

PART 1 GLOBAL ECONOMY

Image Caption: Like tempering metal in fire, the appropriate policy responses can ensure that the Indonesian economy retains flexibility and resilience amid global economic developments fraught with uncertainty.

INFOGRAPHICS: PART I GLOBAL ECONOMY



PART I Global Economy

In 2016, the global economy again faced multiple risks that previously emerged in 2015. Three main risks were manifest in 2016: decline in economic growth, prolonged low commodity prices, and high uncertainty on financial markets. These issues took on added complexity as a result of geopolitical uncertainties in some countries. Various developments subsequently impacted the process of global economic recovery, which moved forward at a sluggish pace in departure from earlier forecasts.

In 2016, global economic growth again lacked momentum and was unevenly distributed. Global economic growth was recorded at 3.1% in 2016, down slightly from 3.2% in 2015 and below the 3.4% forecast at the beginning of the year. In analysis by category of countries, the lethargic global economic growth was mainly attributable to the protracted weakness in advanced economies, where growth slipped to 1.6% from the 2015 level of 2.1%. The economic downturn in advanced countries was contributed by decelerating economic growth in the US, Europe, and Japan. In contrast, economic growth in emerging market economies mounted slightly from 4.0% in 2015 to 4.1%. The positive development in emerging market economies was bolstered by performance in Asian countries such as India and Indonesia, which recorded increased economic growth, while economic growth in China eased from 6.9% to 6.7%.

The sluggish global growth were influenced by a number of factors. In the US, economic growth decelerated in response to the lingering weakness in residential and nonresidential investment caused by the ongoing decline in the oil and mining sectors. In Europe, investment also slowed, primarily in the aftermath of the Brexit referendum at the end of June 2016 that sparked uncertainty and dampened investor appetite for investment. In Japan, the stagnating economy resulted from decline in nearly all components of GDP, namely consumption, investment, and exports. At the same time, the economic slowdown in China was largely influenced by the economic rebalancing strategy of the Government in response to lack of momentum in the global economy.

The impact of the fragile global growth was widespread, as many countries responded to decline in the world economy

by resorting to a domestic-oriented growth strategy. This strategy also brought about a weakening in the relationship between global economic growth and world trade volume. The relationship between the two indicators even more deteriorated because of indications of concurrent decline in the global value chain. As a result, the elasticity of global economic growth with respect to world trade volume fell from 0.6 in 2015 to only 0.3 in 2016. These developments in turn weighed down on the exports and economic growth of numerous countries.

The feeble growth in the world economy affected global commodity prices, which remained low until the third guarter of 2016. Regarding energy commodities, the average world oil price moved in the range of USD28.7 to 41.3 per barrel until the third quarter of 2016, below the 2015 average oil price recorded at USD48.7 per barrel. On one hand, this price trend was the inevitable result of slack demand in keeping with the stagnating condition of the world economy. On the other hand, world oil prices were also low from the influence of added supply on the world oil market due to the OPEC response in increasing production. Only in the fourth quarter of 2016 did world oil prices recover to an average of USD46.5 per barrel. The substantial rise in world oil prices in the fourth guarter was spurred by renewed growth in demand from emerging market economies, notably China and India. An added factor in the higher oil prices was reduction in world oil output, primarily after the commitment by OPEC to cut production.

In similar developments, global prices for non-oil and gas commodities, including prices for commodities exported from Indonesia such as coal, palm oil, and copper, remained low until early in the third quarter of 2016. The low level of commodity prices resulted mainly from the influence of lethargic world demand. Subsequently, however, non-oil and gas commodity prices climbed sharply in the fourth quarter of 2016. These price increases were driven by increasing demand, particularly from China, and production disruption of tin and palm oil.

Prolonged low commodity prices and slack world demand contributed to low world inflation. Until the third quarter of 2016, some countries, such as Japan and European countries, recorded extremely low inflation as the result of sustained low oil prices and slack aggregate demand. However, world inflation began climbing in the fourth quarter of 2016 due to rising commodity prices and an upturn in world aggregate demand. In response to these dynamics, world inflation reached 3.2% in 2016, representing a modest increase compared to the 2015 inflation of 2.9%. The rise in inflation was greater in advanced economies compared to emerging market economies. In advanced countries, inflation mounted from 0.5% in 2015 to 1.2%, while in emerging market inflation held stable at 4.7%.

The still susceptible condition of the world economy fuelled uncertainty on global financial markets. Reflecting this uncertainty was the rise in the VIX index, especially in the first and fourth quarters of 2016. Escalating uncertainty on global financial markets was also influenced by the plans of the US central bank to raise the Fed Funds Rate (FFR). This uncertainty then triggered changes in the pattern of capital flows on global financial markets, which subsequently led to appreciation in the dollar and put pressure on the currencies of many other countries, including Indonesia. These developments were reflected in upward movement in the average DXY index in the first and fourth quarters of 2016 in keeping with US dollar appreciation.

Heightened uncertainty on global financial markets was also spurred by political transition in some of the world's largest economies. At the end of the first half of 2016, uncertainty spiked after the British referendum that resolved to leave the European Union (Brexit), in defiance of market expectations. Uncertainty mounted again when markets responded to the US presidential election. Market actors interpreted the policy platform of US president-elect Donald Trump as having susceptibilities that would disrupt the process of global economic recovery. The policy platform included a more expansionary fiscal policy concurrent with a burgeoning government debt burden, plans for more restrictive international trade policies, and policy actions in immigration.

Responding to the dynamics of the global economy in 2016, many countries employed expansionary macroeconomic policies supported by reinforcement of structural reforms. Central banks employed expansionary monetary policy in many advanced countries, except for the US which announced one increase in the FFR. The Bank of Japan adopted a negative interest rate policy similar to that the European Central Bank, which pursued monetary policy easing. The People's Bank of China also eased monetary policy by lowering the statutory reserve requirement to sustain liquidity that had contracted during a time of capital reversal. The government of China also pursued structural reform policies, such as restrictions in production sectors to limit expansion of production capacity in the steel, coal, and aluminium industries. In India, the central bank lowered the policy rate in synergy with government structural reform policies designed to improve the ease of investment.

Macroeconomic policy in many countries was also reinforced with various forms of international cooperation in which the leading agenda was to promote global growth and economic recovery and to strengthen economic and financial system resilience. This cooperation included work in the G20 and EMEAP forums. Like the International Monetary Fund (IMF), the World Bank also contributed to efforts to bolster global economic growth, working through the various infrastructure investment initiatives in the G20 forum. At the regional level, strengthening of regional resilience was also carried out through surveillance capacity building by the ASEAN+3 Macroeconomic Research Office.







CHAPTER 1 Global Economic Dynamics

The global economy was overshadowed in 2016 by several risks that emerged the year earlier. The risks were triggered by sluggish global economic growth and the decline in world trade volume. Global economic deterioration were then translated into persistently low energy and non-energy prices until the third quarter of 2016. In turn, the unfavorable global economic developments prompted widespread uncertainty to financial markets. Thus, concern over financial market uncertainty were worsen by unexpected geopolitical developments, including the unpredicted results of the Brexit referendum and the US presidential election.

Image Caption:

The global economy can be likened to the rotation of the earth, where one side is in darkness and the other basked in light. In 2016, the darkness predominated in the global economy, bringing economic slowdown and uncertainty to financial markets with adverse impact on the economic performance of emerging markets, including Indonesia. Global economic growth remained below expectations in 2016 and was characterized by several risks that surfaced the year earlier. Accordingly, three salient risks persisted into 2016, namely decelerating global economic growth, persistently low international commodity prices as well as highly uncertain global financial markets. Thus, uncertainty on the global financial markets increased due to several unexpected geopolitical developments, including the unpredicted results of the Brexit referendum and US presidential election. Such developments were mutually interconnected and manifested in a slower global economic recovery.

The latest data confirmed the slower growth in 2016 than those in the previous year. The global economy recorded growth of 3.1% in 2016. Comparatively, it was lower than those of 3.2% in the previous year and grew less than forecast from the beginning of the year of 3.4%. The weak global economic performance was a consequence of the advanced economies lacklustre growth, despite solid economic growth in developing countries. Thus, spillovers from the sluggish global economic recovery proliferated as numerous countries responded through more domesticoriented growth strategies, which reduced the elasticity of world trade volume (WTV) with respect to global economic growth (refer to Box 1.1). Such complexity, in turn, perpetuated the downward WTV trend that has endured since 2010 (Chart 1.1).

Slower global economic growth also resulted in the weakening energy and non-energy commodity prices through to the third quarter of 2016. In terms of energy prices, the global oil price remained low, falling to its lowest point in January 2016. Specifically, the average *Minas* price in the third quarter of 2016 was USD38.8 per barrel, which rebounded thereafter in the fourth quarter to USD47.6 per barrel. Additionally, prices of several nonenergy commodities such as coal, crude palm oil (CPO), and copper remained low. Nonetheless, oil and non-energy prices gradually began to rebound in the second half of the year, particularly in the fourth quarter. As such, growing economic momentum in developing countries, along with supply-side disruptions, were the main contributors to rising non-energy commodity prices.

Consecutively, elevated oil and commodity prices began to intensify inflationary pressures, given a relatively low global inflation. Thus, heightened inflationary pressures from rising oil and non-energy commodity prices, primarily in the second half of the year, were intensified by early signs of growing global demand. Consequently, global inflation in 2016 stood at 3.2%, accelerating from 2.9% in 2015 (Chart 1.2). Such dynamics differed greatly from conditions during the first semester, when extremely low inflation was reported in various advanced countries, including those in Europe and Japan.

Thus, weak global economic growth, accompanied by political transition in several countries, translated into persistently high uncertainty on global financial markets. Political transition led to highly uncertain global financial markets in the second half of the year, particularly after the results of the Brexit referendum and US presidential election were announced, which went against market expectations. Furthermore, uncertainty also peaked in the first quarter of 2016 due to slow economic growth in China and the unpredictable nature of further FFR hikes in the US.



Chart 1.1. World Trade Volume and GDP

Chart 1.2. Global Inflation



Source: WEO-IMF

Source: CPB, WEO-IMF, calculated

1.1. ECONOMIC GROWTH IN ADVANCED COUNTRIES

Economic dynamics in advanced countries were characterized by slower growth and heightened inflationary pressures. Economic growth in advanced countries was recorded at 1.6% in 2016, down from 2.1% in 2015, mainly contributed by weak growth in the US, Europe and Japan (Table 1.1). Meanwhile, inflation in advanced countries stood at 1.2% in 2016, up from 0.5% in the year earlier, and was driven by the increase in international oil and non-energy commodity prices during the second half of 2016 (Chart 1.3). Nonetheless, inflation in several advanced countries remained below the respective targets of each central bank. In fact, deflation was recorded in Europe and Japan during the first semester of 2016.

As such, the US economic growth slowed in in 2016, despite some indication of improvement in quarterly dynamics. US economic growth was recorded at 1.6% in 2016, significantly lower from those of 2.6% in 2015 and less than the earlier forecast of 2.4%. Such developments came in cause of unexpected economic recovery due to unfavorable condition of residential and nonresidential investment in the second half of the year. Declining nonresidential investment was the result of weak investment in the oil and mining sectors due to persistently low international oil and commodity prices since 2014 (Chart 1.4). Meanwhile, residential investment slowed in 2016 after significant purchase of property by investors since the end of 2015 in anticipation of the proposed FFR hike (Chart 1.5).

Regarding the quarterly GDP dynamics, the US labor sector also improved in 2016, nearly approaching the

Table 1.1. Global Economic Growth

	2015	2016	Contribution (%)
World	3.2	3.1	100
Advanced Countries	2.1	1.6	41.85
Japan	1.2	1.0	4.14
US	2.6	1.6	15.59
Euro Area	2,0	1.6	11.30
France	1.3	1.2	2.30
Germany	1.5	1.9	3.34
Italy	0.7	0.9	1.87
Spain	3.2	3.2	1.42
Developing Countries	4.0	4.1	58.15
China	6.9	6.7	17.86
India	7.2*	7.3*	7.32

* Calculation use data from Jan-Dec 2016

GDP of India in 2015 based on fiscal year (March 2015 to March 2016) is 7.5% Source: WEO IMF Jan-17, calculated Chart 1.3. Inflation of Several Advanced Countries and Global Commodity Prices



full-employment condition. Since the second semester of 2016, the US labor sector has become increasingly solid, with unemployment recorded at 4.7% at the end of 2016 and lower than the Non-Accelerating Inflation Rate of Unemployment (NAIRU) set by the Fed at 4.9%. Nevertheless, the impact of lower unemployment on real wages was suboptimal, reflecting a stagnant average income per hour, due to a large composition of low-income part-time workers (Chart 1.6). Furthermore, low real incomes also restricted consumption gains.

Thus, US inflation was observed to accelerate in 2016 but remained below the Fed's target rate. As such, the Federal Reserve set the Personal Consumption Expenditures (PCE) inflation as the long-term target at 2%. Hence, in general, rising inflation in the United States was driven by the increase in commodity prices during the fourth quarter of 2016 and further increase in the US inflation expectations

Chart 1.4. US Industry Sectors and Oil Prices



Source: Bloomberg, calculated

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Chart 1.5. US Housing Sector



Source: Bloomberg, calculated

were driven by the planned expansionary fiscal policy of Donald Trump. By commodity, inflationary pressures primarily originated from the prices of health services and housing, which edged up core inflation beyond 2% since the beginning of 2015. Consequently, the CPI and the PCE inflation increased to 1.5% (Chart 1.7).

Correspondingly, slower economic growth was recorded in Europe in 2016, despite some fair increase of the inflation. GDP in Europe stood at 1.6% in 2016, decelerating from 2% in the earlier year (Chart 1.8). The slow economic recovery in Europe was due to weak export performance after the Brexit referendum and was also influenced by political transition. Meanwhile, inflation in Europe accelerated from 0.5% in 2015 to 1.1% in 2016, which was still below the 2% target set by the European Central Bank (ECB). Thus, rising energy prices pushed up inflation, primarily during the second half of the year and have increased pressures at the producer level, as

3.0 2.5 24 2.0 1.8 1.5 1.0 0.5 0.0 -0.5 -1.0 П IV Ш IV 2015 2016 - Core CPI Target 2% Core PCE DCF

Source: Bloomberg, calculated

Chart 1.7.

Percent

US Inflation

reflected by a positive Producer Price Index (PPI) of 0.1% at year end 2016.

As such economic growth in Japan was recorded at 1.0% in 2016, slowing from 1.2% in 2015. Later, the slow economic growth in Japan had contributed to a lower inflation. As such, limited consumption growth and investment as well as weak net exports were the main contributors to sluggish economic growth in Japan (Chart 1.9). Furthermore, stagnant consumption was reported in 2016 due to limited improvement in labor market situation, coupled with the demographic disadvantages of an aging population. Accordingly, weak consumption undermined retail sales and household spending, while dwindling aggregate demand contributed to low inflation. At the end of 2016, inflation stood at 0.3%, contributed mainly from non-food inflation. In terms of the quarterly dynamics, however, price at the producer level began to creep up, driven by a jump in energy

Chart 1.6. US Labor Sector



Source: FRED, Bloomberg, calculated

Chart 1.8. Decomposition of Europe GDP Growth (Euro Area)



Source: Eurostat







prices, which indicated from the lesser deflation of producer prices.

1.2. ECONOMIC GROWTH IN DEVELOPING COUNTRIES

The economies of developing countries achieved more solid growth in 2016. Thus, economic growth in developing countries was recorded at 4.1% in 2016, slightly higher than those of 4.0% the year earlier due to rising commodity prices in the second half of the year. Such dynamics boosted economic performance in several oil producers, including Russia and Saudi Arabia. In addition, economic growth in Indonesia and India accelerated due to strong domestic demand, which further contributed to robust economic growth in developing countries. Thus, the solid economic growth in developing countries was accompanied by controlled inflation at 4.7%, relatively unchanged from the previous year. The positive developments were linked to successful inflation control in several developing countries, including China, India, Brazil and Indonesia (Chart 1.10).

Likewise, economic growth in India was observed to accelerate, along with declined inflation. Growth in India was recorded at 7.3% in 2016 or slightly higher from 7.2% in 2015. The main sources of growth in India originated from growth in private consumption, while growth in investment decelerated (Chart 1.11). Private consumption increased after the Government issued policy to raise wages and pensions in the public sector during the second half of the year. Moreover, consumption gains were also driven by agricultural sector performance due to favorable weather conditions after droughts in the previous year. Thus, investment growth slowed but remained as the main contributor to economic growth in India. Eventually, slower Source: Bloomberg, calculated

investment growth undermined production, especially the production of capital goods (Chart 1.12). As such, against a backdrop of stronger economic growth, inflation in India continued to decelerate. At the end of 2016, inflation in India stood at 3.4%, considerably lower from 5.6% in 2015, due to controlled food prices and low imported inflation.

Alongside, economic growth in China recorded a decline from 6.9% in 2015 to 6.7% in 2016. Even so, economic growth in China remained within the target corridor set by the Chinese administration of 6.5-7%, and notably higher than the early year forecast of 6.3%. Meanwhile, inflation in China stood at 2.1% in 2016 or increased from 1.6% in the preceding year, in line with robust domestic demand that pushed up core inflation, especially the non-food component in spite of eased inflationary pressures from food component.



Chart 1.11. Contribution of India GDP Growth

Chart 1.12. Production of India Manufacture Sector



Source: Bloomberg

Sluggish economic growth in China was also linked to the rebalancing strategy of the Chinese Government that eventually put adverse implications on investment. The rebalancing strategy involved shifting the sources of growth from an investment-oriented economy through the manufacturing industry, towards a consumption-oriented economy through the services sector (Chart 1.13). In addition, the slowdown was caused by the nature of the trajectory of economic growth in China, which also slowed as the investment boom came to an end and the labor market declined. In general, the rebalancing strategy led to a lower growth than in previous years.

Thus, implementation of the economic rebalancing strategy in China did not progress as fast as expected, thus necessitating a large investment role, which was influenced by government investment through widespread infrastructure project development in 2016, encompassing 303 infrastructure projects, including road development, railways, airports, irrigation, and public transport (Chart 1.14). Meanwhile, despite its large share, of 70%, in total investment, the downward trend of private investment has remained intact since the beginning of 2016. Stronger private investment was recorded in construction sector, especially property construction in the first quarter of the year, due to an easing of property sector policy introduced at the end of 2015 by lowering mortgage rates and downpayments.

Thus, government fiscal stimulus was capable to maintain stable consumption in China, evidenced by average retail sales growth of more than 10% in 2016. Thus, property sector gains also contributed to stable retail sales of furniture and home decorating supplies. Furthermore, automotive sales also grew rapidly compared to conditions in 2015, supported by looser credit requirements, smaller down-payments, as well as the government subsidies. Furthermore, steady credit flows to households and the corporate sector also helped stabilising consumption (Chart 1.15).

1.3. INTERNATIONAL COMMODITY PRICES

The global economic slowdown were transmitted to unfavorably low energy and non-energy commodity prices until the third quarter of 2016 (refer to Box 1.2). In terms of energy commodity prices, the average global oil price was lower in 2016 than in 2015, despite some improvement towards the end of 2016. Accordingly, the price of *Minas* in

Percent. vov q 79 7.9 7.7 76 8 74 7.5 71 7.2 7.0 7.0 6.9 6.8 6.7 6.7 6.7 6 5 4 3 2 0 -1 I II III IV I I III IV I I III IV 2013 2014 2015 2016 Primary Industry Secondary Industry Tertiary Industry - GDF Discrepancy

Chart 1.13. GDP of China based on Industry

Source: China National Bureau Statistics

Chart 1.14. Fixed Asset Investment of China



Source: Bloomberg, calculated

Chart 1.15. Household Credit and Consumption Credit



Source: Bloomberg, calculated

2016 averaged USD41 per barrel, lower from the USD48.9 per barrel the year earlier.

Oil price dynamics were affected by three major developments in 2016, occurring respectively in the first, second-third, and fourth quarters of 2016. In the first quarter of 2016, a low oil price was recorded, even reaching its lowest point in the past decade at USD26.4 per barrel due to abundant supply, large oil inventories and weak demand (Chart 1.16). The burgeoning supply was linked to OPEC's response since 2015 to maintain market share with respect to increased shale oil production in the US. After that period, however, the oil price tended to stabilize in the narrow USD40-50 per barrel range for the next two quarters due to supply disruptions in Canada, Iraq, Kuwait and Nigeria, coupled with less US production, which offset further oil price declines. Then, in the fourth quarter of 2016, the global oil price increased to exceed USD50 per barrel.

In the fourth quarter of 2016, the global oil price increased sharply on expectations of less supply, against a backdrop of the ongoing global economic recovery. The reduction of oil supply was due to the OPEC agreement at the end of September 2016 on a plan to cut production. Thus, on 10th December 2016, OPEC and several non-OPEC countries, including Russia, agreed to cut production by 1.8 million barrels per day, consisting of 1.2 mbpd from OPEC members and 0.6 mbpd from non-OPEC members. The pact is equivalent to around 2% of global supply from January-June 2017 and can be extended for a further six months. After the agreement was reached, the oil price jumped to USD54 per barrel from a stable range of USD40-50 per barrel in the third quarter.

As such, non-energy commodity prices remained low until the third quarter of 2016. The composite index of global non-energy prices was recorded at a low level due to weak demand and abundant supply, before rebounding in the fourth quarter of 2016. Consequently, non-oil and gas export prices from Indonesia experienced an 11.6% contraction in the first quarter of 2016.

Nonetheless, non-energy commodity prices posted significant gains in the fourth quarter of 2016, edging up the commodity price index for 2016 to a level just above that recorded the year earlier. Rising commodity prices in the fourth quarter were also reflected in non-oil and gas export prices from Indonesia, including coal, crude palm oil (CPO), and tin (Table 1.2). The growing global demand of coal especially came from China due to the decline of its domestic. Thus, the strong influence of demand



Chart 1.16. Development of Oil Prices and Export Commodities Price Index

Source: Bloomberg, calculated

Chart 1.17. World Coal Demand



Source: US Energy Information Administration

Table 1.2. Export Commodity Price of Indonesia

Commodity	Unit	2014	2015	2016			2016	
				I	II	111	IV	
Coal	USD/ Metric Ton	75.3	56.8	45.4	48.3	59.8	84.0	59.4
Copper	USD/Metric Ton	6,827.8	5,506.8	4,688.2	4,727.7	4,798.0	5,293.6	4,878.1
Nickel	USD/Metric Ton	16,971.3	11,924.0	8,558.0	8,854.8	10,337.6	10,829.4	9,647.8
Palm oil	MYR/Metric Ton	2,413.7	2,190.7	2,467.4	2,597.5	2,628.7	2,932.5	2,657.9
Rubber	USD/Kg	223.3	178.2	140.0	183.8	173.7	192.7	172,9
Tin	USD/Metric Ton	21,877.4	16,041.9	15.491.3	16,863.0	18,587.3	20,680.9	17,918.2
Aluminium	USD/Metric Ton	1,895.6	1,684.4	1.515.3	1,581.9	1,635.0	1,709.5	1,611.0
Coffee ¹⁾	USD/Pound	196.3	151.6	130.4	136.7	153.0	157.3	144.4

Index

120

110

100

90

80

70

60

Source: IIF

¹⁾ Data 2014 only available from Juni, average periode is Jun-Dec 2014 Source : Bloomberg, calculated

from China raised commodity prices considering China's dominant position in terms of total global demand (Chart 1.17). Meanwhile, the CPO price rebounded on production disruptions due to weather factors, including La Nina in the third quarter of 2016. Accordingly, in general, the price dynamics led to positive growth of 4.6% in the non-oil and gas export commodity price index of Indonesia in 2016.

1.4. GLOBAL FINANCIAL MARKETS

Sluggish global economic growth, along with political transition in several countries, triggered widespread uncertainty on global financial markets. The immense uncertainty blighting global financial markets eventually raised the VIX volatility index significantly to a level exceeding 20 in the first quarter of 2016 (Chart 1.18).¹

Moreover, uncertainty triggered by the Brexit referendum also raised VIX at the beginning of the third quarter of 2016 and exacerbated by unexpected win of Trump in the US presidential election.

Despite high uncertainty in global financial markets, foreign capital flows to developing countries continued to surge during 2016 on the back of solid economic growth along with attractive yields. Nevertheless, the US presidential election announcement spurred pressures of a sudden capital reversal from developing countries in the fourth quarter of 2016. Thus, capital outflow was recorded but relatively small magnitude compared to the level of inflow throughout 2016 (Chart 1.19).

The maintained inflow of foreign capital to developing countries drove up the global stock price index in 2016, climbing from 142.3 at the end of 2015 to 150.4 at the end





Chart 1.18. Development of VIX and DXY Index

Source: Bloomberg

2011

Index

70

60

50

40

30

20

10

0

2012

- DXY Index (rhs)



2013

2014

2015

2016

of 2016. Accordingly, significant increases to indexes in G7 countries after the US presidential election were cited as the main contributors, while gains recorded in Asia-Pacific and developing Asia were more muted, increasing respectively from 109.6 and 100.5 to 111.9 and 102.7.

On the contrary to prevailing dynamics in developing countries, strong pressures on capital outflows were observed in China during 2016, prompted by expectations of yuan depreciation against the US dollar after implementation of a new exchange rate regime. In addition, heightened uncertainty due to the unexpected results of the Brexit referendum and US presidential election exacerbated uncertainty surrounding capital flows in China. Thus, capital outflows from China reduced the position of the country's reserve assets by USD210 billion from USD3.23 trillion at the beginning of 2016 to USD3.01 trillion at the end. Furthermore, the net outflow also precipitated yuan depreciation of 6.6% (ptp) against the USD in 2016.

Box 1.1. World Trade Volume and Future Risks

World trade volume (WTV) has tracked a downward trend for more than a decade. Data for the past six years points to stagnant international trade, growing by an average of 2.33%, which is well below the 6.87% posted prior to the global financial crisis.

Thus, flagging world trade volume (WTV) has primarily been the result of structural factors stemming from maturing global value chain in line with slower fragmentation of international production. The latest OECD-WTO publication on global value chains (GVC) revealed that maturing global value chain has actually occurred since 2000.¹ Estimations using the Input-Output Table of the World Input Output Database (WIOD), with an observation period through to 2014, also confirmed that the phenomenon of global value chain maturation continues (Chart 1). During the period from 2011-2014, global value chains began to stabilize but failed to grow, including the global value chain in Indonesia.

Furthermore, cyclical factors stemming from weak economic growth in advanced countries after the global financial crisis in 2008 have also served to undermine WTV. Estimations showed that post-crisis economic growth in advanced countries has remained below potential, averaging just 1.8% since 2008, which is below the average growth rate for the previous 20 years (1987-2007) at 2.5%.



Chart 1. Estimation of Global Value Chain

The various structural and cyclical factors, in turn, have reduced the correlation between global economic growth and world trade volume. Several indicators have evidenced wider divergence between WTV growth and global economic growth. As such, trade volume index data from 2015 points to a greater decline in import growth than the decline in economic growth (Chart 2).

Moving forward, the risk of less global trade could materialize through planned protectionism in several countries. For example, the risk of protectionism increased after the Brexit referendum on 23rd June 2016. Most British voters chose to leave the EU, which could undermine international trade in the medium-long term due to the impact on free international trade after the UK loses its right to single market access.

The risk of protectionist policy resurfaced in the wake of the US presidential election on 7th November 2016. During his inauguration speech on 21st January 2017, the new US President, Donald Trump, doubled down on his populist agenda through protectionist rhetoric. Following the speech, Donald Trump signed Executive Orders to abandon the Trans-Pacific Partnership (TPP). The planned application of other protectionist policies remains in line with Trump's campaign promises, including renegotiating membership of the North American Free Trade Agreement (NAFTA)





Source: World Bank, 2015

¹ OECD-WTO: Trade in Value Added (TiVA), with an observation period through to 2011.

Tabel 1. Simulation of Implementation Effect of China Importing Tariff by US on GDP of Several Countries

Countries	Δ Trade/GDP(-1) (%)	Δ GDP(%)			
China	-3.14	-0.30			
China's Main Trading Partners					
Japan	-0.26	-0.02			
Когеа	-1.12	-0.10			
Hong Kong	-5.20	-0.45			
Germany	-0.24	-0.02			
Australia	-0.38	-0.03			
Vietnam	-3.21	-0.30			
Mexico	-0.38	-0.04			
Malaysia	-1.42	-0.13			
Netherlands	-0.51	-0.04			

Source: Bank Indonesia, simulation

and threatening legal ratifications for countries violating trade agreements.

Another US protectionist policy that has rattled the markets is the planned imposition of a 45% tariff on imports from China and 35% on imports from México.² In China's case, the introduction of an import tariff would reduce trade between China and the US, which, if left unchecked, would not only undermine growth in China and the US, but also spread to other trading partners and world trade volume in general (Table 1).

How will US protectionism affect Indonesia? Based on Bank Indonesia simulations, the impact of protectionist policies, specifically Trump's policies and the Brexit, on Indonesia remains limited. The impact of spillovers from lower GDP

Countries Δ Trade/GDP(-1) (%) Δ GDP (%) United States -1.67 -0.14 **US Main Trading Partners** Canada -1.92 -0.17 Mexico -2.74 -0.26 -0.22 -0.02 Japan -0.32 -0.03 Germany -0.62 Korea -0.05 UK -0.28 -0.02 France -0.19 -0.02 India -0.23 -002 Italy -0.19 -0.02

growth in China and US on GDP in Indonesia was calculated at only 0.2 percentage points, which is not as large as the impact in other countries.³ The limited impact was due to the relatively smaller decline in US GDP than China's GDP.

A previous study by Anglingkusumo (2014) confirmed the findings, namely that the impact of spillovers from China's economy to GDP in Indonesia was smaller than the impact of spillovers from the US economy.⁴ Meanwhile, the Brexit impact on the Indonesian economy is also expected to be limited because the share of Indonesian exports to the UK accounts for only around 1% of total exports from Indonesia. Nevertheless, the knock-on effect of strained trade ties between UK and Europe demands vigilance considering that Europe (excluding UK) accounts for around 11.4% of exports from Indonesia.

³ The estimations refer to elasticity in the research conducted by Harahap et al. (2016), "Spillovers of United States and People's Republic of China on Small Open Economies: The Case of Indonesia", ADBI Working Paper Series No. 616, November 2016.

² China represents the largest contributor to the US trade deficit. In 2015, the US trade deficit stood at USD744 billion, of which nearly 50% originates from trade with China.

⁴ Anglingkusumo et al. (2014), "National Competitiveness and the Impact of Economic Spillovers in the Global Production Network", Bank Indonesia.

Box 1.2. Impact of US and China Economies on Global Commodity Prices

Two trends distinguished international commodity prices in 2016. The initial trend transpired from the first until third quarter, during which time commodity prices remained low. The commodity price index, which had peaked in 2011 at 126.4, fell constantly in the first three quarters of 2016 to a level of 72.8. The second trend occurred towards yearend, when commodity prices rebounded and the commodity price index closed at a level of 84.3.

Various empirical studies have demonstrated the positive correlation between international commodity prices and economic growth in the US and China, especially in terms of metal and oil prices. Roache (2012) showed that for each 1 percentage point increase in US economic growth, metal prices, such as aluminium, copper, nickel, and tin, increase in the 6.0-9.8% range. Meanwhile, each 1 percentage point increase in US economic growth was also shown to raise the oil price by around 9.9% for the upcoming year.¹

International commodity prices are also linked to USD developments. Empirical data showed that the USD correlated negatively with commodity prices, although recently this correlation has tended to subside. Roache (2012) showed that Real Effective Exchange Rate (REER) appreciation of the USD by 1 percentage point would precipitate a 3.45% drop in the oil price and a decline in the 1.7-3.7% range for metal prices, including aluminium, copper, nickel, and tin for the upcoming year.

Nonetheless, the latest developments point to a weaker negative correlation between the USD and commodity prices.² Since the beginning of 2015, the negative correlation between the oil price and USD has faded and even reversed to become positive at the end of 2016. Likewise, the correlation between the Indonesia Export Price Index (IHKEI) and USD has also declined (Chart 1).



The weaker negative correlation between the USD and commodity prices means that potential USD appreciation may not necessarily translate into lower commodity prices. Consequently, optimism surrounding US economic gains that could drive USD appreciation may not be accompanied by lower oil and other commodity prices due to robust demand for commodities to support US economic activities. In fact, in the near term, the potential for both will become more open.

A similar trend was observed concerning the correlation between economic growth in China and commodity prices. Roache (2012) showed that a 1 percentage point increase in economic growth in China would raise commodity prices in the 0.9-2.3% range for metals and 1.9% for oil. The role of China's economy in terms of influencing international commodity prices is expected to expand due to China's steadily increasing commodity imports. For example, in 2015, China imported more commodities than the US (Chart 2). Similarly, Abiad et al. (2016) also found that a 1 percentage point increase of economic growth in China would raise the prices of coal and metal by 7-22% as well as oil and gas commodities by 5.7%.³

Afterward, rising international commodity prices could persist considering the promising economic outlook in the US and China. The correlation could strengthen

Shaun K. Roache, IMF Working Paper 12/15: China's Impact on the Commodity Market, May 2012.

² Correlation was calculated based on different global events that influenced USD movements, namely (i) pre-crisis (April 2006 – May 2008); (ii) crisis (June 2008 – December 2009); (iii) QE stimuli (January 2010 – April 2013); (iv) taper tantrum (April 2013 – January 2015); and (v) normalization of the Federal Funds Rate (period of expected hikes from February – December 2015 and the period of actual FFR hikes from January 2016 – January 2017).

³ Abiad et al. ADB Briefs: "Moderating Growth and Structural Change in the People's Republic of China: Implications for Developing Asia and Beyond," March 2016.

Chart 2. Import Level of World Commodity



again, however, if growth is driven by infrastructure project development, as proposed in the US and China. Infrastructure development in China is expected to continue through the current gradual economic rebalancing

strategy. Furthermore, the potential for rising commodity prices remains high due to the increase of weak negative correlation between the USD and commodity prices.





CHAPTER 2 Global Economic Policy Response

The global policy response in 2016 were aimed towards mitigating the risk of continued global economic downturn. Hence, accommodative monetary policy was maintained in advanced countries through unconventional monetary policies, in spite of limited fiscal stimulus. Nevertheless, The Federal Reserve continued to normalize its monetary policy, given its slowpaced implementation since 2014. Along the line, developing countries undertook fiscal expansion and easing monetary policy, as well as persevered with structural reforms. Thus, such policies were supported by international cooperation to strengthen the structure of the global economy.

Image caption:

In response to the global economic slowdown and uncertainty on financial markets, authorities in different countries are collaborating more closely in various international forums in order to formulate appropriate policy. The global economic policy response in 2016 was directed towards mitigating the risk of global economic slowdown and global financial markets uncertainty. Along that line, various countries opted to pursue a more accommodative monetary policy response. In doing so, advanced countries, excluding the United States, continued efforts to stimulate economic growth through several measures such as loose monetary policy with low, or even negative, interest rates and asset purchase programs by the central bank. Nonetheless, the fiscal policy response was more muted considering the contracted space for fiscal stimulus. In contrast, developing countries tended to be more expansive, exploiting fiscal space to uplift stimulus and easing monetary policy, while continuing with structural reforms.

The global economic policy response in 2016 was also implemented through international cooperation, in the context of regional and global cooperation. International cooperation were the main agenda at various international forums in order to stimulate global economic growth and recovery, while enhancing global economic and financial system resilience. Furthermore, cooperation to strengthen the structure of the global economy was also the focus of various cooperation forums, including the G20 and Financial Stability Board (FSB) as well as regional cooperation such as the Association of South East Asia Nations (ASEAN) and the Executives Meetings of East Asia-Pacific Central Banks (EMEAP).

2.1. ECONOMIC POLICIES IN ADVANCED COUNTRIES

In 2016, accommodative policy responses in many advanced countries, excluding the United States, were pursued through price and quantity approach (Chart 2.1 and Table 2.1). The policy responses were taken since the global financial crisis of 2008 and aimed to mitigate the significant risk of economic slowdown. Nonetheless, economic recovery in advanced countries since 2008 was subdued and eventually strained the global economic dynamics, resulted in persistently low international commodity prices.

As such, the Bank of Japan (BOJ) persevered with accommodative monetary policy. Furthermore, the BOJ augmented its current stimulus by issuing new, unconventional monetary policy in the form of a negative interest rate. Entering the fourth year of Abenomics in January 2016, the BoJ reiterated its commitment in achieving the 2% inflation target through the three-policy dimensions, namely quantitative and qualitative monetary Chart 2.1. Policy Rate in Advanced Countries



easing, along with a negative interest rate.¹ Hence, the negative interest rate was expected to provide a disincentive for consumers to deposit their money at banks, while simultaneously encouraging the banks to lend. Furthermore, the negative interest rate was also expected to help depreciate the yen comparatively to other currencies, hence boosting export performance.

Yet, the negative policy rate has not either optimally pulled Japan out of deflation or stimulated economic growth. Japan continued to record deflation in 2016, with economic growth nearly experiencing a technical recession. Hence, domestic consumption was difficult to increase due to structural issues of aging population. In addition, external risks and uncertainty had induced the Yen appreciation as a safe-haven currency. Consequently, the yen appreciation, along with weak global demand, precipitated lower inflation, an export contraction, as well as slower investment growth had supressed economic growth in Japan.

Accordingly, the BOJ sought enhance the effectiveness of its monetary policy through a number of policies. Through the quantitative channel, in 2016 the BoJ, as well as several other advanced countries, increased the volume of asset purchases on the money market in the form of Exchange Traded Funds (ETF) by nearly two-fold, to ¥6 trillion per annum.² In its monetary policy assessment released in September 2016, BoJ stated that the inflation target of 2%

Abenomics is the economic policy package released by the Prime Minister of Japan, Shinzo Abe, at the beginning of 2013. Abenomics is based upon "three arrows" of aggressive monetary policy, flexible fiscal policy, and structural reforms.

² An ETF is a financial market product that tracks an index, referring to commodities, bonds or a basket of assets. An ETF trades like a common stock sold on a stock exchange.

Table 2.1. Quantitative Monetary Policy in **Advanced Countries**

No	Advanced Country	Quantitative Monetary Policy
1.	United States	QE1 (Nov 2008 - June 2010) MBS: USD600 billion (net) T Notes: USD20 billion (per month) QE2 (Nov 2010 - 2011) T Notes: USD600 billion QE3 (Sep 2012 - Oct 2014) USD40 billion, increased to USD85 billion on Dec 2012, then decreased to USD65 billion on Sept 2013. Decreasing US tapering started from Jan 2014.
2.	Euro Zone	PSPP+CBPP3+ABSPP Jan 2015: €60 billion per month EAPP+CSPP Mar 2016: €80 billion per month
3.	United Kingdom	QE1 (Mar-Jul2012) £375 billion (net) QE2 (Aug 2016-now) UK Gilts: £60 billion Corporate bonds: £10 billion
4.	Japan	Oct 2010 - Oct 2011: ¥55 trillion (net) April 2013: QE in amount ¥60-70 per year Oct 2014: QE increased to ¥80 trillion per year July 2016: QE ETF increased to ¥6 trillion per year from ¥3,3 trillion

Note: PSPP: Public Sector Purchase Programme, CBPP3: Covered Bond Purchase Programme 3. ABSPP: Asset Backed Securities Purchase Programme Source: Federal Reserve, ECB, BoE, BoJ

had not be attained due to several external factors and lower inflation expectations. Subsequently, the BoJ strengthened its quantitative and qualitative easing (QQE) policy by adding more controls to the yield curve of government bonds, thus approaching 0%. Furthermore, BoJ also adjusted its inflation target from "attaining inflation of 2%" to "attaining inflation above 2%" in order to anchor inflation expectations to a higher level.

Accommodative monetary policy in Japan was well-suited with the country's expansive fiscal policy. In 2016, Japan launched further fiscal stimulus package, worth ¥7.5 trillion (around USD73 billion), as its second largest package since the global financial crisis. Thus, the stimulus program targeted infrastructure projects, as well as disbursed as cash handouts, pension programs and child care to support the current structural reforms in Japan.

Along the line, European Central Bank (ECB) implemented loose monetary policy to stimulate the economy. The ECB increased its Quantitative Easing (QE) by expanding the Asset Purchase Program (APP) from €60 billion to €80 billion per month and extending the scope of eligible assets. In addition, the ECB also lowered the reference Deposit Facility (DF) rate by 10bps to -0.40%, the lowest level in ECB history. Eventually, the negative interest rate eroded the share value of banks in Europe due to concerns that the banking industry would have difficulties attracting funds from the public if negative interest rates were applied to savings products. In response, the ECB issued policy for affordable long-term loans for the banks as an alternative source of funding.

Furthermore, in 2016, the European Commission endorsed countries in Europe to institute pro-growth fiscal policies to drive the economic recovery. Consequently, several European countries, including Greece, Italy, Cyprus and Portugal, must reduce their respectively high debt burdens (Chart 2.2) before providing fiscal stimulus in order to support the effectiveness of fiscal policy as well as ensuring fiscal sustainability and resilience.

Contrarily to the policy responses in Japan and Europe, within the last two years, the US continued to normalize its monetary policy through the Federal Funds Rate (FFR) hikes. Nonetheless, aggressive monetary policy normalization was not possible due to faded economic recovery in the first half of the year despite labor market gains. Furthermore, inflation was under controll due to a low oil price. In turn, US economic growth began to pick up in the third quarter of 2016 and uncertainty surrounding the political transition began to subside, which provided room for the Federal Reserve to raise the FFR by 25bps in December 2016.

Hence, fiscal space in the US has been eroded by the elevated level of government debt. Since the recent significant fiscal stimulus in 2009, namely the American Recovery and Reinvestment Act (ARRA), the volume of government spending has declined, contrasting the balance

Chart 2.2.





sheet of the Fed that has continued to increase through aggressive QE policies.

Structural Policies in Advanced Countries

Policymakers in advanced countries also instituted structural policies, emphasizing solutions to demographic problems, particularly aging populations. Japan has the largest portion of an aging population, with 33% of the population aged 60 or above, followed by Germany (28%), Italy (28%) and Finland (27%).³ With large aging populations, households are more inclined to save their wealth rather than to spend on consumption. Furthermore, aging populations are also a burden on the working age population. Consequently, advanced countries are currently striving to restore the population composition by raising birth rates, for instance in Japan, through the provision of preschool education, along with subsidized fertility treatments and additional assistance for single-parent families. Through such endeavours, the Government of Japan has targeted an increase in the birth rate from 1.45 in 2015 to 1.8 in 2025 (Chart 2.4).

Structural policies were also directed towards reducing labor market segmentation in advanced countries. The promise of lifetime employment by firms in Japan, for instance, has led to segmentation between the permanent and the temporary employees. In current situation, Japanese firms would rather fill new job vacancies with low-income temporary workers and are reluctant to recruit permanent employees due to various rule in labor laws, including

Chart 2.3. United States Fiscal ad Monetary Stimulus



Source: Bloomberg & US Bureau of Economic Analysis

Chart 2.4. Japan Birth Rate



Source: Japan's Ministry of Health

remuneration and facilities that are a burden for companies. Under such conditions, unemployment in Japan has declined, but the aggregate salary increase was decelerated (Chart 2.5). Similar conditions were found in Europe, where segmentation has occurred between secured and unsecured jobs. Thus, solving the problem of the European labor market segmentation requires a fundamental change in labor laws and culture at the corporate level. Consequently, the structural reform process is expected to progress slowly.

2.2. ECONOMIC POLICIES IN DEVELOPING COUNTRIES

In line with advanced countries, macroeconomic policy response in developing countries was also steered towards mitigating the risk of sluggish economic growth. In general,

Chart 2.5. Japan Employment and Real Income



Source: Bloomberg

³ United Nations, Department of Economic and Social Affairs (2015) World Population Aging 2015.

the room for macroeconomic policy was much broader in developing countries compared to those in advanced countries, in terms of both monetary and fiscal policy. Hence, monetary policy easing in developing countries was made possible by low inflationary pressures in 2016 (Chart 2.6). Thus, the different monetary policy responses among developing countries were only affected by differences in foreign capital flow sensitivity to global financial market uncertainty, including uncertainty surrounding the proposed FFR hikes. As such, space for fiscal stimulus was also available in developing countries considering the relatively low ratio of government debt to GDP compared to those in advanced countries (Chart 2.7).

India, amongst others, adopted an accommodative monetary policy response. As the risk of inflation subsided, the Reserve Bank of India (RBI) cut its policy rate twice in 2016 to a level of 6.25% at the end of 2016. The policy rate cut was plausible given the low risk of foreign capital outflow. Hence, by lowering the reference rate, the Reserve Bank of India (RBI) aimed to stimulate lending amongst private banks to the real sector, in spite of sluggish stateowned bank lending to the real sector due to high credit risk (Chart 2.8).

Nonetheless, India was more prudent in terms of implementing expansive fiscal policy because the fiscal deficit of India to GDP was considerably high relative to other Asian countries. Therefore, the Government of India initiated fiscal consolidation to reduce the deficit to zero by 2020. In doing so, in the government's expenditure budget for 2016-2017, the Government of India has targeted a deficit of 3.5% of GDP, down from the 3.9% of GDP realized in the previous year. In terms of fiscal consolidation, the Indian Government emphasized that government spending would target sectors with a strong multiplier effect on economic



Chart 2.6. Comparison of Policy Rate in Some Developing Countries

Chart 2.7. Government Debt to GDP Ratio Developing Countries Compared to Advanced Countries





Source: IMF

growth. Furthermore, government spending was focused on the agricultural sector and rural economic development, such as electrification, irrigation, and harvest insurance programs, as well as infrastructure projects.

As such, the monetary policy response in China continued to give high priority to economic stability. China has maintained a neutral monetary policy stance since 2011 and in 2016, the People's Bank of China (PBoC) maintained a neutral monetary policy stance by preserving adequate liquidity in the economy.

In its effort to strengthen its monetary policy stance, the People's Bank of China (PBoC) issued numerous policy to mitigate the risk of foreign capital outflows. Accordingly, the PBoC controlled capital flows and injected liquidity to mitigate the ongoing foreign capital outflows from China, triggered by expectations of USD

Chart 2.8. Bank Lending Growth in India



Source: Centre for Monitoring Indian Economy (CMIE)

appreciation. Subsequently, China strengthen its capital control by implementing more stringent Outbound Direct Investment (ODI) requirements as well as reducing lower limit of remittances from USD50 million to USD5 million. Additionally, the PBoC also strived to anchor yuan depreciation expectations by disseminating the China Foreign Exchange Trade System (CFETS) as a market reference to assess yuan exchange rate fluctuations.

Thus, the monetary policy stance of the People's Bank of China (PBoC) was enhanced by a 0.5% reduction to the reserve requirement, from 17% to 16.5% in February 2016, in order to offset the decline in its reserve assets. Furthermore, the reduction was aimed to accommodate open market operations that matured in March 2016, totalling 1 trillion yuan. As such, the PBoC was considerably aggressive in responding the FFR hike in December 2016 by extending 600 billion yuan to financial institutions in the form of emergency loans.

The macroeconomic policy mix in China was also supported by accommodative fiscal policy, which drive the government's budget deficit to nearly over the 3% threshold. In doing so, The Chinese Government administered the development banks to invest in government-guaranteed projects. Furthermore, the Government also implemented quasi-fiscal spending by issuing bonds through Local Government Financial Vehicles (LGFV). LGFV are financial institutions owned by local governments, which balance sheets are separated from the state budget. Thus, the funds generated from the bond issuances are invested into local government projects. As a result, the realization of various stimulus was evidenced by the sharp increase of investment at state-owned enterprises in 2016 (Chart 2.9).

In addition, The Chinese Government also introduced various special fiscal policies to boost consumption. For instance, the Government reduced the tax on purchases of small cars in October 2015, while providing subsidies on purchases of environmentally friendly cars. Such measure was effective in accelerating automotive sales volume to 14.1%. Likewise, the property sector also enjoyed stronger sales driven by government stimulus. Thus, tier-2 market performance in the property sector was improved by less stringent downpayment requirements, while unsold houses were offered as social housing. Simultaneously, the Government tightened the requirements on Tier-1 property due to the potential bubble being created.

In spite of accommodative monetary policy stance adopted by developing countries in Asia, such as India and Indonesia, several Latin American countries opted to raise policy rates.

Chart 2.9. Growth of Private Investment and China's Government



Source: Bloomberg

Central banks in México, Peru and Chile ultimately raised their respective reference rates several times in 2016 in order to anticipate the risk of foreign capital outflows and exchange rate depreciation because of the FFR hike. In addition, central banks in Latin America also stabilized the financial markets in response to uncertainty surrounding the FFR hike.

Structural Policy in Developing Countries

The cyclical policy response pursued in developing countries was supported by structural policy to improve allocation of resources and rapidly increasing production capacity. Thus, Dabla-Norris et al. (2016) recommended that low-income countries should focus policy on reforms to overcome the barriers to goods and production factors mobility.⁴ Meanwhile, in more advanced developing countries, structural reforms need to focus on enhancing productivity and fostering innovation.

The focus of structural policy in India was to improve the ease of investing in the country. India targeted placing in the top 50 countries in terms of ease of doing business. Therefore, India has improved electricity infrastructure and its railway system, while relaxing the requirements on foreign investment as well as automating and digitalizing the registration and approval process for new businesses. Furthermore, India has also begun to improve its tax system and refine bankruptcy laws.

⁴ Dabla-Norris E., G. Ho, and A. Kyobe, 2016. "Structural Reforms and Productivity Growth in emerging market and developing countries." IMF Working Paper WP/16/15. IMF.

As such, China has also implemented a structural reform agenda. The Chinese Government plans to reduce corporate costs, while reducing the supply of housing and industrial goods. Production sector reforms are planned through restrictions on production capacity gains, specifically targeting the steel, coal and aluminium industries. Nonetheless, the structural reforms will put adverse risk to economic growth. Therefore, the Chinese Government held back the pace of its reform measures in order to successfully attain the 2020 economic growth target. Additionally, the chinese government continued extending fiscal stimulus through government investment, despite the prospect of slowing economic rebalancing between consumption and investment due to such policy.

2.3. INTERNATIONAL COOPERATION

The global policy response was further supported by strengthening international cooperation through coordination at various forums. In addition to the protracted economic recovery, the international forums also worked on monitoring global challenges and risks, including financial market volatility, flagging economies in several developing countries, the emergence of domesticoriented policies, as well as non-economic factors such as geopolitical tensions and terrorism. In response to such global issues, international forums reinforced cooperation, provided recommendations and strengthened commitment to stimulate growth and accelerate the economic recovery along with enhancing economic and financial system resilience.

Cooperation to Stimulate Growth and Accelerate the Economic Recovery

International cooperation to stimulate inclusive growth and accelerate the recovery was promoted by the G20 under the leadership of China. The G20 agenda to accelerate the economic recovery was implemented through the Hangzou Leaders Communique on the G20 High Level Conference in Hangzhou on 4-5th September 2016. According to the agreement, each member nation is expected to implement monetary policy, fiscal policy, and structural reforms to achieve robust, balanced, sustainable and inclusive growth. Regarding the structural reforms, the G20 has demonstrated advanced measures to implement the commitments documented in the Growth Strategies. Thus, assessment from international organizations showed that 55% of the Growth Strategies in 2016 were implemented, which are expected to create 1.5 percentage points of additional growth to GDP in G20 countries by 2018.

Moreover, the G20 also urged all economic agents to seek new sources of economic growth and increase potential growth through ratification of the G20 Blueprint on Innovative Growth that contains global efforts to spur a new industrial revolution and economic cooperation initiatives. Thus, the G20 also facilitated the joint commitment of 11 Multilateral Development Banks (MDB) to support investment infrastructure.⁵ In conjunction with the MDBs, the G20 also formed the Global Infrastructure Connectivity Alliance to improve synergy and cooperation amongst various global infrastructure programs. Accordingly, the Alliance will also integrate the Global Infrastructure Hub (GIH) formed in 2014.

G20 countries are also committed to increase economic openness, which will be realized through efforts to facilitate and to strengthen trade and investment cooperation amongst G20 members. To that end, G20 member nations are expected to ratify the Trade Facilitation Agreement (TFA) and urge other World Trade Organization (WTO) members to resemble. Furthermore, the G20 ratified the G20 Strategy for Global Trade document, containing measures for member countries to lower trade costs and to utilize trade and investment policy coherence.

The International Monetary Fund (IMF) also contributed to accelerate the global economic recovery and supported efforts to overcome global economic challenges. In its Global Policy Agenda, the IMF formulated four policy priorities to be implemented by the members such as: (i) optimization of the policy mix; (ii) prioritization of structural reforms; (iii) preparations for human resources in dealing with technological change; and (iv) increased global cooperation. Furthermore, the IMF will also strengthen surveillance over global economic dynamics as well as individual member countries. Thus, IMF is committed to helping low-income countries reduce poverty through the Poverty Reduction and Growth trust (PRGT) scheme.

In line with the IMF, the World Bank is also committed to nurturing global economic growth. Hence, the World Bank undertook several infrastructure investment initiatives and strengthened its role as the leading global financial institution for development. Thus, in terms of the development agenda, the World Bank delivered its Vision for 2030 to facilitate achievement of the Sustainable

⁵ The MDB that signed the Joint Declaration of Aspirations on Actions to Support Investment Infrastructure include the World Bank, African Development Bank, Asian Development Bank, Asian Infrastructure Investment Bank, Development Bank of Latin America, European Bank for Reconstruction and Development, European Investment Bank, Inter-American Development Bank, Islamic Development Bank, New Development Bank and International Finance Corporation.

Development Goals (SDGs) by 2030 as well as a global agenda to overcome the adverse impacts of climate change, as stipulated in the 21st Conference on Parties Agreement.

Cooperation to Enhance Resilience

In order to enhance global resilience, the G20 cooperated with international organizations. For instance, to analyse the development of global capital flows and increase the availability of data, the G20 cooperated with to the IMF, Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS) through endorsement of the second phase of the Data Gaps Initiative (DGI-2). In addition, the G20 requested international organizations to compile an effective capital flow management implementation reference through benchmarking and various research. Along the line, the global financial safety net was strengthened through the establishment of IMF facilities in line with the needs of its members, by strengthening sources of IMF financing and reinforcing cooperation with regional financial safety nets. Hence, the G20 also strived to reduce global economic dependency to the USD by encouraging the uptake of Special Drawing Rights (SDR) as a unit on the financial statements and balance of payments (BOP) as well as to foster issuances of government bonds in the SDR.

Thus, in order to enhance resilience through financial sector and financial market regulation, the G20 supported coordinated global financial sector reform efforts by the Financial Stability Board (FSB), prioritizing four main areas. The first priority aims to increase the resilience of financial institutions. To that end, financial institutions are required to maintain adequate capital and liquidity to absorb emerging potential risks. The second priority is to prevent financial institutions from becoming too big to fail. Accordingly, the G20 continued to implement Total Loss Absorbing Capacity (TLAC) standards, aiming to sufficiently prepare Global Systemically Important Financial Institutions (GSIFIs) to absorb losses, thus obviating the government bail-out. In addition, the G20 strived to strengthen financial market infrastructure through the formation of the Central Clearing Counterparty (CCP) to conduct clearing activities and guaranteeing financial market transactions.

The third and fourth priorities of the Financial Stability Board (FSB) are to reform the over-the-counter (OTC) derivatives market and shadow banking system.⁶ The OTC derivatives market received attention due to its complexity and limited transparency, which impaired the authorities' ability to monitor and respond to risk accumulation, as well as evaluate the spillovers that emerge when a financial institution fails. In addition, the intermediation function implemented by shadow banking entities outside the banking sector has also garnered attention since it contributed to the global financial crisis. Thus, mechanism to monitor shadow banking activities and risks as well as the range of policies taken in response to the risks have been developed. Furthermore, the G20 also released the High-Level Principles for Digital Financial Inclusion as guidelines to promote financial inclusion.

International cooperation to enhance global resilience was also facilitated through regional cooperation forums. In 2016, Bank Indonesia chaired the Central Bank Governors Meeting for the Asia-Pacific region through the Executives Meeting of East Asia-Pacific Central Banks (EMEAP). One of the central issue was the impact of postponed payment settlement (T+1 margin settlement) in the US and EU. The corresponding regulations were deemed to have an adverse impact on liquidity, the function of the financial system, and global economic growth. Therefore, the EMEAP governors requested the US and EU authorities to cooperate with EMEAP to resolve the issue, while also requesting each respective authority to delay implementation of the regulation.

As such, ASEAN+3 countries continued to strengthen regional resilience in the face of global uncertainty risk.⁷ The Chiang Mai Initiative Multilateralization (CMIM) was strengthened by: (i) honing the Operational Guidelines; (ii) strengthening the Economic Report and Policy Dialogue (ERPD) matrix; (iii) refining the coordination mechanism between CMIM and the global financial safety net; and (iv) reviewing the CMIM-IMF de-linked portion (DLP).8 In CMIM-IMF DLP review, Bank Indonesia was responsible for compiling the framework review and measurement methodology, while overseeing the review process. Thus, regional resilience was also strengthened by enhancing the surveillance capacity of the ASEAN+3 Macroeconomic Research Office (AMRO) through collaboration and cooperation with the International Monetary Fund (IMF) and by refining the surveillance framework.

Thus, financial integration in the ASEAN region is another strategic issue and therefore was being discussed at the

⁷ ASEAN central bank cooperation with three additional countries, namely Japan, China and South Korea.

⁶ Shadow banking is defined as intermediation activities involving entities and activities, in part of entirely, outside of the banking sector.

⁸ CMIM is a multilateral cooperation agreement that regulates swap transactions between ASEAN+3 countries and Hong Kong to provide financial support in USD.

Senior Level Committee (SLC) on Financial Integration⁹. As such, Bank Indonesia chaired the 12th SLC held in Jakarta on 14th October 2016. At the meeting, SLC members agreed to strengthen two areas in order to achieve the vision of the ASEAN Economic Community (MEA) 2025. First, ASEAN countries will conduct an overall assessment on the benefit of economic integration. Second, ASEAN countries will assess macroeconomic and financial stability to safeguard the MEA integration process.

⁹ SLC consists of central bank deputy governors and co-chairs of the ASEAN Working Committee and is mandated with providing guidelines for regional financial integration initiatives and implementation.

