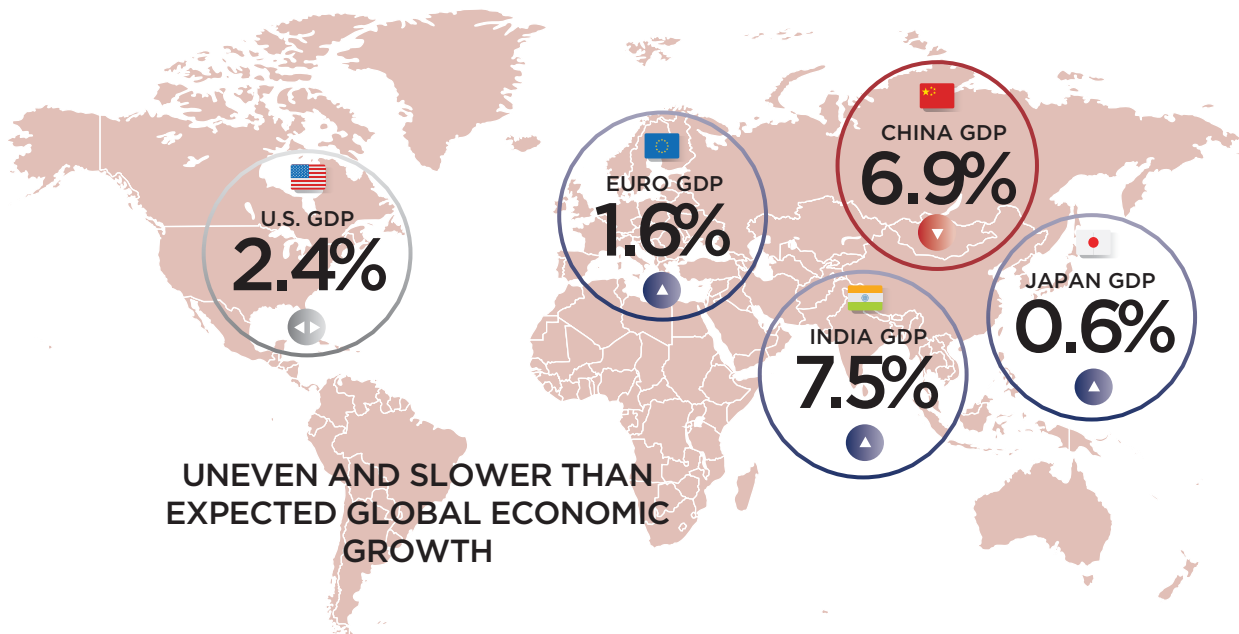


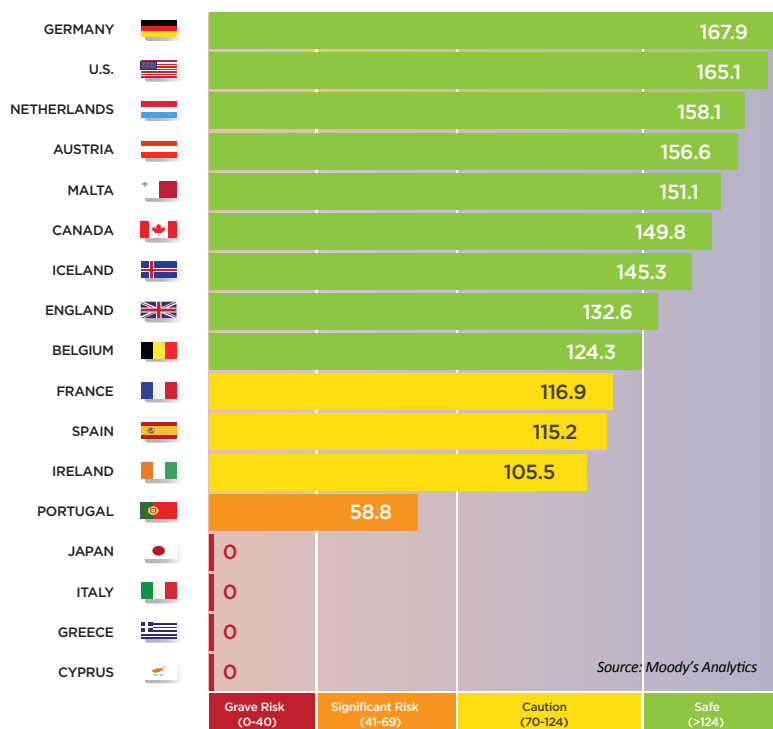


PART I

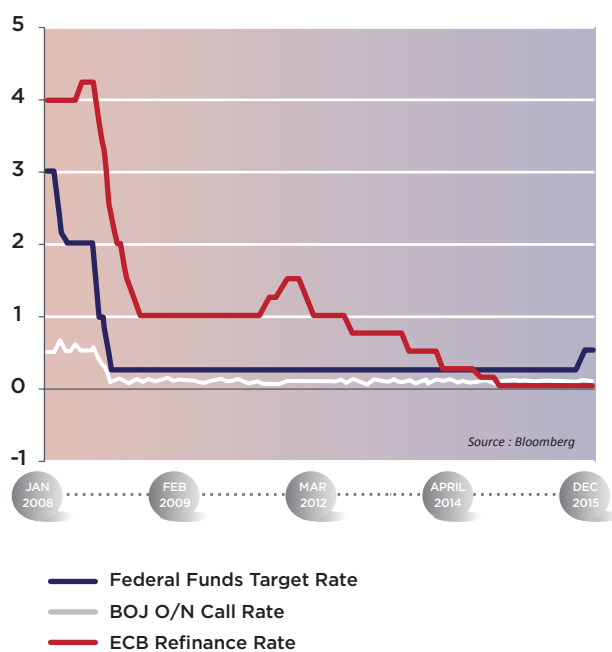
# GLOBAL ECONOMY



### Limited Fiscal Space in Advanced Economies



### Monetary Policy Divergence in Advanced Economies



### INTERNATIONAL COMMODITY PRICE TRENDS STILL IN DOWNHILL



# PART I

## GLOBAL ECONOMY

In 2015, the recovery in the global economy progressed more slowly than expected. The world economy grew by only 3.1%, below the forecast of 3.5% at the start of the year and the 2014 growth rate of 3.4%. The economic growth in advanced economies that fell short of earlier forecasts was insufficient to serve as the engine of global economic recovery. Measures for promoting economic growth, particularly in advanced economies, had only limited success because quantitative easing policies were not fully supported by fiscal stimulus and implementation of structural reforms. Furthermore, the multispeed recovery in economic growth led to divergence in monetary policy among the advanced economies. The U.S. Federal Reserve embarked on a monetary policy normalization, while on the other hand, the European Central Bank and the Bank of Japan continued to implement accommodative monetary policies.

Global economic recovery in 2015 was also marked by changes in the landscape of economic growth. Growth slowed in emerging markets while the economies of advanced countries charted a gradual recovery trend. Although lower than predicted, economic growth in advanced economies edged upwards from 1.8% in 2014 to 1.9% in 2015. Conversely, economic growth in emerging markets slipped from 4.6% in 2014 to 4.0% in 2015. Despite experiencing a significant slowdown, the emerging market retained a dominant position in the contribution to global economic growth by 58%. Advanced economies, on the other hand, only accounted for 42%.

The global economic slowdown in 2015 was driven by both cyclical and structural factors. The cyclical factors were mainly related to the economic slowdown in China, the continued downturn in commodity prices, and uncertainty over U.S. monetary policy normalization. The structural factors, on the other hand, were visible mainly in advanced countries, and arose from declining potential output caused by the demographic factor of the ageing population and falling levels of investment in the aftermath of the global financial crisis. The decline in potential output and the policy responses pursued by advanced economies had significant spillover effects on emerging markets, transmitted through both the trade and financial channels.

The economy in China slowed further, as a result of the economic rebalancing policy that has so far not succeeded in raising consumption. In 2015, China's economy grew by only 6.9%, having slowed from the 2014 growth of 7.3%. This slowdown was prompted by the economic rebalancing policy from an investment-driven towards a consumption-driven economy in order to achieve higher quality and more sustainable economic growth. However, the improvement in consumption growth was only limited and insufficient to offset the considerably greater slowdown in investment. This resulted in a weakening of Chinese demand for imports that brought repercussions for emerging markets through the trade channel.

The downturn in global growth, particularly in China, led to a sustained fall in world commodity prices during 2015. Commodity exporting countries, including Indonesia, suffered from the twin impacts of diminishing volume of demand and falling commodity prices that hit export performance. In 2015, the Indonesia Export Commodity Price Index plunged 14.9%, a markedly greater loss than the index contraction in 2014 that reached 4.2%. The fall in commodity prices in response to the economic slowdown in China was exacerbated by tumbling world oil prices, which are closely linked to the prices of certain commodities. The weakening in world oil prices represents the effect of oversupply from both OPEC members and non-OPEC countries amid shrinking demand brought about by the global economic slowdown. Contributing to the glut in the world oil supply were the policies of oil-producing countries who have maintained production levels despite falling oil prices in order to maintain their market share on the world oil market.

The economic slowdown and fall in commodity prices contributed to a decline in global inflation. In 2015, global inflation was recorded at 3.3%, down from 3.5% in the previous year. Inflationary pressure eased mainly in advanced economies. In 2015, inflation in advanced economies came to only 0.4%, well below the 2014 inflation of 1.4%. In some advanced economies, notably the U.S., Europe, and Japan, inflation came well below the prescribed targets. On the other hand, inflation in

emerging market economies mounted to 5.6% in 2015 from 5.1% one year previously. This increase is explained mainly by the pass-through effect of depreciation in exchange rates.

In the financial sector, global financial markets were marked by rising volatility in 2015, reflecting high levels of uncertainty. The mounting volatility on world financial markets in 2015 is explained by three factors: (i) sentiment over monetary policy normalization in the U.S. that influenced global financial markets from early 2015; (ii) sentiment fuelled by concerns over resolution of the crisis in Greece during the first quarter of 2015; and (iii) devaluation of the yuan by the People's Bank of China in August 2015. The uncertainty over increases in the U.S. Federal Funds Rate (FFR) prompted risk-off behavior among global investors accompanied by diminished capital inflows into the financial markets of developing economies that in turn put pressure on exchange rates.

In response to the dynamics of the global economy and financial system, some emerging market economies pursued a policy mix to integrate monetary and fiscal policy and structural reform. Learning from the experience of some advanced economies that relied too much on monetary policy to stimulate economic growth, a number of emerging economy countries opted for a policy mix approach to bolster the otherwise flagging economic growth. The policy mix consists of a combination of monetary relaxation with macroprudential policy, fiscal policy, and structural reforms. China, India, and Indonesia are examples of emerging market economies that have consistently implemented a sound policy mix for macroeconomic management accompanied by an agenda for structural reforms. In emerging markets, there is a pressing need for structural reforms in order to improve efficiency and competitiveness and thus pave the way for the economy to achieve sustainable growth.

Efforts were also pursued to strengthen international cooperation in anticipation of global economic challenges

that lasted throughout 2015. The G20 Forum emphasised the need for action to bring about strong, inclusive economic growth. At the same time, the IMF also encouraged its member countries to bolster the demand side with the use of a macroeconomic policy mix and to accelerate the implementation of structural reforms. In a similar vein to the IMF, the Islamic Development Bank (IDB) expanded its role in funding assistance for the infrastructure projects of its member countries, including support through establishment of the World Islamic Investment Bank (WIIB). International cooperation was also focused on maintaining financial system stability for resilience in the face of shocks, including establishing an agenda for reform of international financial standards. To safeguard resilience in the region, the ASEAN+3 countries strengthened their Regional Financial Arrangement (RFA) collaboration by implementing the Chiang Mai Initiative Multilateralization (CMIM) while also expanding the role of the ASEAN+3 Macroeconomic Research Office (AMRO).

Looking ahead, the outlook for global economic conditions is more favourable with higher growth rate. The onset of normalization of U.S. monetary policy will ease uncertainties on global financial markets. On the other hand, the still fragile economic recovery in the U.S. indicates that increases in the FFR will be gradual. This will lead to less divergent global monetary policies, thereby easing pressures on the financial markets of emerging market economies. The ongoing improvement in the advanced economies and the early signs of results from implementing a policy mix and particularly structural reforms in emerging markets will boost global economic growth to 3.4% in 2016. Even so, the rise in global economic growth is not expected to bring improvement in commodity prices, which will instead undergo mild correction. This condition poses a challenge for commodity-exporting countries, including Indonesia, to work consistently in implementing structural reforms in order to create new sources of economic growth in diversification away from commodities so that growth can become more sustainable and resilient to global shocks.





The global economy grew slower in 2015 than previously projected. Furthermore, the multispeed recovery triggered monetary policy divergence: the U.S. raised its policy rate, contrasting Europe and Japan that expanded quantitative easing.

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# Chapter 1

## Global Economic Dynamics

The global economy recovery in 2015 was weaker than previously projected, tainted by moderation and imbalances coupled with ubiquitous uncertainty blighting global financial markets. The global economy was underpinned by growth in advanced countries, primarily the United States, despite sluggish growth in Europe and Japan. Meanwhile, economic growth in developing countries also tended to decelerate, driven predominantly by the economic slump experienced in China. Congruous with the global economic downshift, international commodity prices, including oil prices, continued to slide.

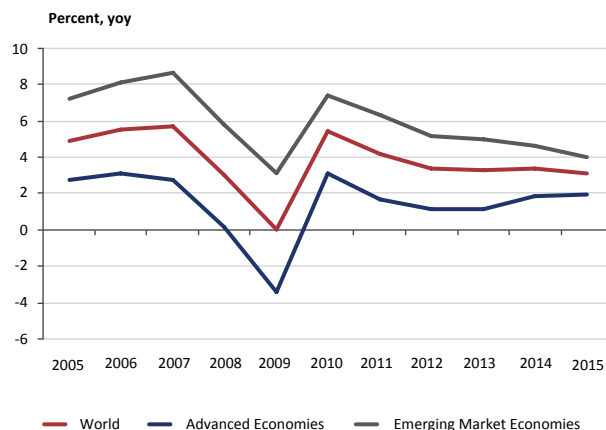
A weaker-than-expected global recovery lingered in 2015. The rebalancing process in the wake of the global financial crisis (GFC) continued in advanced countries, which also began to spillover to emerging market (EM) countries. Post-crisis, a negative output gap, globally and individually, triggered low inflation in numerous countries, particularly advanced countries, which provided adequate space to loosen monetary policy in order to kick-start economic growth. Unfortunately, the expected pace of growth remained unachievable due to the languid implementation of much needed structural reforms combined with limited fiscal policy support in a number of advanced countries.

Disparity between the phases of economic recovery in several advanced countries prompted monetary policy divergence globally.<sup>1</sup> On the one hand, the U.S. began to normalize its monetary policy stance in December 2015, for which the proposed implementation was communicated at the end of 2014. Conversely, however, Europe and Japan extended loose monetary policy. Uncertainty regarding the timing and magnitude of the policy rate hike in the U.S. along with global monetary policy divergence intensified volatility on global financial markets, which triggered risk-off behavior amongst investors. Such conditions, coupled with deleveraging in advanced countries, eroded inflows to emerging market countries and eventually led to negative outflows. Furthermore, lower international commodity prices on the back of weak demand from China also exacerbated external pressures in emerging market countries, especially net exporters.

Against such an inauspicious backdrop, the global economy grew at 3.1% in 2015, down from 3.4% the preceding year (Chart 1.1). Actual growth in 2015 was below the Bank Indonesia projection at the beginning of the year as well as the International Monetary Fund (IMF) forecast of 3.5%, building on the momentum achieved in 2014. Global economic moderation was the result of both cyclical and structural factors. Cyclically, the main factor was the economic downswing observed in China that ultimately perpetuated the international commodity price slide. Additionally, policy spillover from advanced countries further undermined global growth. Structurally, however, lower potential output due to the ageing populations of advanced countries, together with sluggish investment after the global financial crisis, slowed global growth. In terms of inflation, the global slowdown, soft oil prices and sliding commodity prices coalesced into lower global

1 Disclosed by the International Monetary Fund (IMF) and European Central Bank (ECB).

**Chart 1.1. Global Economic Landscape: Economic Growth**

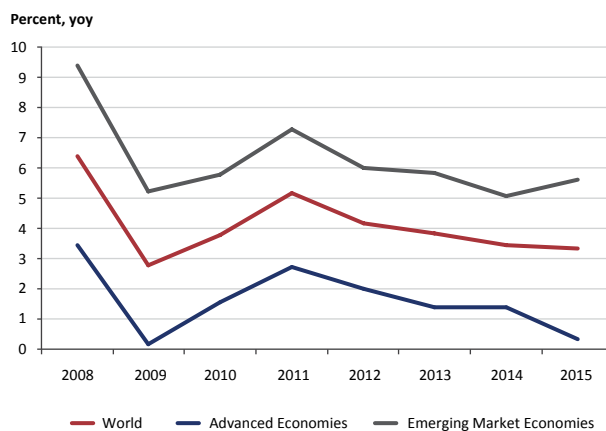


Source: WEO IMF, processed

inflation (Chart 1.2). Global inflation stood at 3.3% in 2015, down from 3.5% in 2014.

Weaker global growth in 2015 compared to the preceding year was considered the most binding challenge faced by countries worldwide, including Indonesia. In addition, the world trade structure experienced a number of increasingly significant changes over time that adversely affected the domestic economy of Indonesia. Consequently, trade elasticity to the economy was seen to decline due to mature global supply chains.<sup>2,3</sup> Such

**Chart 1.2. Global Economic Landscape: Inflation**



Source: WEO IMF, processed

- 2 Global supply chains: the trade of raw materials or intermediate goods between countries in order to produce finished articles.
- 3 A range of studies conducted by various institutions, including the International Monetary Fund (IMF), World Bank, European Central Bank (ECB) and OECD produced similar findings.

conditions amplified the impact of sliding commodity prices on external sector performance in Indonesia. In addition, challenges also stemmed from a decline in capital inflows into Indonesia throughout 2015 in line with the shift in the composition of global liquidity and deleveraging in advanced countries.

## 1.1. ECONOMIC GROWTH AND INFLATION IN ADVANCED ECONOMIES

Economic performance in advanced countries was marked by moderate growth and very low inflation. Growth in such countries was recorded at just 1.9% in 2015, accelerating slightly from 1.8% in 2014. Meanwhile, inflation stood at just 0.4% in 2015, well below the 1.4% posted in 2014 due primarily to cheap international oil and commodity prices. In general, inflation in major advanced countries, including the U.S., Europe, and Japan, fell below target. Additionally, prices in Europe and Japan even experienced deflation, contrasting the intense inflationary pressures felt in emerging market countries such as Russia, Brazil, and other Latin American countries, where exchange rate depreciation exacerbated inflation.

In response to low inflation and lacklustre recoveries, advanced countries opted to extend loose monetary policy in order to stimulate demand. Consequently, the recoveries in such countries gained momentum, predominantly on the back of U.S. growth, albeit at a slower pace than previously expected. A gradual recovery endured in Europe, while torpid gains in Japan also contributed to global growth. Notwithstanding, the dependence on loose monetary policy was not accompanied by adequate fiscal stimuli nor the accelerated implementation of structural reforms. Therefore, the efficacy of loose monetary policy was tempered in terms of catalysing economic growth. Despite improvements on the previous year, the economic contribution of advanced countries (42%) to global growth was less than that contributed by emerging market countries (58%) (Table 1.1).

U.S. economic growth was lower than expected in 2015. The U.S. economy achieved growth of 2.4% in comparison to the 3.6% projected previously due to the North American cold wave that struck in 2015 combined with strike action at ports on the West Coast in the first quarter of 2015. Such conditions reduced private spending during the same period that led to a build-up of inventory in the subsequent quarters and ultimately lowered production output (Chart 1.3). In addition, sluggish growth in the U.S. also placed pressures on U.S. manufacturing industry

**Table 1.1.** Realization of Global Economic Growth

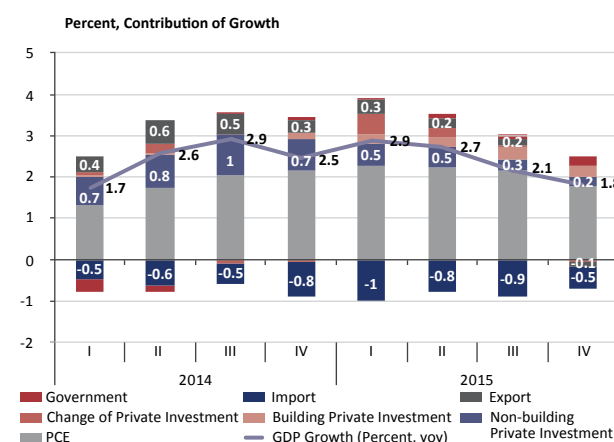
GDP (%yoy)	2014	2015*	
	Growth (%)	Growth (%)	Growth (%)
World	3.4	3.1	100
Advanced Economies	1.8	1.9	42
Japan	-0.03	0.6	4
U.S.	2.4	2.4	16
Euro Zone	0.9	1.6	11
France	0.2	1.4	2
Germany	1.6	1.3	3
Italy	-0.4	1.0	2
Spain	1.4	3.5	1
Emerging Markets	4.6	4.0	58
China	7.3	6.9	17
India	7.3	7.5	7

Source: update WEO IMF Jan-16, Bloomberg  
\*provisional figures

performance due to a contraction of external demand for exports congruous with the global economic slowdown and broad U.S. dollar appreciation (Chart 1.4).

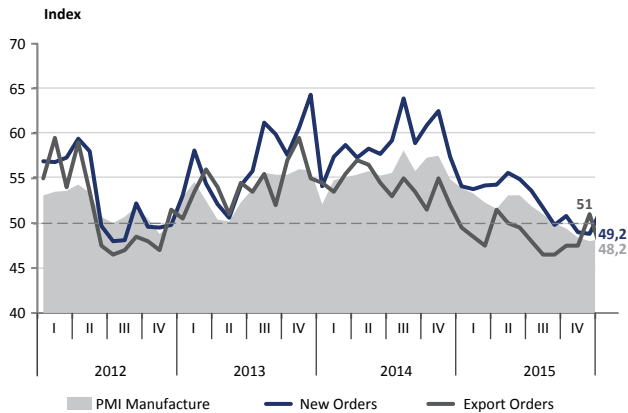
Despite relatively sound performance, the impact of U.S. economic momentum globally was minimal because U.S. growth stemmed primarily from non-tradeable sectors. Based on 2013-2015 data, around 76% of U.S. economic growth came from non-tradeable sectors, in particular the Processional and Business Services Sector as well as the Real Estate Sector. Consequently, U.S. growth was not expected to contribute tangibly to growth in other countries.

**Chart 1.3.** Decomposition of U.S. GDP Growth



Source : BEA, processed

**Chart 1.4. U.S. Manufacturing Sector**



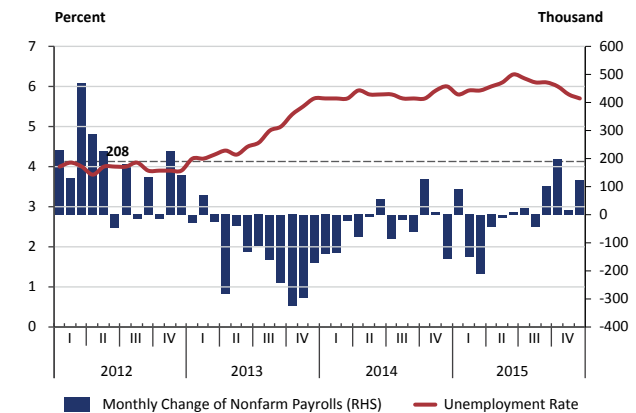
Source: Bloomberg, processed

U.S. economic momentum was predominantly supported by consumption. Private spending followed an upward trend despite slowing in the first quarter of 2015. The solid increase in private consumption was consistent with lower fuel prices in the U.S. that occasioned greater purchasing power. Furthermore, the labor sector continued to improve throughout 2015, which boosted consumption. Low fuel prices and increasingly conducive labor market conditions also bolstered consumer confidence, which ultimately served to increase private consumption further.

The U.S. labor market improved in 2015 in line with relatively robust economic gains, marking a drop in unemployment (Chart 1.5). The ratio of the unemployment and job openings, which is a reflection of demand in the labor sector, tended to increase to pre-crisis levels. Improvements were noted to affect all sectors, as observed cyclically and from the corresponding long-term trends. In addition, non-farm payrolls and earnings growth also improved, particularly in the services sector. The number of part-time employees for economic reasons declined, reflecting a persistently lower supply of labor.

The U.S. housing sector also contributed to U.S. economic gains in 2015. Home sales continued to grow in line with low mortgage rates. Congruously, the U.S. housing sector index rallied (Chart 1.6). Moreover, the prevalence of front loaded property purchases prior to the Federal Funds Rate (FFR) hike by the Federal Reserve also drove house sales. Future performance of the housing sector is also set to improve, evidenced by increases in Building Permits and Housing Starts as an early indicator of the U.S. housing sector.

**Chart 1.5. U.S. Employment Sector**

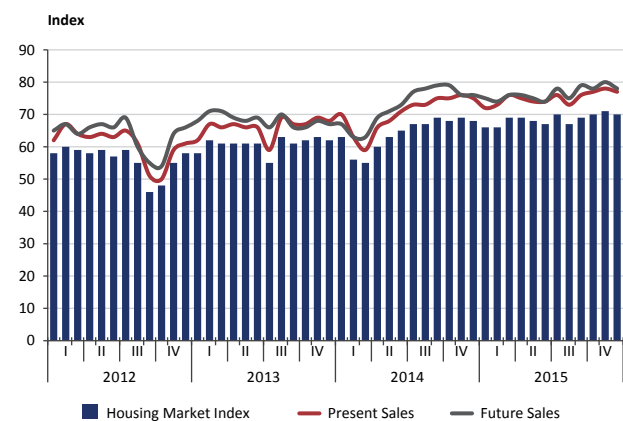


Source: Bloomberg, processed

The economy of Europe achieved growth of 1.6% in 2015 improving from 0.9% in 2014 (Chart 1.7), supported by a surge in domestic demand. Consumption in Europe, which accounted for 75% of GDP, tended to increase, indicated by strong retail sales data and new car registrations. In addition, consumption was also bolstered by gains in the labor sector as the level of unemployment noted gradual declines throughout Europe.

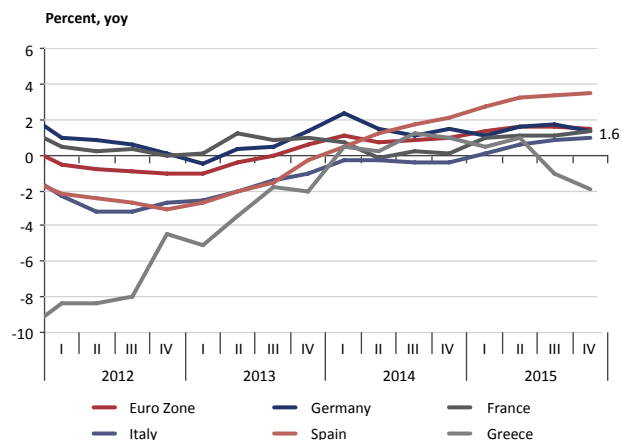
Manufacturing activity in Europe remained expansive and was balanced throughout the core countries (Chart 1.8). Manufacturing expansion in Europe was supported by strong domestic demand despite slower export growth. Solid domestic demand managed to improve manufacturing sector performance, which boosted manufacturing output. Such conditions ultimately raised the GDP outlook, considering the historically positive

**Chart 1.6. U.S. Housing Sector**



Source: Bloomberg, processed

**Chart 1.7. Euro Economic Growth**

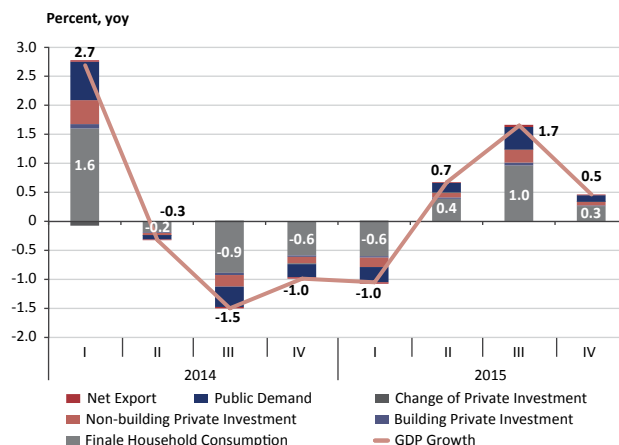


Source: Bloomberg, processed

correlation between Purchasing Managers' Index (PMI) and GDP in Europe. Nonetheless, export growth continued to decrease in line with the sluggish global economy, primarily in the form of less demand from China and other emerging market countries.

The economy of Japan also improved in 2015, growing by 0.6% and reversing the 0.03% contraction posted in 2014. Nevertheless, the economic recovery in Japan was slow and relatively weak, reflecting limited gains in the consumption sector throughout 2015 (Chart 1.9). Weak consumption was driven by limited gains on the labor market, an ageing population, the government's austerity policy, and compounded by policy to raise the sales tax in April 2014. Support for the labor sector to improve consumption was also inadequate, with an unstable level of unemployment reported along with limited

**Chart 1.9. Japan Economic Growth**

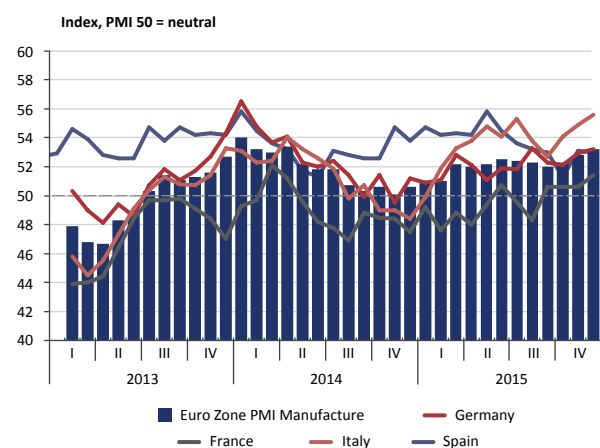


Source: Bloomberg, processed

salary growth. Insufficient support for the labor sector manifested when corporate profits were not passed on to the employees. Consequently, consumers lost confidence and put off consumption.

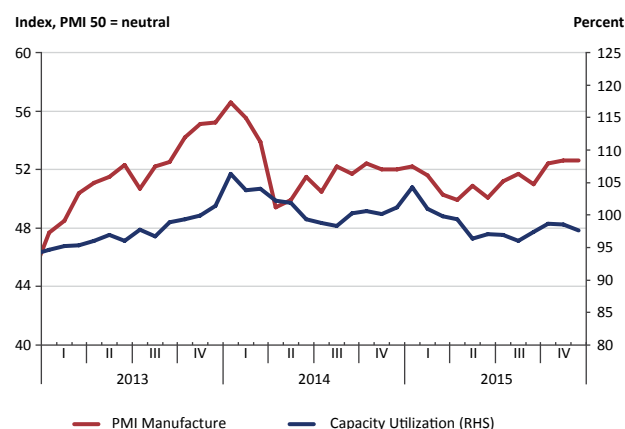
Manufacturing sector gains did, however, help to drive economic growth in Japan, with the corresponding manufacturing indicators following an expansionary phase in the second half of the year (Chart 1.10). Despite spillover from the economic moderation happening in China, demand for exports from Japan was bolstered by advanced countries that had enjoyed recent economic improvement. In addition, domestic demand also increased due to seasonal factors during the approach to yearend holidays, which boosted manufacturing sector performance at the end of 2015.

**Chart 1.8. Euro Manufacturing Sector**



Source: Bloomberg, processed

**Chart 1.10. Japan Manufacturing Sector**



Source: Bloomberg, processed

## 1.2. ECONOMIC GROWTH AND INFLATION IN EMERGING MARKETS

In contrast to advanced countries, the economies of emerging market countries continued to slow, while inflationary pressures continued to accelerate. The slowdown was led by economic moderation in China and the inherent spillovers therein through lower commodity prices, the trade channel as well as the confidence channel considering China's significant role in the economies of other emerging market countries. On the other hand, capital flows to emerging market countries ebbed in line with global monetary policy divergence, which heightened volatility on financial markets, along with deleveraging in advanced countries. Such conditions weakened domestic exchange rates and intensified financial risks. Moreover, structural problems and domestic policies were also responsible for economic disparity amongst the different countries.

The economies of emerging market countries grew slower in 2015 at 4.0% on average compared to 4.6% the preceding year earlier. Despite decelerating, emerging market countries maintained their dominant contribution to global economic growth in 2015, consistent with the 58% contribution of emerging market countries to the global economy and higher level of growth (4.0%) compared to advanced countries (1.9%). Meanwhile, inflation in emerging markets stood at 5.6% in 2015 compared to 5.1% in 2014 as a result of significant depreciation in countries such as Russia, Brazil, and other Latin American countries. In contrast, countries such as China and Indonesia achieved lower inflation in 2015 due to the ongoing international commodity price slide, including oil prices.

Economic moderation in China, as a primary determinant of global economic performance, was a consequence of economic rebalancing policy instituted by the authorities in China. Rebalancing was sought to transform the domestic economy from investment driven to consumption driven. In that context, economic transformation was pursued in China in order to achieve higher quality, sustainable economic growth in the long-term.<sup>4</sup> In its implementation, investment growth slowed throughout 2015, while the acceleration of consumption was inadequate to sustain overall growth.

In line with that, credit growth followed a downward trend in China during the second half of the year. In addition, the manufacturing sector experienced a

prolonged contraction in line with deteriorating external sector performance in the form of dwindling demand for exports as the global economy moderated against a backdrop of sluggish domestic demand. The Chinese economy was also replete with external pressures linked to deluge of foreign capital outflows stemming from global monetary policy divergence. In response, the China's authorities introduced a series of policies to maintain macroeconomic stability and stave off further economic declines. Consequently, China's economy grew 6.9% in 2015, down from 7.3% the year earlier.

The various policies instituted by the Chinese authorities began to bear fruit at the end of 2015. Retail sales rebounded in 2015 to 11.1% (yoy) or 17.2% (qtoq), the highest level in the past four years. Meanwhile, household disposable income grew 8.1%, surpassing GDP growth, despite prevailing stock market shocks. On the other hand, property construction began to rebound at the end of 2015 despite growth remaining in negative territory.

Economic moderation in China, combined with industrial policy that suppressed domestic value added, undermined trade performance in other emerging market countries as trading partners of China. Also, this strategy was reflected in a decrease in the role of China in the global value chain. The current account deficit in China expanded, while external sector performance tended to decline. ASEAN member countries and South Korea are solid examples of emerging market countries affected by spillover from China's flagging economy through the trade channel.

Growth slowed in various emerging markets, as net producers of commodities, in line with the protracted international commodity price slide throughout 2015. The commodity price contraction reduced revenues in EM net-exporters through wider current account deficits. Additionally, domestic structural and political issues in each respective country exacerbated domestic economic declines. Brazil, México, Nigeria, Russia, and Saudi Arabia are examples of emerging market countries that experienced economic moderation due to soft commodity prices coupled with structural and political issues.

The economy of India, as an emerging market country, maintained robust growth. The country recorded growth of 7.5% in 2015, accelerating on the previous year. Nonetheless, the high level of growth recorded in India was also partially due to an upward revision as a result of changing the method to calculate GDP growth at the

<sup>4</sup> China's Third Plenum, 2013.

beginning of 2015.<sup>5</sup> Domestic demand, however, remained strong, supported by government-led infrastructure projects. Although India was affected by weaker demand for exports from China, the domestic manufacturing sector remained expansive on the back of domestic demand, reflecting restored economic sentiment, robust car sales, production output gains and an improved infrastructure index.

### 1.3. GLOBAL COMMODITY PRICES

International commodity prices faced numerous corrections throughout 2015. On an annualised basis, the Indonesia Export Price Index contracted -15%, deteriorating from -4.2% in 2014 (Chart 1.11).<sup>6</sup> The deeper Indonesia Export Price Index contraction was a result of the global economic slowdown, specifically China as the leading consumer of products exported from Indonesia. The close relationship between commodity prices and economic performance in China is reflected in the strong correlation between the international non-fuel commodity price index and economic growth in China at 0.7 (Chart 1.12).

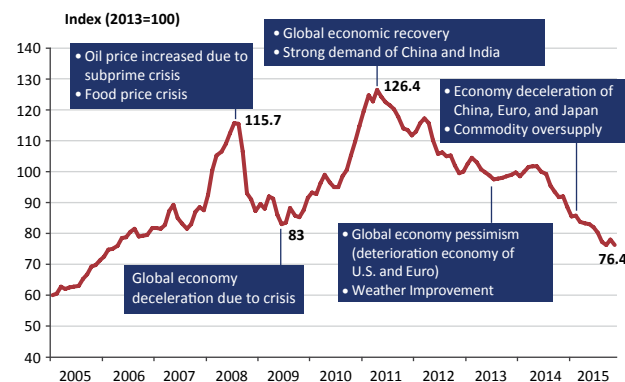
Sliding export commodity prices in Indonesia during 2015 mainly affected coal, crude palm oil (CPO), and rubber. Accordingly, the coal price fell 24.5% in 2015 due to fewer shipments to China in line with China's policy to protect domestic industry as well as policy to reduce carbon emissions from power stations. Meanwhile, the price of CPO dropped 8.2%, triggered by oversupply in Malaysia. Furthermore, low international soybean and crude oil prices, as substitute products, also lowered the price of CPO. The price of rubber sank 18.6% in 2015 due to a slump in demand from China for natural rubber. A decrease in the rubber price in line with a shift in demand from natural to synthetic rubber, which also fell in price consistent with cheaper oil. Moreover, a declining automotive industry further exacerbated downward pressures on rubber prices.

In terms of crude, the world oil prices followed a downward trend in 2015. This situation was due to oversupply from OPEC and non-OPEC countries

<sup>5</sup> Under the old method, GDP growth in India in 2013 and 2014 stood at 4.7% and 5.6% respectively. The change to calculating GDP in India involved a change to the base year and a change from factor cost to market price in accordance with the System of National Accounts (2008).

<sup>6</sup> A composite index of major export commodity prices from Indonesia, including coal, crude palm oil (CPO), rubber, copper, nickel, tin, aluminum, and coffee.

**Chart 1.11. Development of Export Commodity Prices**

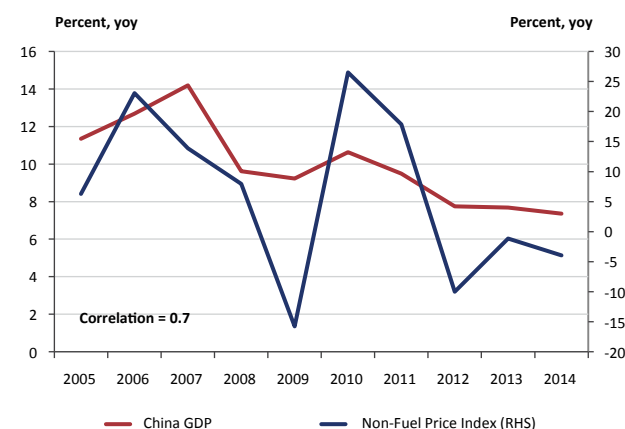


Source: Bloomberg, processed

despite dwindling demand because of global economic moderation. In addition, broad U.S. dollar appreciation throughout 2015 made oil prices relatively more expensive for the majority of countries not using the U.S. currency. It also contributed to lower demand for oil. At the end of 2015, the oil price faced yet another correction, despite declines in terms of oil production and rig counts in the U.S. This correction was caused by the large U.S. oil inventory which prompted negative sentiment and additional downward pressures on oil prices.

Although oil prices fell to nearly price in 2008, production continued to increase in 2015 sourced either from OPEC or non-OPEC countries. Higher production from OPEC members during 2015 was part of a strategy amongst oil producers to maintain market share. The strategy was

**Chart 1.12. China GDP and Non-fuel Commodity Price**



Source: CEIC, processed

spearheaded by Saudi Arabia, where oil production costs are remarkably low at just USD5 per barrel. On the other hand, non-OPEC oil producers, primarily the U.S., enjoyed improved production efficiency. Therefore, the lower rig count did not translate into significantly less production.

Moving forward, the risk of lower oil prices is high. The risk of further oil price declines could stem from policy to ease export restrictions in the U.S., additional oil supply from Iran after reaching a nuclear deal as well as limited potential declines to production in OPEC members due to narrower fiscal space coupled with geopolitical instability.<sup>7</sup> Nonetheless, there also remains the risk of incrementally rising oil prices in line with less supply from the U.S. due to less investment in the oil sector. This is possible albeit still net total world oil supply.

## 1.4. GLOBAL FINANCIAL MARKETS

Global financial markets in 2015 were blighted by heightened volatility, reflecting increased uncertainty. Heightened volatility was primarily triggered by uncertainty beginning at the end of 2014 surrounding the magnitude and timing of the proposed FFR hike in the U.S., followed by the debt crisis unfolding in Greece in March 2015, yuan devaluation in August 2015 and deep corrections on China's stock markets in the same month.<sup>8</sup> Initially, the proposed FFR hike was expected to take place in the middle of 2015 but expectations were shifted backwards after the release September FOMC meeting on 8th October 2015, which eased volatility stemming from uncertainty. Thereafter, however, strong U.S. economic data along with the official statement relayed at the FOMC in October 2015 brought expectations forward until the end of 2015, which again triggered uncertainty on financial markets. Ultimately, the Federal Reserve raised its policy rate by 25bps at the FOMC in December 2015. Nonetheless, considering that the increase had already been widely anticipated by the markets, excessive shocks on global

<sup>7</sup> According to prevailing policy, oil exports from the U.S. account for just 5% of total production and oil producers require a license from the U.S. Government to export crude oil, with the exception of exports to Canada and exports of condensed oil. With such export restrictions in place, the U.S. oil market suffers from abundant oversupply, leaving U.S. oil prices lower than international prices. If U.S. export restrictions were lifted, the price disparity would narrow.

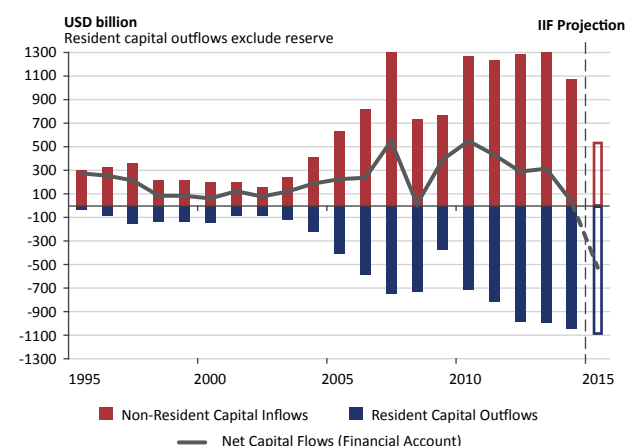
<sup>8</sup> The Greek debt crisis surfaced in March 2015 when the Greek government extended the repayment of its external debt by four months. At the end of June 2015, however, crisis conditions peaked when the Greek Government had spent all of its cash on public necessities. Uncertainty concerning whether Greece would be able to service its debt spurred widespread shocks on global financial markets.

markets due to the 25bps bump did not materialise. On the other hand, the European Central Bank (ECB) and Bank of Japan (BoJ) extended quantitative easing policy throughout 2015, which led to global monetary policy divergence. Such conditions, accompanied by deleveraging in advanced countries and a shift in the composition of global liquidity following the normalization of U.S. monetary policy, eroded capital inflows to emerging market countries, leading to negative net flows (Chart 1.13).

In addition to the developments transpiring on global financial markets, the global composite stock price index slumped to 142.3 at the end of 2015 from 146.3 at the end of 2014. Similar conditions were reported in terms of composite stock price indexes in Asian emerging market countries, Asia-Pacific countries and G-7 countries. On average, however, composite stock price indexes in Asian emerging market countries, Asia-Pacific countries and G-7 countries were relatively stable. The yields of government bonds, specifically in net-exporting emerging market countries such as Brazil and other Latin American countries, were observed to increase as the economic outlook deteriorated in line with sliding commodity prices (Chart 1.14 and 1.15).

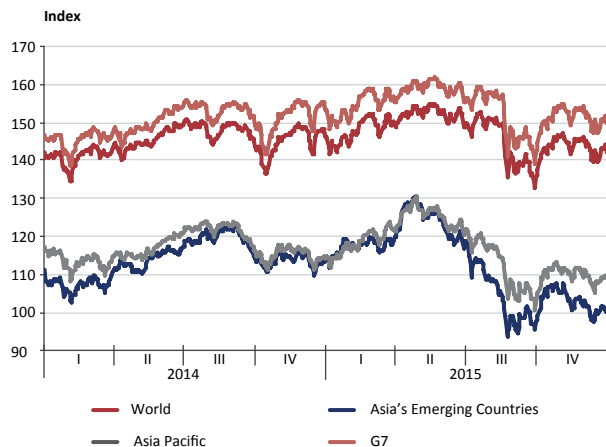
Market sentiment regarding uncertainty surrounding the magnitude and timing of the proposed FFR hike along with economic developments in China influenced global stock market performance throughout 2015. In 2015, global stock prices rallied on the back of economic gains in advanced countries. Nonetheless, global stock market performance plummeted in the second semester 2015 due to uncertainty over the timing of the FFR hike and stock market shocks in China that spilled over to affect other global bourses. In the middle of 2015, China's stock

Chart 1.13. EM Capital Flows Development



Source: Capital Flows for Emerging Markets – IIF, January 2016

**Chart 1.14. Global Stock Market Development**



Source : Bloomberg, processed

markets slumped dramatically, triggered by concerns of an economic slowdown. Consequently, the Shanghai Stock Exchange Composite Index plunged drastically by 75% in July and August 2015 (Chart 1.16). Furthermore, the unexpected decision to devalue the yuan in August 2015 exacerbated already intense pressures on financial markets in China and other emerging market countries.<sup>9</sup> Built-up uncertainty on China's financial markets due to yuan devaluation was reflected by an increase in credit default swaps (CDS) and the magnitude of decline in the position of reserve assets, equivalent to USD512 billion in 2015.

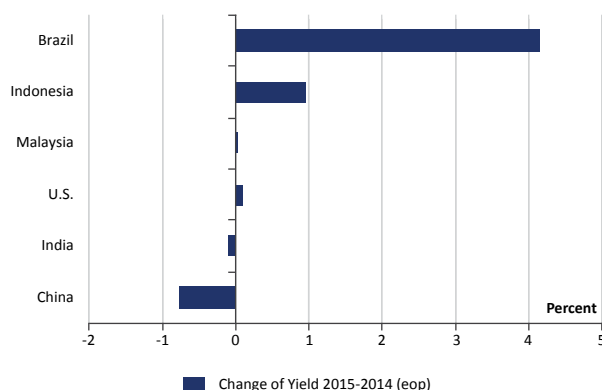
**Chart 1.16. Shanghai Stock Exchange Composite Index**



Source: Bloomberg, processed

Therefore, corporate external debt risks also surfaced in China. Accordingly, yuan depreciation more than doubled the position of corporate external debt. The build-up of risks and uncertainty ultimately spilled over to global stock markets due to fears of a deeper economic downturn in China.

**Chart 1.15. Government Bond Yield Development**



Source : Bloomberg, processed

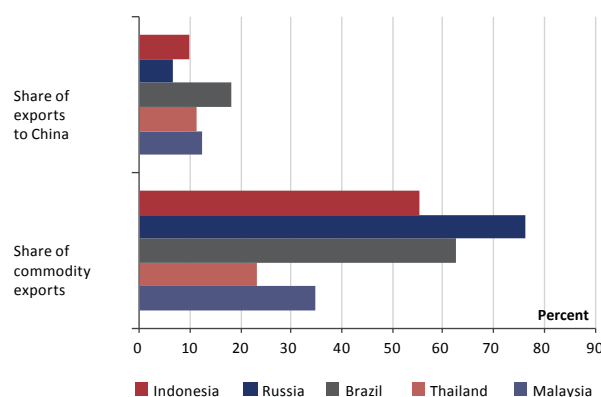
<sup>9</sup> Yuan devaluation on 11th August 2015 was the highest recorded in the past five years and was prompted by a more market-driven exchange rate regime change after the CNY was included in the SDR basket. Consequently, the exchange rate was determined based on the following criteria: (i) the USD/CNY level of the previous day; (ii) demand/supply factors; and (iii) the market movements of other currencies.

Economic moderation in China, as the second largest global economy, has directly and indirectly influenced the export performance of emerging market trading partners. Furthermore, the economic downshift in China has also undermined demand for commodities in line with China's role as one of the largest global consumers. Such conditions have depressed international commodity prices and undermined export performance in net exporting emerging markets.<sup>1</sup> This Box aims to compare performance and policy responses across a number of emerging market countries, namely Malaysia, Thailand, Brazil, Russia, and Indonesia itself in the face of such arduous conditions.

The impact of economic moderation in China and sliding international commodity prices on emerging market countries was influenced by the respective trade structure of each country. Higher dependence on primary sectors or industrial commodities exacerbated the impact of lower commodity prices on external sector performance, which ultimately affected overall economic performance. Of the five emerging market countries in the observation sample, Russia accounts the largest share of export commodities (76.4%), followed by Brazil (62.4%), Indonesia (55.4%), Malaysia (34.8%), and Thailand (23.3%) (Chart 1). In addition to confronting lower commodity prices, the five sample countries were also subjected to capital outflow pressures to varying degrees. The full panoply of policy responses has been formulated and instituted in response to the external pressures faced, paying due consideration to economic, social and political conditions in each respective jurisdiction.

When formulating the appropriate policy mix, limited fiscal and monetary space can impede optimal policymaking to alleviate the external pressures faced. Table 1 shows that in line with its high dependence on export commodities, Russia experienced the deepest contraction in 2015 compared to the other emerging market countries. The decline was not only precipitated by lower oil and commodity prices but also economic sanctions imposed due to the Ukraine crisis. A persistently weaker economic outlook, combined with a shift in the composition of global liquidity, subsequently triggered capital outflows from Russia. The state responded by releasing peg the Russian ruble against the U.S. dollar and euro. Thereafter, exchange rate depreciation heightened inflationary pressures,

Chart 1. Export Structure of Several EM Economies



Note: based on SITC 3 category 0-4, WITS-World Bank, 2014

thereby constricting room to further ease monetary policy.<sup>2</sup> From a fiscal perspective, the Government of Russia strived to maintain a low deficit despite a dramatic decline in export receipts from oil and gas, accounting for just 52% of the previous year. To maintain a low deficit, the Government of Russia decided against providing the fiscal stimuli required to avert a deeper economic contraction.

Similar circumstances prevailed in Brazil, with the second largest share of export commodities in the sample and the

Table 1. Economic Indicators in Several EM Economies

Economic Indicator	Year	Malaysia	Thailand	Brazil	Russia	Indonesia
GDP Growth (%)	2014	6.0	0.9	0.1	0.6	5.0
	2015	5.0	2.8	-3.0	-3.7	4.8
Inflation (%)	2014	3.1	1.9	6.4	7.8	6.4
	2015	2.7	-0.9	11.3	12.9	3.3
Policy Rate (%)*	2015	3.25	1.5	14.25	11	7.25
Exchange Rate depreciation	2015	19.3	5.5	41.6	17.8	10.2
Fiscal deficit (%GDP)	2015	6.5	2.5	10.3	2.6	2.5

Note:  
\*At the end of 2015  
Source: CEIC, processed

1 According to IMF data, commodity and energy prices in 2015 contracted 35.3%, while non-fuel prices contracted 17.5%.

2 Nonetheless, the Central Bank of Russia still lowered its policy rate by 600bps from the beginning of the year until August 2015.

largest export share to China. The external sector of Brazil also sustained intense pressures during 2015. However, fiscal space was limited due to a wide government deficit stemming from various economic problems in recent years coupled with political instability. On the monetary side, monetary policy space was also narrow as a result of high inflation and a deluge of capital outflows that led to severe Brazilian real depreciation (Table 2). Consequently, Brazil's economy suffered from a deep contraction in 2015.

Meanwhile, the economies of Indonesia and Malaysia posted positive growth despite slowing on the previous year. Both countries have a number of differences, however, in terms of the trade structure and policy response. Indonesia has a relatively large share of export commodities to total exports, thus the potential decline in external performance was more pronounced than in Malaysia. Bracing for the impact of external pressures, Indonesia instituted prudent monetary policy mixed with an accommodative macroprudential policy and fiscal stimuli. To spur domestic demand and long-term growth, the Government of Indonesia also increased capital spending on strategic infrastructure projects. The fiscal space created by the Government was attributed to fiscal reforms, involving significant reductions to energy subsidies. The Government did face fiscal challenges, however, in the form of smaller revenue from the oil and gas sector, which accounted for 20% of total government revenue in 2014.

On the other hand, Malaysia enjoyed broader export product diversification in comparison to Indonesia so the impact of lower commodity prices was less pronounced. Notwithstanding, the global economic slowdown still triggered pressures on exports from Malaysia due, amongst others, to the large export share to China. Global pressures coupled with simultaneous political turmoil in Malaysia drove foreign capital out of the country, leading to significant ringgit depreciation. In addition, the

Government of Malaysia experienced a decline in receipts from the oil and gas sector, the impact of which was notable because 30% of government revenues stemmed from oil and gas in 2014. Consequently, the government reduced subsidies and streamlined operational spending while introducing tax reforms to manage the fiscal deficit.<sup>3</sup> The various policies helped to maintain relatively robust economic growth in Malaysia despite a 1% drop on the previous year.

Furthermore, Thailand, with the smallest share of export commodities, succeeded in boosting domestic economic growth. This condition was influenced by broad export product diversification, including high-tech manufacturing products, as well as the monetary and fiscal policy mix applied. Controlled inflation provided adequate space to ease monetary policy. Also, the Government of Thailand implemented fiscal expansion by accelerating government spending disbursements for transport and irrigation as well as introduced stimulus packages to the tune of USD11 billion aimed, amongst other, at helping micro, small, and medium enterprises (MSMEs) repay loans and settle taxes. Government fiscal stimuli were also disbursed to rural areas through the "Village Fund" scheme in the form of concessional loans and government investment projects in rural areas. The prevailing fiscal response sparked additional domestic demand and restored public confidence in the Thailand economic outlook.

**Table 2.** Policy Response Indicators in Several EM Economies

Policy Response Indicator	Malaysia	Thailand	Brazil	Russia	Indonesia
Change of policy rate*	0 bps	-50 bps	200 bps	-600 bps	-25 bps
Additional Fiscal Deficit*	0.0	0.3	3.6	2.0	0.2

Note:

\*Compare to the end 2014

Source: CEIC, processed

<sup>3</sup> Commencing on 1st April 2015, the Government of Malaysia introduced the Goods and Services Tax for businesses as a replacement for the Government Sales and Services Tax.



As a form of international cooperation, the Finance Ministers and Central Bank Governors of the G20 convene regular meetings. On 4-5th September 2015, such a meeting was held in Ankara, Turkey, where members agreed the pressing need to stimulate economic growth and boost investment.

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## FINANCE MINISTERS AND CENTRAL BANK GOVERNORS MEETING

4 - 5 SEPTEMBER 2015

ANKARA



## Chapter 2

### Global Economic Policy Response

Accommodative monetary policies were the crux in the mix of policy responses that advanced economies (AE) had carried out to revive growth amidst the global economic slowdown. The lack of supporting fiscal policies and sufficient structural reforms, however, resulted in different recovery phases and divergent monetary policies among the AE. Meanwhile, emerging markets (EM) had taken up relatively more comprehensive mix of policy responses. International cooperation was also strengthened to drive more quality growth and maintain stability in the financial system. Nevertheless, all these policy responses have yet to significantly spur global economic growth.

In 2015, monetary policies were the primary measure for the world's economies, particularly for the AE, which had applied their monetary policies by way of interest rate instruments and quantitative easing (QE) policies. The United States (U.S.) Federal Reserve System (The Fed) had normalized its monetary policies and raised its benchmark rate. Meanwhile, the European Central Bank (ECB) and the Bank of Japan (BoJ) still kept their benchmark rates down and continued with their QE policies. This difference in monetary policies reflects the different recovery phases within the AE. The Fed's policies were in line with the U.S. economy's improving fundamentals, particularly in the labor market. On the other hand, the policies of the ECB and the BoJ were in response to the ongoing risk of deflation and continued slowdown.

Meanwhile, the policy responses of the EM had relatively been more comprehensive than those of the AE, due to the complexity of the problems that the EM had to address. The monetary policies of the EM were in general complemented with fiscal policies and structural reforms. Most emerging market economies had taken up loose monetary policies followed by fiscal stimulus in the form of increased government spending. Developing countries had also carried out structural reforms to address each of their relevant structural problems. These structural reforms were mainly focused on providing proper infrastructure, improving the investment climate, and addressing population issues. The EM's policy responses were also aimed to mitigate the financial market turmoil as the impact of the global economic slowdown and the normalization of monetary policy of the U.S.

The outcome of the global economic policy responses remained limited, as worldwide economic growth continued its downturn from 2014 and fell short of its estimates. This was mainly due to the policy responses having relied too much on monetary policies. With limited support from fiscal policies and structural problems remaining unaddressed, recovery within the AE was only moderate. Meanwhile, the monetary policies of the EM alone were also unable to prop up global growth. This was partly related to the fact that the implementation of accompanying fiscal stimulus and structural reforms that still need time before having any actual effect towards the economy.

The global economic slowdown and risks of financial market turmoil has thus been a major concern for international cooperation forum. Efforts on reviving growth and maintaining financial market stability have become the main discussion in the forums. With stronger economic cooperation, it is expected that a solution can

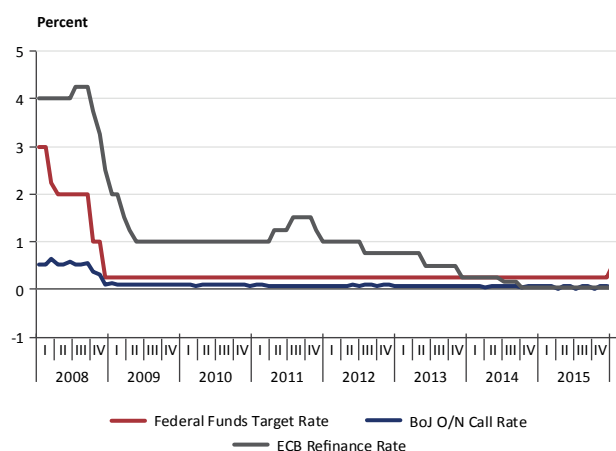
be found for achieving higher and more sustainable quality growth, while maintaining stability in the financial system, and build up regional economic resilience.

## 2.1. POLICY RESPONSE OF ADVANCED ECONOMIES

The policies of the U.S. were in response to the country's improving economy, particularly in the labor market. This improvement in the economy led the U.S. monetary authority to believe that the inflation rate will reach 2% in the medium-term. As an anticipatory measure, The Fed then normalized its monetary policies by raising its reference rate during the Federal Open Market Committee (FOMC) meeting in December 2015 (Chart 2.1).

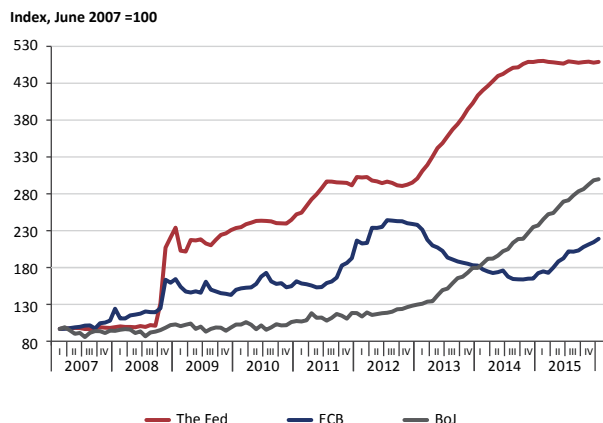
The Fed had carried out several preparatory measures as well before normalizing its monetary policies, by way of three main policies. First, rolling over its holdings of maturing U.S. Treasury securities to maintain its balance sheet in line with accommodative monetary policies (Chart 2.2). Second, setting up relevant liquidity management instruments to guide market interest rates towards their intended levels. The instruments in this case were interest rates on bank reserves and large-scale reverse repo transactions. The third and last policy was carrying out an effective communication strategy to provide a forward guidance for the market on the direction of its monetary policies. The Fed had indicated that it will keep its benchmark rate low throughout 2015. It then clearly hinted of a rate increase during the FOMC meeting in October 2015, and actually raised the rate by the end of the year.

Chart 2.1. The Fed, ECB, and BoJ Reference Rate



Source: Bloomberg, processed

**Chart 2.2. The Fed, ECB, and BoJ Total Assets**



Source: Bloomberg, processed

The Fed's decision during the December 2015 FOMC meeting to raise its Federal Funds Rate (FFR) target to between 0.25% and 0.5% was not considered as a tightening of its monetary policy. The Fed stated its stance of remaining accommodative, and explained that the rate hike was part of normalizing its monetary policy to maintain stable market prices. The Fed believed that the improving U.S. labor market will lead to inflation reaching 2% in the medium-term. Looking further ahead, The Fed has hinted that the FFR will be raised gradually, in line with its strategy to keep the momentum for recovery while anticipating risks from the global economic slowdown.

In the Euro area, policies were carried out to respond to the threat of deflation and sluggish economic growth in Europe. The ECB therefore decided in January 2015 to carry out more aggressive QE measures through the Expanded Asset Purchase Programme (EAPP). The EAPP was intended to spur the region's domestic demand through the financial sector and the credit market, and was implemented through the purchasing of EUR60 billion in assets, including Eurozone government bonds. The EAPP was carried out between March 2015 and September 2016, and continued ECB's loose but more passive monetary policy during 2008-2014.<sup>1</sup>

In terms of conventional monetary policy, the ECB kept its reference rate at a very low level of 0.05%. The ECB also cut its deposit facility rate by 10 basis points (bps) to -0.3% in December 2015. This negative interest rate

policy was intended to encourage credit growth in the Euro area. It is taken given that credit growth as the main financing source of European economic activities was still quite low.

With inflation in the Euro area still far below its intended level the ECB expected to perform additional policies. The ECB is expected to resort to further non-conventional monetary policies. These include carrying out open-ended QE measures and increasing its asset purchases. Further rate cuts will possibly be off the desk for the meantime, for fear of risking negative effects on the banking sector.

Similar to Europe, Japan's policy response was carried out to revive growth and address deflationary risks, relying on a combination of monetary policies and fiscal policies. The BoJ maintained its accommodative monetary policies by keeping its benchmark rate at a very low level of 0.1% throughout 2015. The BoJ also continued with its QE measure by purchasing up to JPY80 billion in assets each year. In terms of fiscal policies, the Japanese government allocated up to JPY3.5 billion as a fiscal stimulus, and in February 2015 announced tax incentives for companies raising their workers' pay. In April 2015, the fiscal authorities also postponed the implementation of the second phase of the sales tax from 8% in October 2015 to 10% in October 2017.

All of Japan's efforts have, however, yet to significantly revive its economy. Growth remained sluggish. Growth in domestic consumption was off target. This was due to Japan's rigid labor law holding up the tax incentives for companies raising their workers' pay. Postponing the sales tax hike also failed to spur more consumption. The fiscal policies even caused credit rating agencies Fitch and Moody's to downgrade Japan's credit rating by a notch to A, as the policies were seen as increasing risks on the economy.

This limited impact on the economy is expected to compel Japan to carry out more stimulus policies. The BoJ is expected to top up its QE asset purchases. Application of negative interest rates policy is also a policy option that may be taken by BoJ. From the fiscal side, the Japanese government's limited fiscal space has left it with few options other than carrying on with its previous policies.

One of the most urgent structural problems that Japan and other developed countries needs to address is their ageing population. As the number of older-aged people increases within a population, the level of savings also increases to the point of slowing down consumption. The population's high dependency ratio also affects its

<sup>1</sup> LTRO (Long-Term Refinancing Operation), CBPP (Covered Bond Purchase Programme), and ABSPP (Asset-Backed Securities Purchase Programme).

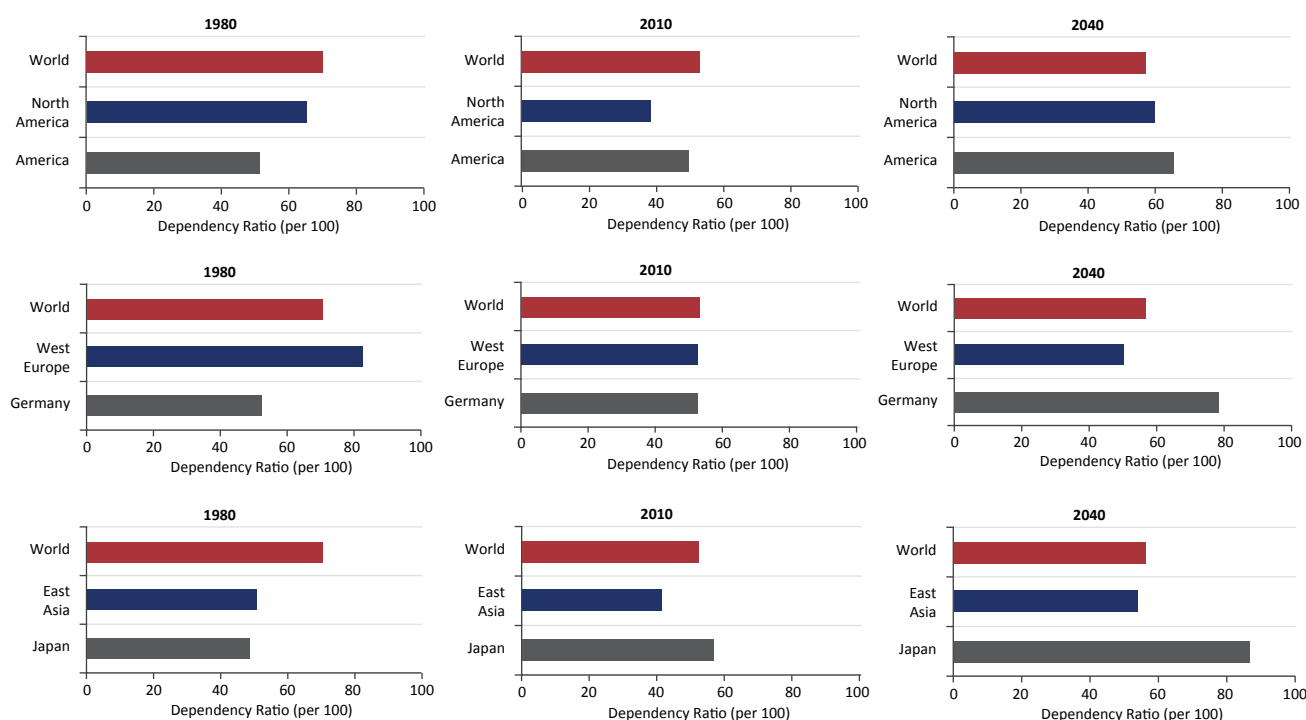
productivity level due to the increasing number of non-working people. Older-aged populations are also prone to fiscal drag, in which tax revenues decline while spendings for health care and pensions increase. The median age of Japan's population in 2014 was 46 years, with a life expectancy of 84 years, the highest in the world. By age, Japan's population is composed of 13% of young people (0-14 years), 61% of people in the productive age (15-64 years), and 26% of elder people (> 65 years). Japan's dependency ratio is therefore 63%, higher than both the world average and other developed countries (Chart 2.3).

This demographic condition has made it difficult for Japan to carry out reforms to increase consumption levels. The Japanese government has since 1985 encouraged people nearing retirement and those already retired to continue working, and had increased the retirement age from 55 years to 60 years. Yet with a fertility rate among the lowest in the world (only 1.4 children per female population), while its health care service is among the world's best, Japan's demographic condition is unlikely to change for the better.<sup>2</sup> Policy measures to address

structural problems due to demographic conditions are not trivial and require time to be effective. Experience from several developed countries in increasing their fertility rates to improve their demographic structure has proven to be difficult. Such condition relates to the individual preferences and lifestyles of each country. Meanwhile, short-term measures such as immigration are also difficult to implement, due to political opposition and potential risks of social unrest.

Another structural problem that needs to be addressed by developed countries, particularly in Europe and Japan, is their limited fiscal space.<sup>3</sup> This condition is caused by the level of public debt has been high. A study by credit rating agency Moody's reveals that while the U.S. and a few European countries still have sufficient fiscal space, most other European countries such as Portugal, Ireland, Spain, France, and Belgium have only limited fiscal space. Japan, Italy, Greece, and Cyprus similarly have only limited fiscal space, such that increasing public debt would be risky towards macroeconomic stability (Chart 2.4).

**Chart 2.3. Advanced Countries Dependency Ratio**



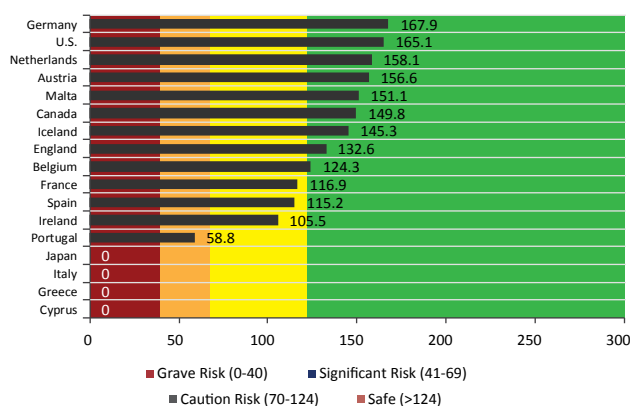
Source: BBC Capital, UN World Population Projection

<sup>2</sup> According to the World Bank's 2015 data on Japan's population.

<sup>3</sup> The International Monetary Fund (IMF) defines fiscal space as room in a country's state budget that can still be utilized without exceeding the budget's debt allocation or creating risks on the country's macroeconomic stability.

Chart 2.4.

## Advanced Countries Fiscal Space



Source: Moody's Analytics, 2015

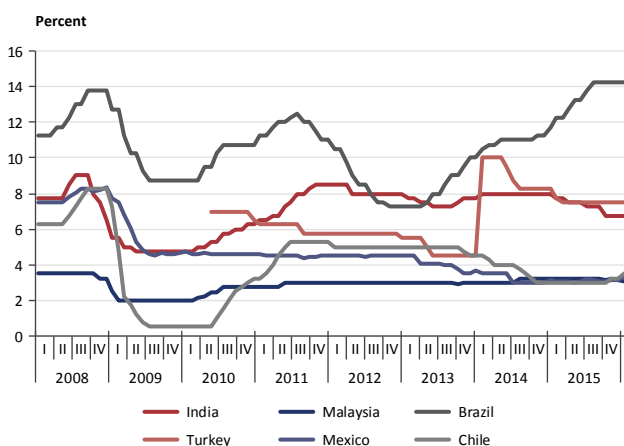
## 2.2. POLICY RESPONSE OF EMERGING MARKETS

The monetary policies of most EM throughout 2015 were accommodative, in response to the downturns in their respective economies. However, not all EM conduct an accommodative monetary policy. Several EM in Latin America such as Brazil, Mexico, and Chile, however, had resorted to tighter monetary policies, to manage inflationary pressures due to depreciations in their respective currencies (Chart 2.5).

Apart from accommodative monetary policies, most of the EM also carried out structural reforms. Those reforms included reforming their financial markets, increasing the capacities of their economies, and developing infrastructure. Deregulations were also carried out to

Chart 2.5.

## Policy Rate in Emerging Markets



Source: Bloomberg

improve the investment and business climate. Other structural reforms were aimed at reducing reliance on the external sector and increasing the consumption of local products.

China was among the EM that actively put out policies with wide spectrums throughout the year. The policies were a mix of monetary policies, macroprudential measures, and structural reforms for the finance, fiscal, manufacturing and trade sectors, as well as for addressing relevant population issues. The policies were varied in their time-frames, intended to address short-term, medium-term and long-term issues altogether, despite this different timing of the policies' targets had itself created a complexity in their implementations.

The slowdown of China's economy had compelled the country's authority to ease up on its monetary and macroprudential policies. The People's Bank of China (PBoC) cut its benchmark interest rate five times during 2015, by as much as 125 bps down to 4.35%. The PBoC also carried out macroprudential policies that included lowering both the targeted and overall minimum reserve requirement, easing the loan-to-value requirement, and injecting liquidity to several banks to increase lending. Other macroprudential policies included mitigating the risks from shadow banking activities, which was implemented by converting the debts of local government financing vehicles to banks, into municipal bonds. These municipal bonds could then be used as collateral for monetary operations.

Regarding the financial markets, China modified its currency regime and pursued market liberalization. The Chinese renminbi (or yuan)'s daily exchange rate band was widened from 1% to 2% in March 2015. The yuan's fixed exchange rate had since August 2015 also been made more flexible and market-driven.<sup>4</sup> Liberalization of the financial market, meanwhile, was carried out by opening up more access for foreign investors to China's onshore markets. China also promoted the yuan's international standing, by developing offshore transactions at other global financial centers, such as Singapore and London, apart from previously only at Hong Kong. This financial market liberalization and promoting the yuan's international standing is part of China's commitment to get the yuan included in the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket of currencies,

<sup>4</sup> The yuan exchange rate now refers to the U.S. dollar exchange rate during the previous trading day, the demand and supply of foreign currencies, and the movement of other money markets.

which the IMF approved in November 2015.<sup>5</sup> Besides its economic advantages, the yuan's inclusion into the IMF's SDR basket is strategically important in boosting China's geopolitical role.

China also embarked on several structural reforms to meet the target of doubling its gross domestic product (GDP) and income per capita by 2020. The structural reforms included increasing domestic consumption, as well as stabilizing investments and exports. For that, China launched several long-term strategies, such as "Made in China 2025" and "One Belt One Road". The "Made in China 2025" program aims at upgrading the quality of the country's manufactured goods. Meanwhile, the "One Belt One Road" program is an initiative to bolster investments abroad and expand export markets. Other long-term structural reforms included replacing the 1-child policy, which had been enforced since 1978, with the two-child policy since October 2015. This policy is intended to anticipate potential ageing population issues, which are expected to affect China in the middle of the 21st century. The policy is also expected to maintain China's dependency ratio in line with efforts to rebalance its economy.

China's simultaneous efforts, however, had created complications of its own. Policies to rebalance its domestic economy, amidst the global economy slowdown, caused growth to decelerate below estimates. This in turn caused rapid deleveraging of China's economy and disrupted its financial markets, particularly the stock market. These shocks to the financial markets resulted in capital outflows, a weakening of China's currency, and a sharp decline to its foreign exchange reserves. The yuan's recent inclusion into the IMF's SDR basket, which required China to liberalize its financial markets, made it even more difficult to stabilize the markets.

This financial market turmoil jeopardized China's long-term economic goals. The government of China responded with tighter policies to stabilize the situation. China's monetary authority tightened its control over the currency exchange rate fixing, and consistently intervened in both the onshore and offshore forex markets. In September 2015, China's monetary authority set a minimum reserve requirement, without remuneration, of 20% for outstanding forward transactions. In December 2015, it introduced the Renminbi Trade Weighted Index (TWI) as a market guidance, so as not to refer only to the exchange rate against the U.S. dollar.

<sup>5</sup> The Chinese yuan will effectively be included in the IMF's SDR basket on October 1, 2016.

Policies to stabilize the stock market were also carried out. Since July 2015, China's stock market authority has forbidden shareholders of over 5% in stock to sell any shares within 6 months of purchase. Authorities also encouraged state-owned enterprises (SOEs) and public companies to purchase shares and forbade any kind of short selling in the stock markets. Stock holdings were also allowed to be collateral for bank loans.

Among the EM, India was one of the countries that responded to the economic situation in 2015 with a consistent and focused policy mix. India's recent policies were consistent in maintaining macroeconomic stability and fostering growth. Its monetary authority had eased its monetary and macroprudential policies without creating significant inflationary pressures. From the government's side, policies were focused on increasing the capacity of India's economy by developing infrastructure and improving the business climate. Fuel subsidies were gradually reduced as well, to provide more fiscal space.

The Reserve Bank of India (RBI) had opted for a loose monetary policy. RBI cut its benchmark interest rate four times throughout the year, by as much as 125 bps down to 6.75%. Easing inflationary pressures due to weakening global commodity prices had enabled the RBI to make the aggressive rate cuts. The RBI macroprudential policies were also accommodative towards credit growth, to support the financing of priority sectors in India's regions. This was implemented by raising in December 2015 the minimum amount of loans that rural regional banks must disburse to priority sectors (such as agriculture, micro-businesses and SMEs, education, infrastructure and renewable energy), from 60% to 75% of total lending).

Meanwhile, the Indian government carried out policies to deregulate the country's investment sector and expedite infrastructure development. The policies included lifting restrictions on foreign direct investments (FDI) in infrastructure construction projects. Foreign investors were also allowed to own up to 50% of insurance and defense industry companies, and to wholly own coal mining companies. The Indian government also embarked on reforming the country's Agrarian Law to facilitate land acquisition for industry and infrastructure development. One-stop permit services were also developed, aimed at issuing permits within a maximum of 10 days. Lastly, minimum market prices on agricultural products were also lifted, to attract more investments in the agriculture and plantation sectors.

To provide more fiscal space, the Indian government carried out several tax and subsidy reforms. The Tax Law

was revised to simplify the structures of national and regional taxes, so as to increase the tax rate. Tax incentives were in the form of eliminating any kind of double taxation. Apart from tax reforms, the Indian government also began cutting kerosene subsidies, and continued its cuts on diesel subsidies.

All these consistent and focused policies had in the end managed to bolster India's economy throughout 2015. Growth was sustained and inflation well managed. Business confidence in India had even increased (Chart 2.6). This positive sentiment further supported the resilience of India's economy against otherwise discouraging external factors.

### 2.3. INTERNATIONAL COOPERATION

The global economy's slow and imbalanced recovery, coupled with divergent monetary policies among the AE, became the year's highlight in international cooperation forums. Also in the spotlight, these were a strengthening U.S. dollar, the U.S. normalizing its monetary policy, the slowdown in China, and declining global commodity prices. As a response, countries around the world strengthened their cooperation to achieve sustainable and quality growth, while also maintaining financial system stability and bolstering regional economic resilience.

#### International Cooperation to Boost Growth and Trade

The G20 forum of the world's 20 largest economies stressed the importance of working together to achieve inclusive growth, which was then formulated in the "3 Is" of Implementation, Investments and Inclusiveness. This "3 Is" formula then became the tenet for the G20 in implementing its commitments, boosting investments as an engine for growth, ensuring inclusive growth, and strengthening dialogs between G20 and low-income developing countries.

Furthermore, the G20 set three priority agendas to achieve this robust and inclusive growth. First, strengthening the recovery of the global economy and further stimulating potentials for growth. This was carried out through the coordination of macroeconomic policies, formulating country-specific investment and infrastructure strategies, improving the labor market to be more inclusive, and boosting trade and investments. Regarding trade in particular, the G20 will support the policies of countries encouraging business, especially small and medium-sized

Chart 2.6.

India Business Situation Index



Source: Bloomberg, processed

enterprises (SMEs), to become part of the global value chains (GVCs).

Second on the agenda, is improving the resilience of the global economy. This will be achieved with the support of regulations in the financial sector, by reforming the international financial architecture, improving the international tax system, and promoting a culture of anti-corruption. Regarding reforms on the international financial architecture, a particular priority is on the composition of the IMF's SDR basket, to better reflect the significant currencies used in global trade and in the world's financial system. Meanwhile, regarding the international tax system, the G20 will support the G20's and the Organization for Economic Cooperation and Development (OECD)'s Base Erosion and Profit Shifting Action Plan to address problems with tax evasion.

The third and last agenda, is ensuring sustainable development. This will be achieved by carrying out: (i) inclusive and sustainable development, with the implementation of the 2030 Sustainable Development Goals (SDGs) and the Addis Ababa Action Agenda, (ii) inclusive financing, with the implementation of national remittance plans to cut global remittance fees to a maximum of 5% from the total amount transferred, and with the implementation of other initiatives in the Global Partnership for Financial Inclusion (GPFI), and (iii) ensuring energy sustainability, with commitments to the G20 Energy Access Action Plan of improving access to electricity, starting with Sub-Saharan Africa. The G20 will also improve on energy efficiency, invest in clean energy technologies, and support research and developments programs to address climate change. The G20 had also agreed upon the Toolkit of Voluntary Options for

Renewable Energy Deployment, which outlines measures to develop renewable energy resources, and reiterated its commitment to reduce fossil fuels.

The G20 member countries continued to strengthen as well their commitment in implementing the 2014 Brisbane Growth Strategy. Growth strategy outlines measures to increase the member countries' GDP by at least 2% above the baseline GDP estimate in IMF's 2013 World Economic Outlook. This is expected to be achieved by 2018, which will increase the total world GDP by 2.1% (around USD 2 trillion), as well as create millions of new jobs.

Regarding the importance of public and private investments for infrastructure projects in stimulating further growth, the G20 had agreed to set up the Global Infrastructure Hub (GIH).<sup>6</sup> The G20 will continue strengthening the capacity building of its member countries, implement more projects based on public-private partnerships (PPP), and encourage more participation from multinational agencies and national development banks in financing projects. Stock markets will also be tapped as the main financing source for needed investments.

In overall, the Brisbane Growth Strategy has shown progress, with the G20 member countries having implemented more than a third of their commitments. Although this progress is of varying degree, all member countries have continued to fulfill all of their commitments. Each Country-Specific Growth Strategy has been reassessed and peer-reviewed, to ensure their implementations are consistent in achieving the collective growth target. Each member country is allowed to customize their implementations of the strategy through the Adjusted Growth Strategy, to accommodate such variables as external factors, changes in the ruling government, policy changes, and shifts in economic trends from previous estimates.

Besides the G20, the IMF had also encouraged better international cooperation to stimulate a robust and balanced growth for the global economy, and to create more jobs. The IMF encouraged its member countries to continue improving business confidence and domestic demand through a mix of macroeconomic policies and structural reforms. In particular regards to stimulating growth and improving resilience, the IMF had initiated the Global Policy Agenda (GPA), which mainly outlined (i) the

implementation of fiscal policies supporting growth, with investments for infrastructure as a priority, and (ii) the implementation of monetary policies that are conducive and properly communicated by advanced economies.

Meanwhile, the Islamic Development Bank forum had committed to more active participation in the infrastructure projects of its member countries. One of its participation is to set up the World Islamic Investment Bank (WIIB). The WIIB is expected to provide another means of financing for infrastructure projects, to facilitate growth for the sharia-based economy, and become a catalyst for the development of sharia-based financial instruments.

Indonesia itself had embarked on expanding its financial, trade and investment agreements with other countries to boost growth. Bank Indonesia expanded its Bilateral Currency Swap Agreements (BCSA) with Indonesia's trade partners, to facilitate transactions for more bilateral trade while reducing risks from an overly dependence on the U.S. dollar. Bank Indonesia on December 15, 2015 signed a AUD10 billion BCSA with the Reserve Bank of Australia (RBA), following the KRW10.7 trillion BCSA with the Bank of Korea (BOK) and the CNY100 billion BCSA with the People's Bank of China (PBoC). Besides facilitating trade, the BCSA can also be used to facilitate more investments, to strengthen financial cooperation, or for other purposes as agreed.

Regarding international cooperation in the trade sector to boost growth, Indonesia actively participated in the Association of South-East Asian Nations' (ASEAN) Regional Comprehensive Economic Partnership (RCEP). ASEAN's RCEP forum had in principal agreed on initiating cooperation in the trade of goods, services and investments between ASEAN's ten member countries and six trade partners.<sup>7</sup> Thresholds on import duty cuts, commitments in the services and investment sectors, as well as initial offers on market liberalization have all been agreed.

## International Cooperation to Maintain Financial Stability

The G20 had within its agendas formulated an international standard for financial reform, which sets a total-loss-absorbing-capacity (TLAC) for global systematically-important banks (GSIBs), so as to prevent a too-big-to-fail situation. The standard is complemented

<sup>6</sup> GIH will develop a knowledge-sharing platform and strengthen collaboration between governments, the private sector, development banks, and other international agencies to improve financing for infrastructure.

<sup>7</sup> China, Japan, South Korea, Australia, New Zealand, and India.

in its implementation with relevant recovery plans and cross-border crisis management procedures. The TLAC itself is meant to provide sufficient liquidity that can be used for global financial institutions with systemic risks during a crisis. Also, it can avoid the use of public funds for bail-outs.

The G20 also carried out structural reforms for over-the-counter transactions in the derivative market. The reforms were aimed at strengthening the infrastructure of the derivative market, particularly its transparency and risk management, and limiting risks of negative spillovers. The G20 agreed that all derivative contracts must adhere to standards of being cleared through central clearing counter-parties and reported to trade repositories. The G20 forum also highlighted efforts in reducing risks to the stability of the global financial system from imprudent and non-transparent practices of shadow banking, formulating a Shadow Banking Roadmap in response. The roadmap outlines more strict regulations and stronger surveillance on shadow banking practices.

The IMF had on November 30, 2015 included the Chinese yuan into its SDR basket, which will become effective on October 1, 2016. The IMF concluded that the Chinese yuan had fulfilled the criteria of being freely usable for high

volumes of trade. With the Chinese yuan included in the IMF's SDR basket, member countries will be able to further diversify their foreign exchange reserves and reduce their dependency on the U.S. dollar. This in turn will help maintain stability in the financial systems of emerging markets, most of whom have significant trade relations with China.

In the Southeast Asian region, the ASEAN+3 forum continued strengthening the region's economic resilience through its Regional Financial Arrangement (RFA). Implementations of The Chiang Mai Initiative Multilateralization (CMIM) were formulated and carried out, and the ASEAN+3 Macroeconomic Research Office (AMRO) was set for a more active role as well. An Operational Guideline for the CMIM activities were completed, and an Economic Review and Policy Dialogue (ERPD) Matrix was developed. The CMIM activities themselves have been focused on strengthening coordination with the IMF's Global Financial Safety Net facilities, and improving operational technicalities for implementing other relevant international standards. Meanwhile, the AMRO has been prepared to take on a more significant role, on par with such international financial institutions as the IMF and the Asian Development Bank (ADB).

The ASEAN regional cooperation forum concluded 2015 by entering a new historic era, with the ASEAN Economic Community (AEC) coming into effect on December 31. The AEC envisions a single market and single production base for the ASEAN region, a region with high competitiveness, with equal development, and that is tightly integrated with the global economy. In order to realize this single market and single production base for ASEAN, economic liberalization of its member countries is needed, in order to establish the free-flow of goods, services, skilled labor, capital and investments in the region. All this presents both huge opportunities as well as challenges for Indonesia, both of which of needs to be managed properly so as to reap the best of benefits from the AEC.

The ASEAN single market itself is not the final goal of the AEC, but is a stepping stone for the region's further aim, which is the ASEAN Community Vision 2025. It is therefore important to assess how far ASEAN had by 2015 followed through with its integration process for the AEC itself. This can be assessed by comparing the commitments for integration of each ASEAN member country with the accomplishments of those commitments. In overall, most of the commitments had been fulfilled and implemented.

Regarding the free-flow of goods, the integration process through market liberalizations can be said to be nearly complete. The most significant measure of this is the lifting of import duties among ASEAN member countries to nearly 0%. Several facilities to boost intra-regional trade had also been implemented, including the setting up of the ASEAN Single Window, to simplify export-import procedures and the standardization of products.

In the services sector, the integration process can be seen in more service providers from ASEAN member countries expanding their operations within the region. Workers are freely to be employed within the region as well, to support the commercial presence of those expanding businesses. In further regard to this liberalization of ASEAN's labor market, Mutual Recognition Agreements (MRAs) for cross-border employment of certain skilled workers had been reached. Integration in the financial services sector, which entitles market liberalizations for the free-flow of capital, had also shown progress, with agreements allowing Qualified ASEAN Banks (QABs) to operate throughout the region. Meanwhile, liberalizations regarding investments were pursued by cooperating together to

promote both intra-regional and outside investments to ASEAN, as well as improve the region's business climate and infrastructure. It can thus be concluded that the integration process for the AEC had sufficiently progressed on schedule before its end of 2015 deadline.

Indonesia had been among the most progressive in pursuing market liberalizations for the AEC. Indonesia had significantly reduced import duties, and likewise gained export facilities through the ASEAN Trade in Goods Agreement (ATIGA). Indonesia has also been integrating its trade system with ASEAN through its National Trade Repository and National Single Window. In liberalizing the services sector, Indonesia had ratified Package 9 of the ASEAN Framework Agreement on Services (AFAS), with commitments to open up 97 sub-sectors of services.

Regarding liberalizations of the financial services, Indonesia had ratified the related Package 6 of the AFAS, as well as the ASEAN Banking Integration Framework (ABIF). Meanwhile, liberalizations on investments saw Indonesia addressing long-standing issues in several sub-sectors, as well as collectively facilitating and promoting more investments through the sharing of data and information on potential investments. Liberalization of the labor market, particularly for skilled workers, saw Indonesia improving the qualifications and competitiveness of its domestic workforce, by harmonizing relevant labor regulations and encouraging the proper certification of skills.

As previously mentioned, the ASEAN economic integration is a dynamic and ongoing process, and does not end with the AEC coming into effect. During its 27th Leader Summit on November 22, 2015 in Malaysia, ASEAN already moved further again by adopting the AEC Blueprint 2025, outlining the region's economic integration for 2016-2025. The AEC Blueprint 2025 was adopted along with the ASEAN Community Vision 2025, the ASEAN Political-Security Community (APSC) Blueprint 2025, and the ASEAN Socio-Cultural Community (ASCC) Blueprint 2025, all of which became the Kuala Lumpur Declaration under the theme "ASEAN 2025: Forging Ahead Together". The AEC Blueprint 2025's main priority is completing any pending implementations of the AEC 2015 commitments by the end of 2016. Certain commitments from Cambodia, Lao PDR, Myanmar, and Vietnam must also be completed by 2018 at the latest.

The AEC Blueprint 2025 envisions five intertwined and reinforcing features for ASEAN: (i) a Highly Integrated and Cohesive Economy, (ii) a Competitive, Innovative, and Dynamic ASEAN, (iii) Enhancing Economic Connectivity and Sectoral Integration, (iv) a Resilient, Inclusive, People-Oriented, People-Centered ASEAN, and (v) a Global ASEAN. For the financial sector in particular, the ASEAN Financial Integration 2025 Vision comprises the three main aspects of Financial Integration, Financial Inclusion, and Financial Stability, reflecting a holistic approach in balancing between initiatives of financial liberalization with financial stability and financial inclusiveness. This is in contrast to previous approaches of carrying out liberalizations of several financial sub-sectors individually.

Financial Integration is crucial in facilitating intra-regional trade and investments, and can be achieved by leveraging the participation and encouraging tighter cooperation between ASEAN indigenous banks, insurance companies, and capital markets. Financial Integration must also be supported by a robust, secure, efficient, and interconnected financial market infrastructure. Regulations concerning financial market liberalizations must therefore be deliberated with ASEAN's interest of achieving more cohesive, efficient and prudent financial markets taken into account. ASEAN had agreed on providing wider market access and operational flexibility for the region's indigenous banks that pass as QABs under the ABIF.

Meanwhile, Financial Inclusion means that benefit of the Financial Integration must be cater to a wider society, particularly those previously without financial access. It is also expected to encourage the development of low-cost digital financial services and financial services for low-revenue SMEs. ASEAN has also been educating the public on financial literacy and raising public awareness on consumer protection, which includes protection against digital financial crimes.

While Financial Integration has its benefits of driving trade and investments, it also creates potential risks. Financial Stability is thus as crucial for ASEAN, and efforts to maintain financial stability has been carried out, including: (i) improving surveillance of the region's macroeconomic and financial situation, by identifying potential risks and vulnerabilities in the region's financial systems, and improving information sharing among the region's monetary and fiscal authorities, (ii) forging further cooperation between ASEAN member countries in implementing the ABIF, and (iii) formulating standards and regulations on prudential financial that are more

cohesive within ASEAN and that complies to international best practices.

The ASEAN Financial Integration 2025 Vision also underlines the fact that an integrated, inclusive, and stable financial sector requires proper Capital Account Liberalizations, Payment and Settlement Systems, and Capacity Building. Liberalization of the capital markets will enable capital to flow more freely, facilitating intra-regional investments, trade, and credit. However, due to different levels of preparedness among ASEAN member countries, the capital market liberalization will be pursued with the interests of each member country taken into account, and allowing each member country to apply certain safeguard measures for their capital markets. Meanwhile, ASEAN will also improve the standards and infrastructure of the payment and settlement systems in the region that will in turn further facilitate cross-border trade and remittances, as well as facilitate the development of retail payment systems and improve existing capital markets. A secure, efficient, and competitive payment and settlements system is in the end expected to be realized. Lastly, existing gaps between the financial systems of the ASEAN member countries will be addressed through capacity building.

In achieving the goals of the AEC Blueprint 2025, particularly in the financial sector, the finance ministries and central bank governors of ASEAN member countries have authorized several Working Committees to formulate a Strategic Action Plan (SAP) for ASEAN Financial Integration Post-2015. The SAP will also ensure that the 2025 ASEAN economic integration be achieved. In regards to all this, Bank Indonesia has took the lead by participating more actively in formulating the Strategic Direction for the Working Committees in their deliberation of the Strategic Action Plan. The Strategic Direction had been formulated by taking into account the six key features of ASEAN's financial integration, that are: (i) Ensuring the financial services and capital mobilization meet the need of the real sector, (ii) Balancing financial integration with financial stability to ensure that the benefit of integration will be sustainable, (iii) Lowering transaction costs, (iv) Having greater consumer choices and protection, (v) Improving financial inclusion, and (vi) Increasing risk diversification. These key features are meant to ensure benefits for the real sector from ASEAN's financial integration, which is facilitating the flow of capital and investments for the region's real sector, and achieving the AEC 2025 Vision of "A Cohesive, Integrated, Competitive, Global and People-Centered ASEAN's Economy".



Against a backdrop of inauspicious external conditions, government spending on infrastructure was a key source of economic growth in Indonesia during 2015. Furthermore, labor absorption in the construction sector also increased.

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