.7 billion) at the end of July 2013. In addition, PBOC liberalised lending rates at the end of October 2013 while still maintained the deposit rate ceiling. Such policy was part of the country structural reforms agenda and aimed at reducing shadow banking practices (Table 2.1)².

India also introduced structural reforms in the real sector and financial sector on top of the policy rate. The structural reforms aimed to mitigate economic risks relating to rising inflationary pressures, a burgeoning

2 The People's Bank of China (PBOC) determines bank lending and deposit rates. In 2013, lending rates started to be liberalized in harmony with market mechanisms.

Table 2.1. China's Structural Reform Plan (3rd Planum 2013)

Plan	Implications
1. Financial and Banking Reform	
<ul style="list-style-type: none"> - Yuan convertibility acceleration (including RMB Internationalization) and interest rate liberalization. - Bond market development - Opening opportunities in the banking sectors to private institutions. - Setting up free trade zone in several areas 	<ul style="list-style-type: none"> - China's financial market are more open, which facilitates financial transactions and boost export competitiveness - Liberalizing interest rate to reduce shadow banking, have more competitive banking and efficient savings allocation. - Having private players in the banking sector promotes competition and quality in the financial service industry (which the SOEs are currently dominating). - Encourage a flow of production factors and accelerating infrastructure
2. Tax and Fiscal Reform	
<ul style="list-style-type: none"> - Allowing state government to expand financing channels (including bond issuance) for construction projects. - Tax reform 	<ul style="list-style-type: none"> - A more sustainable fiscal condition for regional government as well as reducing shadow banking. - A sustainable infrastructure development in China's provinces - Impose progressive tax, including bigger tax in state-owned corporate's dividends used for safety net, including insurance, to boost consumption.
3. Citizenship Reform	
<ul style="list-style-type: none"> - Easing off the one-child policy - Accelerating the hukou reform hukou (citizenship system, reform = less barrier) 	<ul style="list-style-type: none"> - Raise consumption by increasing population and slowing down the decrease in China's labor (therefore withholding wage raise (wage > productivity) and increase utility capacity) - Hukou reform promotes urbanization and labor transfer as well as raise income (urban income > rural)
4. SOE Reform	
<ul style="list-style-type: none"> - 30% of state asset dividend payment are submitted to the state - Reorganizing SOEs, and transforming them into state-owned asset investment companies - Publishing IPO, allowing private companies to take part in government projects 	<ul style="list-style-type: none"> - Increased portion to fund social welfare (a sustained infrastructure development in China's provinces) - A bigger role played by the private sector in China's economy - Reduce monopoly as well as increas SOE efficiency and good corporate governance.

Source: Bloomberg and various sources (processed)

current account deficit and rupee depreciation. In the real sector, the policy undertaken by the Government of India encompassed raising taxes on imported goods and limiting imports of gold and electronic goods, as well as reducing fuel subsidies.

In the financial sector, the Government and Reserve Bank of India (RBI) instituted a policy to stabilise the exchange rate. Moreover, the Government of India launched a policy to manage the outflow of capital by corporations and individuals, refine regulations on foreign direct investment (FDI) in the retail sector and strived to improve the supply of foreign exchange. Meanwhile, the RBI lowered the upper limit on foreign investment by residents from 400% of net worth to 100%, excluding state-owned enterprises in the oil industry and those with special consideration. The RBI also increased the foreign exchange liquidity on financial markets through a set of short-term lending rate instruments, relaxing regulations on foreign debt, raising the limit on bank loans from 50% to 100% of unimpaired tier 1 capital and mobilising the foreign exchange deposits of non-residents through a three-year foreign exchange

swap facility (FX swap). The policy response adopted also included the planned to establish a state-owned enterprise to borrow foreign exchange totalling US\$11 billion in order to boost the supply of foreign exchange on financial markets in India.

Brazil, Indonesia and India are all emerging market countries that adopted a tight monetary policy stance in response to mounting inflationary pressures and a widening current account deficit. Brazil and Indonesia were the two countries that raised their policy rate most frequently during 2013, totalling six and five times respectively (Chart 2.2). Meanwhile, India adopted a tight policy stance at the end of the reporting year after implementing loose monetary policy at the beginning of the year. A contrasting policy direction was also followed in Thailand, Turkey and South Korea, where the policy rate was lowered during 2013. Turkey lowered its policy rate as many as four times in the reporting period, while maintained a tight monetary policy stance through imposing a higher reserve requirement ratio (RR). In addition to interest rate policy, several countries also

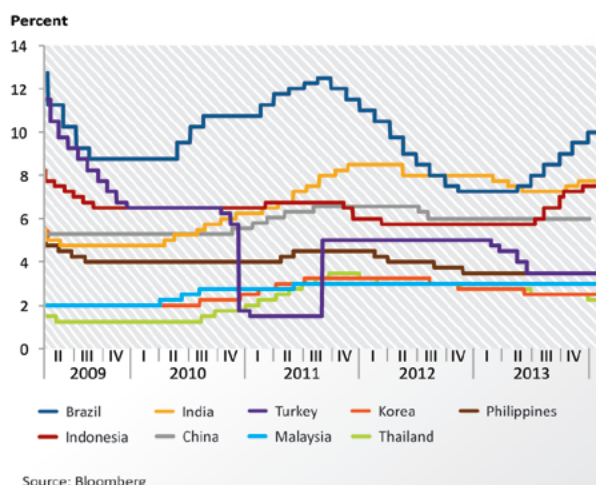


Chart 2.2. Emerging Markets' Policy Rate

implemented different policies through a policy mix and/or macroprudential policy in response to economic pressures that intensified in 2013 (see Box 2.1. Macroeconomic Performance and the Policy Response of Countries running a Current Account Deficit).

2.3. International Cooperation

The policy response taken in each respective country was also accompanied by strengthening international cooperation. International cooperation was strengthened in response to the protracted global economic recovery along with growing risk in a number of emerging market countries. The sluggish global economic recovery was attributable to several factors, such as policy uncertainty, deleveraging in the private sector, suboptimal bank intermediation, the imperfect global rebalancing process as well as widespread uncertainty in advanced countries following their fiscal consolidation process. In addition, the issues of fiscal sustainability and financial stability were also a challenge in the medium term, especially for advanced countries. Ultimately, such conditions roused awareness among countries regarding the crucial role of structural reforms and international policy coordination.

Through international cooperation, the world realised that the process of rebalancing economic growth cannot only be achieved by emerging market countries alone. Since the global financial crisis in 2008, emerging market countries have been the drivers of the global economy, however, their resilience is now starting to be questioned.

In response, the focus of discussions at international cooperation forums during 2013 was directed towards efforts to expedite economic recovery, ensure economic and financial stability, achieve fiscal sustainability in advanced countries, reinforce the resilience of emerging countries, and resolve uncertainty as well as financial market imbalances as a result of tapering quantitative easing (QE).

Recognising the aforementioned issues, the G20 and IMF agreed to continue structural reforms and policy coordination as well as advance the realisation of policy commitments. In this regards, G20 member countries set a number of priority measures. The first was to expand the potential for growth and create employment opportunities by continuously strengthening the foundations of long-term growth. Second was to avoid domestic policies that undermine other countries. Third was to formulate a credible medium-term fiscal target. Fourth was to improve global economic surveillance and fifth was to enhance macrofinancial analysis and policy advice.

Members of the G20 also committed to refrain from competitive depreciation policy and rebuff all forms of protectionism. This commitment was taken in response to the adverse effects of loose monetary policy that could lead to a currency war. Therefore, exchange rate policy should not be aimed towards boosting export competitiveness. In other words, monetary policy should be aimed more at achieving price stability and domestic economic recovery.

International cooperation forums, both multilateral and regional, also paid attention to the issue of spillover from the quantitative easing exit policy in advanced countries to emerging market countries. Agreement was reached through such economic forums that to minimise the possibility of negative spillover, the exit policy of monetary easing in advanced countries must be accompanied by prudent management and communication. Consequently, clear communication pertaining to the direction of central banking policy as a form of forward guidance deemed critical.

Concerning financial sector reform, the G20 forum agreed to monitor and assess the impact of reforming financial sector regulations on financial system resilience, stability and economic growth. Financial system resilience and stability must be maintained through the establishment of sound financial institutions as well as by strengthening supervision and regulating of shadow banking. A number of measures to establish sound financial institutions and quell the idea of too-big-to-fail are now being

implemented consistently through Basel III pursuant to the schedule and recommendations under the Basel III framework on “leverage” and “a net stable funding ratio”. Furthermore, G20 member countries also developed a roadmap to strengthen the supervision and regulation of shadow banking in accordance with the respective conditions in each country up to the end of 2015.

In addition to the implementation of Basel III as well as the supervision and regulation of shadow banking, G20 member countries acknowledged the requirement to more comprehensively reform in the financial sector. Financial sector reforms consisted of the following elements, among others: (i) implementing the Financial Stability Board’s (FSB) Key Attributes of Effective Resolution Regimes in financial sectors with systemic risk, while concomitantly overcoming the barriers to cross-border crisis resolution; (ii) formulating recommendations regarding the capital adequacy of globally systemic financial institutions; (iii) publishing a list of globally systemic insurance companies; (iv) formulating recommendations for infrastructure of systemic financial markets; (v) boosting financial market transparency and resilience through a follow-up plan in line with the implementation of OTC derivative market reforms; (vi) expediting efforts to reduce dependence on credit rating agencies (CRA); (vii) increasing inter-institutional transparency and competition among credit rating agencies; and (viii) compliance to international cooperation standards and information exchange in the interest of financial sector supervision and regulation.

In addition to the financial sector, the G20 forum also highlighted several other pertinent issues to support the economic recovery process and help achieve sustainable economic growth. The forum subsequently agreed on the focus of development cooperation as follows: (i) food security; (ii) financial inclusion; (iii) development of human resources and the mobilisation of domestic resources for development; (iv) advocating long-term funding for development, in particular through infrastructure and SMEs; (v) supporting a multilateral trade system and rule making within WTO trade negotiations; and (vi) overcoming tax evasion, primarily related to cross-border taxation, by renewing prevailing regulations.

To close the year of 2013, G20 member countries agreed on the St. Petersburg Action Plan that sets out efforts to overcome near-term risk, while strengthening foundations for sustainable long-term growth. In order to overcome near-term risk, the G20 agreed to focus on the following issues: (i) reinforcing financial stability in Europe; (ii) encouraging fiscal policy to prop up economic growth; (iii)

promoting investment, particularly in infrastructure; (iv) maintaining financial stability and strengthening economic resilience to external shocks; and (v) moving forward with measures to realise a flexible exchange rate system in each country in line with market mechanisms and reflecting economic fundamentals. Furthermore, in order to strengthen the basis of long-term economic growth, G20 members also agreed to: (i) formulating a credible, medium-long term fiscal strategy that promotes economic recovery and creates employment opportunities; and (ii) implementing a more relevant, concrete and on target structural reform agenda.

At the regional level, escalating risk in the economy and on global financial markets compelled countries in the region to address the structural problems affecting each country. Efforts to spur domestic demand in order to sustain the global economy without imposing structural reforms were found to exacerbate economic risk in a number of emerging market countries. Although the economic fundamentals of countries in the region remained relatively solid compared to conditions prior to the crisis in 1997, monetary authorities acknowledged that structural reforms were also necessary in order to boost sustainable growth in the long term. Structural reforms also required a credible fiscal and monetary policy in order to maintain financial market stability.

Heightened risk along with pervasive uncertainty and global financial market imbalances encouraged the relevant authorities in the region to prioritise financial sector stability in pursuing central banks cooperation in the region. As a concrete measure, ASEAN+3 member countries (ASEAN, Japan, China and South Korea) agreed to reinforce and refine the ASEAN+3 financial safety net in order to maintain financial system resilience and stability of the region. One such effort involved bolstering adequate foreign exchange reserves (as a second line of defence) through a swap mechanism with other ASEAN+3 members as counterparties.

Commitment to maintain financial market stability was also undertaken in the form of financial market deepening through bond market development, regulations improvement as well as infrastructure development. Up to the reporting year of 2013, significant progress had been made the launching of a credit guarantee scheme for bond issuances in the region. The guarantee would be provided by the Credit Guarantee Investment Facility (CGIF), an institution formed under the auspices of the Asian Bond Market Initiative (ABMI). Furthermore, agreement was reached at the Asian Bond Market Forum (ABMF) regarding the

partnerships between the private sector and regulators under the Cross-Border Settlement Infrastructure Forum (CSIF). Going forward, the CSIF will initiate improvements in the cross-border settlement process, including the possibility of establishing a Regional Settlement Intermediary (RSI).

Initiatives to integrate regional economies under the umbrella of the ASEAN Economic Community (AEC) continued unabated during the reporting period. ASEAN member countries recognised the importance of financial sector stability amid global financial market imbalances in order to support the realisation of the ASEAN Economic Community (AEC), particularly in the area of liberalising flows of capital. To this end, consensus was reached concerning the need for discretion in the form of safeguard measures to maintain financial sector stability in the region. Notwithstanding, policy dialogue was also required to identify macroeconomic and financial stability risks in order to ensure the safeguard measures do not conflict with the spirit of liberalising freer flows of capital. In addition, countries in the region also agreed to manage more flexible policies, including the application of macroprudential measures, to mitigate the impact of capital outflows.

In the banking sector, the era of low interest rates represented an arduous challenge for the banking industry in the Asia-Pacific region. In view of this, the issue on Asia Pacific bank profitability during the era of low interest rates had been a main agenda at the meeting of the Bank

for International Settlements (BIS). Interest income (net interest margins/NIM) of banks in Asia-Pacific slumped along with commercial bank profits and yield curves which tended towards flat. Consequently, local currencies bond market development, along with financial market deepening, were expected to suppress the cost of funds incurred by banks, hence sustaining profitability in broad terms. A narrower interest rate spread was expected to provide an incentive to the banking sector in terms of eliminating inefficiencies, which in turn will maintain profitability.

Another milestone in international cooperation had been reached at the end of 2013 when all the World Trade Organisation (WTO) members agreed on international trade initiatives for the first time in its history. The WTO trade agreement, otherwise known as the Bali Package, was announced at the Ninth Ministerial Conference of the World Trade Organisation, held in Nusa Dua, Bali. The trade agreement was expected to create around US\$1 trillion (around Rp12,000 trillion) worth of global economic activity. The focus of the Bali Package was set forth in ten main commitments, namely to facilitate trade; general services for agriculture; public stockholding for food security purposes; tariff rate quota on agricultural products; export competition; trade in cotton; rules of origin; preferential treatment to services and service suppliers of least-developed countries, duty free and quota free market access for least-developed countries; and a monitoring mechanism on special and differential treatment of least-developed countries.

Macroeconomic Performance and the Policy Response of Countries Running a Current Account Deficit

External shocks occurring in 2013 had a significant impact on several emerging market countries, especially countries running a current account deficit. Such countries were subject to various risks and therefore compelled them to apply various policies to overcome the external shocks at that time. In the domestic economy, the risks faced in each respective country could be measured using the Z-score¹ ranking method. A number of indicators were applied as benchmarks according to that method, including inflation, current account deficit and dependence on short-term capital flows for financing.

According to the Z-score approach, Indonesia had the lowest risk compared to the other four countries running a current account deficit² on the back of low external debt combined with robust economic growth. The external debt of Indonesia was lower than that of South Africa and Turkey. In terms of economic growth, Indonesia achieved 5.8% in 2013, the highest of all the other comparison countries. Nonetheless, inflation risk and foreign holdings of bonds in Indonesia tended to be higher than in other countries. The rate of inflation in Indonesia in 2013

was 8.4%, while the ratio of foreign holdings was also high at around 31% (Table 1).

Turkey had the highest risk of external vulnerability, evidenced by the current account deficit as well as heavy dependence on short-term portfolio inflows and short-term debt. In 2013, the ratio of the current account deficit to GDP in Turkey was -7.2%, the highest among Indonesia, South Africa, India and Brazil. Furthermore, Turkey also had the heaviest dependence on short-term portfolio inflows to finance the current account deficit, accounting for 35% of GDP. In addition, the highest external short-term debt, amounting to 134%, also made Turkey the most vulnerable to external shocks.

The current account deficits in the five countries mentioned placed additional pressures on exchange rates and financial markets. In the third quarter of 2013, however, a number of improvements occurred along with easing pressures on financial markets, as reflected by exchange rate appreciation against the US dollar and rebounding stock indexes. Nevertheless, the gains were only temporary in relation to the Federal

Table 1. Macroeconomic Indicators

Country	Inflation Risk	Current Account Deficit	Dependence to Short Term Portfolio Inflow to Fund Deficit	2014 Election
Indonesia	2013: 8.4% 2014: 7.5% Target: 4.5±1%	CAD 2013: -3.3% CAD 2014: -3.7% Main export: Primary products	Foreign ownership ratio: 31% Foreign exchange reserve: US\$99.4 billion (44% of GDP) Short term debt to foreign exchange reserve ratio: 47.9%	July
Turkey	2013: 7.4% 2014: 6.0% Target: 5.0%	CAD 2013: -7.2% CAD 2014: -7.2% Main export: textile, automotive, iron and steel, chemical products	Foreign ownership ratio: 35% Foreign exchange reserve: US\$112 billion (49% of GDP) Short term debt to foreign exchange reserve ratio: 134%	March
South Africa	2013: 6.5% 2014: 5.5% Target: 3-6%	CAD 2013: -6.8% CAD 2014: -6.1% Main export: Primary products	Foreign ownership ratio: 34% Foreign exchange reserve: US\$42 billion (121% of GDP) Short term debt to foreign exchange reserve ratio: 71.6%	April-July
India	2013: 9.9% 2014: 8.8% Target: N/A	CAD 2013: -4.4% CAD 2014: -3.8% Main export: Natural resources	Foreign ownership ratio: 6.7% Foreign exchange reserve: US\$295.7 billion (67% of GDP) Short term debt to foreign exchange reserve ratio: 35.6%	May
Brazil	2013: 5.9% 2014: 5.8% Target: 4.5±2%	CAD 2013: -3.6% CAD 2014: -3.2% Main export: Primary products	Foreign ownership ratio: 17% Foreign exchange reserve: US\$375.8 billion (73% of GDP) Short term debt to foreign exchange reserve ratio: 35.6%	October

Source: Bloomberg, WEO October 2013

1 A standard score to measure individual standard deviation from the average.

2 The order of lowest risk to highest is as follows: Indonesia, Brazil, India, South Africa and Turkey.

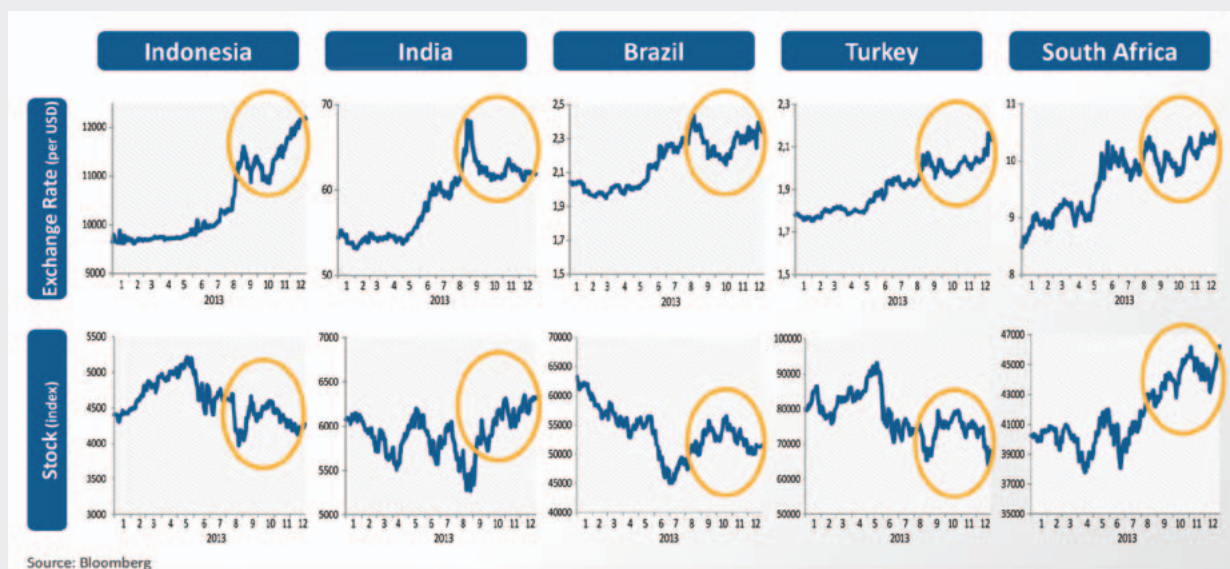


Chart 1. Financial Market Development

Reserve's postponement of its tapering policy. In the following quarter, the exchange rates of Indonesia, Brazil, Turkey and South Africa experienced depreciatory pressures once again. On the other hand, the exchange rate of India appreciated as the current account deficit narrowed. Conversely, the stock indexes of Indonesia, Brazil and Turkey continued to suffer intense pressures until the end of 2013 (Chart 1).

Confronting the external pressures, countries running a current account deficit introduced aggressive and wide-ranging policies. Similar to other emerging market countries, throughout 2013 the economies of the five countries in question faced intense pressures, particularly in relation to the external balance. The problems faced included current account deficits, mounting exchange rate and financial market pressures as well as capital outflows. Although relatively diverse, the policies instituted by Indonesia, India, Brazil, Turkey and South Africa were comparatively aggressive. On the other hand, Turkey, India and Indonesia also faced a loss of market confidence in the predictability of monetary policy in each respective country. Meanwhile, as the issue of tapering off policy intensified since May 2013, countries running a current account deficit responded with a policy mix primarily aimed at minimising capital outflow from the financial sector (Table 2).

Bank Indonesia adopted a tighter monetary policy stance earlier and more aggressively than the other affected central banks. Up to the third quarter of 2013, Indonesia faced the problem of a growing current account deficit. On the other hand, the emergence of the tapering off policy in May 2013 compounded pressures on exchange rates and financial markets as well as capital outflow. In response, Bank Indonesia applied an aggressive policy mix aimed at maintaining economic stability. Bank Indonesia adopted a tighter monetary policy stance earlier and more aggressively than the central banks of India, Turkey and South Africa that tended towards more accommodative monetary policy. Conversely, although Brazil also adopted a tighter policy stance, the policy mix applied was ineffective in terms of improving the external balance of Brazil.

The timely policy response implemented by Bank Indonesia successfully steered the current account of Indonesia towards a more sustainable level. After following a burgeoning trend since the first quarter of 2013, the current account deficit showed signs of improvement in the final quarter of the year. Accordingly, the current account deficit narrowed from 3.9% of GDP in the third quarter of 2013 to 2.0% of GDP in the fourth quarter of the same year. In contrast, the current account deficits of those

Table 2. Policy Response

Policy	Indonesia	India	Turkey	South Africa	Brazil
Interest Rate	BI Rate's gradual hike of 175 bps (from 5.75% on May 2013 to 6.00% on June 2013, and a gradual hike to 7.5% on December 2013).	Gradual policy repo rate decrease of 50 bps (from 7.75% on Jan 2013 to 7.25% on December 2013).	Policy rate decrease from 5.5% (January 2013) to 4.5% (May 2013). Policy rate remains 4.5% up to December 2013.	Accommodative monetary policy stance, maintaining policy rate at 5.0%	SELIC Rate gradual hike of 275 bps (from 7.25% on January 2013 to 10% on December 2013)
	Gradual adjustment in the interest rate corridor: a hike of 175 bps in Deposit Facility (4.0% in May to 4.25% in June, gradually increasing to 5.75% in December 2013), a hike of 75 bps in Lending Facility (6.75% in July to 7% in August, gradually escalating to 7.5% in December 2013).	Maintaining Cash Reserve Ratio at 4.0%	Overnight Lending Rate adjustment, sloping 125 bps from 9% (January 2013) to 7.75% (May 2013), maintaining O/N Lending Rate at 7.75% until December 2013	Using bond and FX Swapsto reduce money market liquidity	
	Enhancing Monetary Operations through SDBI Auction, FX SSwap	Closing the window of Liquidity Adjustment Facility (LAF) to only INR 750 billion or 1.0% of net deposit	Decreasing O/N interest rate by 150 bps from 5% (January 2013) to 3.5% (May 2013). O/N loan interest remains 3.5% to December 2013. Withholding repo auction for 1 week into FX sales.		
Exchange Rate	Adjusting exchange rate to the fundamental of economy	Soft swap rate to creditors	Increasing reserve requirement for foreign exchange and gold	Giving room for exchange rate depreciation	Swap and credit auction program to prevent real's further depreciation (August 2013)
	Foreign exchange overnight (O/N) term deposit	Swap/spot foreign exchange (FX) direct and indirect sales to public sector oil companies	Withhold sales of foreign exchange intraday auction		
	External debt relaxation	Relaxation on permit regulation of foreign direct investment (FDI)	Reducing minimum FX sales from US\$20 millions to US\$50 millions		
	Reference rate (JISDOR)	Limiting personal overseas transfer to maximum US\$ 75thousand per year	Export credit relaxation		
		Erasing 3-5 years foreign exchange savings rate. Restricting gold import by quota and tariff. Relaxing provisions in money market transaction for foreign investors External debt relaxation Hedging facilities for exporters and importers as well as shortening earning repatriation time for exporters	Lengthening loan maturity and easing collateral on export credit discount		

Policy	Indonesia	India	Turkey	South Africa	Brazil
Macro Prudential	Issued Loan to Value (LTV) regulations in the property sector (July 2013)	Establish two-day fund facility to banks through marginal standing facility (MSF)	Adjustments on foreign currency Reserve Requirement (May 2013): 50% hike on foreign currency deposits up to 1 year from 12.5% to 13%, unchanged rate on foreign currency deposits up to 3 years amounted to 9.0%, and 50bps increase on foreign currency loans up to 1 year from 11% to 11.5%		Tax deductions for foreign investment (purchase of bonds by foreign investors in the domestic market) in June 2013
	Relaxation on Bank Indonesia Certificate (SBI)'s month holding period (from 6 months to 1 month in August 2013)	Reduce borrowing limit by banks in the daily liquidity adjustment facility (LAF)			
	Tightening of RR LDR (August 2013)	Lowering the ratio for the cash requirement to mitigate banking liquidity risk.			
	Tightening of secondary RR (August 2013)	Increase capital requirement ratio to banks with unlimited risk exposure to foreign currency			
	Overnight foreign currency Term Deposit				
Fiscal	Tax incentives in an effort to improve current account (August 2013)	Importing oil from Iran in Rupees			Tax cuts on specific sectors Raise taxes on financial operations (IOF/ financial operations tax) on FDI
		Lowering gold and silver imports			
		Gold foreign exchange in state owned enterprises			
		Trimming departments' spendings			
		Cutbacks in routine expenditures			
Coordination	Strengthening coordination with the Government in order to promote a more sustainable structure of current account balance	Establishing expert committee to examine monetary policy framework and to advice government in enhancing transparency and predictability of monetary policy.			Strategies to curb real volatility with a reduction in the duration of the bonds (repurchase of long-term and sales of short-term bond)
Communication	Strengthening communication strategy through the delivery of key messages	Advising exporters to convert dollar revenues and to bring them back to India in 1 year's time.	Forward guidance: Additional tightening of monetary policy will be conducted everyday until further notice.		

Source : Bloomberg, Bank Indonesia

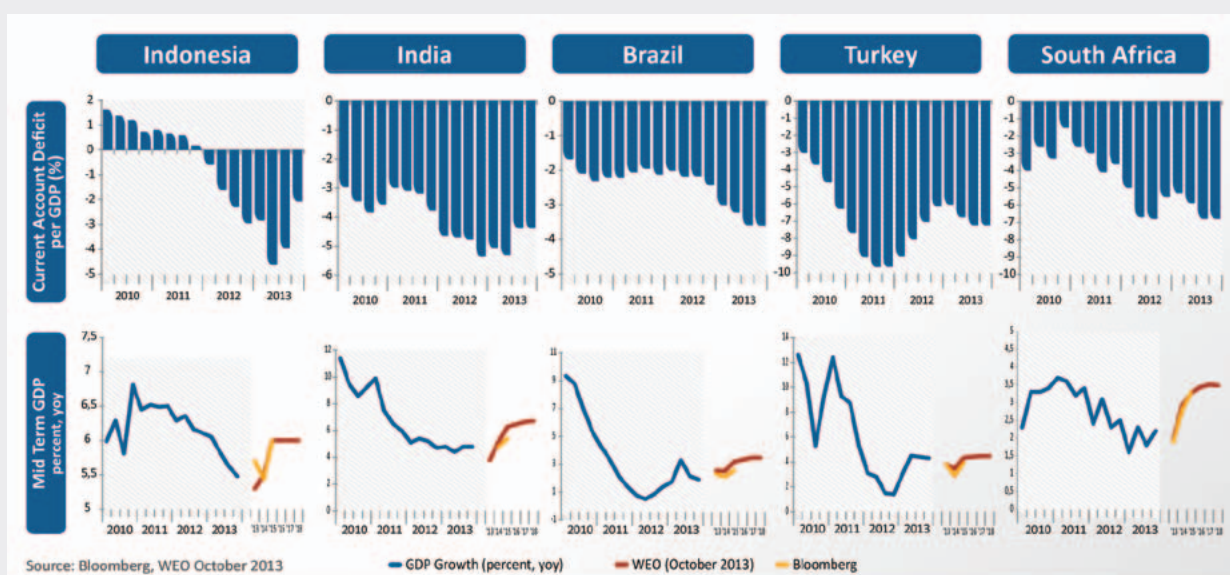


Chart 2. Current Account Deficit and Economic Growth

countries that delayed implementation of tighter monetary policy, like Turkey and South Africa, had not experienced any improvement in the position of their respective current account up to the end of 2013. The timely policy response of Bank Indonesia also hastened the most robust domestic economic

growth compared to India, Brazil, Turkey and South Africa. The economy of Indonesia expanded by 5.8% in 2013, exceeding the IMF projection of 5.3%³. As the external balance conditions are improving, the outlook for the Indonesian economy is more optimistic.

3 World Economic Outlook, October 2013 edition, IMF.

