



Shadow Falls

As the earth shadows the moon and dark clouds diminish the light.
Shadow falls in the midst of steps, hampering sight, diminishing hope.






PART 1

HEIGHTENED UNCERTAINTY IN THE GLOBAL ECONOMY

Buoyant optimism for global economic recovery that carried through until mid-2011 was again hit by the effects of the lingering sovereign debt crisis in Europe and slow pace of economic recovery in the United States (US). Efforts to boost economic recovery through expansionary fiscal policy, including liquidity support for banks, have failed to promote recovery in major advanced economies (Eurozone countries and the US) and have thus exacerbated the fiscal burden of these economies. In Europe, the sovereign debt crisis initially broke out in the peripheral countries (Greece, Ireland and Portugal). However, the setbacks in the sovereign debt crisis resolution and weak economic activity led to a deepening in the crisis, which subsequently propagate to some of the core eurozone countries. The contagion from the crisis has gathered momentum due to the closely interconnected among Europe's economies and banking sectors. In the US, expansionary fiscal and monetary policies proved insufficient to bring improvement in the corporate and household balance sheets. Under these conditions, the economic recovery, which gained momentum until early 2011, suffered renewed setbacks and kindled fears over medium-term fiscal sustainability. High public debt burdens under uncertainty of fiscal sustainability subsequently triggered a downgrade in the US credit rating. Adverse developments in both major advanced economies plunged global economic recovery into high uncertainty, which in turn inflamed negative sentiment and triggered turbulence in global financial markets.

The turmoil on financial markets was not limited to advanced economies, but has also directly impacted the financial markets of emerging market economies. Worsening negative sentiment on global financial markets fuelled a deleveraging process with global investors withdrawing their investments in sovereign debt instruments issued by advanced economies, particularly in the crisis-hit advanced economies. At the same time, heightened uncertainty and perceptions of risk also prompted a flight to quality by global investors, who shifted investments into more secure and liquid instruments such as government bonds and US dollar currency. Through the combination of these processes, the crisis in the advanced economies produced a liquidity tightness and falling global financial asset prices. Financial markets in emerging markets economies were also not immune to the fallout from the financial market turmoil in these advanced economies. The deleveraging process and flight to quality also prompted global investors to liquidate their holdings and pull out part of their funds in emerging markets economies in order to safeguard liquidity or even to cope with mounting perceptions of global risk. The capital reversal resulted in a steep drop in stock and bond prices and put downward pressure on exchange rates in emerging market countries, particularly during the second half of 2011.

The deteriorating economic conditions in advanced economies also bore down the global economy



development. Uncertainty over economic recovery in the US and Europe led to weakened domestic demand, sapping growth in the two regions with the economies in some countries even shrinking. Japan's economy contracted, albeit more as the result of the natural disaster at the beginning of the year. Weakening economic recovery in advanced economies also impacted emerging markets economies, with the high growth levels of previous periods giving way to decline in the second half of 2011. Lower demand for goods and services in advanced economies dampened growth in world trade volume, which in turn impacted exports of manufactured goods from emerging market economies. Regarding price movements, the downturn in the global economy was also accompanied by a decline in world commodity prices during the second half of 2011. The exceptions to this were gold and oil prices, which continued to soar due to the flight to safety by global investors and the escalating geopolitical crisis in the Middle East and North Africa (MENA) regions. Along with these developments, inflationary pressure that had risen in some countries in the previous period fell back towards the end of 2011.

To cope with these dynamics in the global economy, various countries pursued widely differing policies. Emerging markets that had earlier adopted a tight policy stance then shifted to an accommodative policy. During the first half of 2011, increasing inflationary pressure alongside rapid growth prompted some central banks to respond with increases in their policy

rates. In the face of surge capital inflows from global financial markets, central banks in emerging market economies also allowed greater flexibility for exchange rate appreciation and introduced macroprudential policies targeting the management of capital flows, and particularly short-term capital flows. However, as economies slowed and inflationary pressure declined in the second half of 2011, emerging market economies held back from interest rate hikes and some countries even lowered their policy rates. On the fiscal side, emerging markets economies stayed the course with policies for maintaining fiscal sustainability while nevertheless providing stimulus packages for their economies. At the same time, advanced economies generally maintained loose monetary policies and expansionary fiscal policies to provide a further boost to economic recovery. Some advanced economies pursued fiscal consolidation reflected in actions to curb fiscal deficits and the burden of public debt, even though in many cases hampered by political conditions and the desire to provide a stimulus for the economy. In addition, various initiatives for global cooperation were pursued to mitigate the impact of the crisis and boost global economic recovery. These include forums for international cooperation such as the International Monetary Fund (IMF), Bank International Settlement (BIS) and G-20, in addition to Asia-Pacific regional cooperation under Executives' Meeting of East Asia Pacific Central Banks (EMEAP) and South East Asian Central Banks (SEACEN), despite constraints to implementation of some agreed commitments.



Chapter I

GLOBAL ECONOMIC DEVELOPMENT AND POLICY



GLOBAL ECONOMIC DEVELOPMENT AND POLICY



Global economic growth slowed to 3.8% in 2011 after reaching 5.1% in the preceding year. Such a slowdown stemmed from a sharp decline in advanced economies growth as a consequence of a worsening government debt crisis in the US and Europe coupled with a natural disaster in Japan. This development affected the growth pace of emerging markets, which also headed downward, due to their sluggish export demand. This was reflected in the modest growth of the world trade volume, which was 6.8%, far below the previous year's growth of 12.8%. The economic slowdown within emerging markets was also attributable to their tight monetary policies introduced in early 2011 in a move to combat inflationary pressures during such a period of time.

The slowdown in global economic growth also triggered a decrease in global inflationary pressure, especially during the second half of 2011. Inflationary pressure went up in the beginning of year mostly due to surging oil prices as an impact of geopolitical crises in the MENA region, which also pushed the prices of other commodities up. In the second half of 2011, however, inflationary pressure subsided in line with the drop in global economic growth and commodity prices. In respond to such economic and inflationary dynamics, advanced economies maintained highly accommodative policies. On the other hand, emerging markets tended to implement tight policies early in the year, and then shifted to more accommodative policies by the end of the year.



1.1 GLOBAL ECONOMIC DEVELOPMENT

Global economic development in 2011 was marked by increasing uncertainties about global economic recovery. Early in the year, optimism prevailed over the post 2008 economic crisis marked by the emergence of various positive developments within the crisis hit

advanced economies. However, uncertainties escalated starting with the disruptions resulting from the Great East Japan earthquake and tsunami. Furthermore, it was worsened by the spreading unrest in MENA region and the worsening sovereign debt crisis of advanced economies, which served as the main factor in increasing uncertainties about global economic recovery. Such multiplying uncertainty factors directly triggered turbulence in the global financial and trade market as well as the decline in global economic growth. As a result, global economy expanded by a modest 3.8% in 2011, far below the previous year's growth of 5.1% (Table 1.1)

The deteriorating sovereign debt crisis in 2011 was reflected by rising intensity of sovereign debt crisis in Europe and the hampering US economic recovery. In Europe, the sovereign debt crisis originated in Greece, Portugal, and Ireland. The crisis was caused by over expansionary fiscal policies to bolster economic recovery in the aftermath of the 2008 financial crisis amid the absence of sufficient level of economic growth. This condition was further worsened by unsuccessful structural reform to boost economic competitiveness and productivity. As a consequence,

Table 1.1 World Main Economic Indicators

Main Indicators	2008	2009	2010	Percent			
				2011f Jan 2011	2011f Apr 2011	2011f Oct 2011	2011
World GDP	2.8	-0.7	5.2	4.4	4.4	4.0	3.8
Advanced Economies	0.2	-3.7	3.2	2.5	2.4	1.6	1.6
United States	0.0	-3.5	3.0	3.0	2.8	1.5	1.8
Euro Area	0.5	-4.3	1.9	1.8	1.6	1.6	1.6
Japan	-1.2	-6.3	4.4	1.6	1.4	-0.5	-0.9
Emerging & Developing Economies	6.0	2.8	7.3	6.5	6.5	6.4	6.2
Asia	7.7	7.2	9.5	8.4	8.4	8.2	7.9
China	9.6	9.2	10.4	9.6	9.6	9.5	9.2
India	6.4	6.8	9.9	8.4	8.2	7.8	7.4
Latin America	4.3	-1.7	6.1	4.3	4.7	4.5	4.6
World Trade Volume	2.9	-10.7	12.7	7.1	7.4	7.5	6.9
Export							
Advanced Economies	1.9	-11.9	12.2	6.2	6.8	6.2	5.5
Emerging & Developing Economies	4.6	-7.7	13.8	9.2	8.8	9.4	9.0
Import							
Advanced Economies	0.4	-12.4	11.5	5.5	5.8	5.9	4.8
Emerging & Developing Economies	9.0	-8.0	15.0	9.3	10.2	11.1	11.3
CPI Inflation							
Advanced Economies	3.4	0.1	1.6	1.6	2.2	2.6	2.7
Emerging & Developing Economies	9.2	5.2	6.1	6.0	6.9	7.5	7.2

Source: IMF, WEO

a sharp increase in fiscal deficit took place and this made the public debt of those countries to rise up continually until 2010 (Table 1.2).

By mid 2011, the intensity of sovereign debt crisis sweeping over European countries was on the rise. The crisis took a turn for the worse following a further downgrade in the Greek and Portuguese credit ratings (Table 1.2). At the same time, the public debt burden within European major countries grew heavier, spreading concern over the fate of their fiscal sustainability and economic recovery prospect. In October 2011, Standard & Poor's (S&P) and Moody's downgraded Italian's credit rating amid a mounting public debt burden.

The sovereign debt crisis subsequently spilled over into European banking sector. The contagion of the sovereign debt crisis into the banking sector was attributed to highly interconnected banking system within European region as reflected in the considerable exposure of European banks (mainly in France and Germany) to the government bonds of PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) (Table 1.3). Falling government bond yields of PIIGS countries bore a potential to induce negative effects against banks' balance sheet, triggering worries over a possibility of banking systemic risk. A number of France based banks even suffered from a downgrade in their credit ratings because they hold government bonds of PIIGS countries within their portfolios. A study done by International Monetary Fund (IMF) published by Global Financial Stability (GFSR) on September 2011 edition shows the extent of the systemic risk potential of those banks. The decreasing values of the Greek government bonds affected the balance sheet of European banks and government (a rise in sovereign contingent liabilities), besides narrowing access to financial market which potentially put a deleveraging strain on banks. This

development subsequently led to a growing concern over any possibilities of rising intensity in the sovereign debt crisis within European region in addition to increasing uncertainty over the economic recovery prospect on this region.

The path to economic recovery in the US was also hampered by rising fiscal burden. The over expansionary fiscal and monetary policy in the aftermath of 2008 global financial crisis was proven to be sustainably incapable of restoring financial performance (balance sheet), both in corporation and household sectors. This condition caused the economic recovery process in the US, which showed some indications of improvement by early 2011 took a reversal course and put a strain on public's nerve over its sustainability. This was further exacerbated by the amount of US government debt that had touched the debt ceiling of 14.3 trillion US dollar set by the Congress. Meanwhile the US government's effort to seek for Senate's approval for a debt limit hike proceeded quite hard, although the government finally won the approval. Such an augmenting debt burden took its toll on a downgraded US's credit rating for the first time over the last decades, fueling global financial market shock.

Subsequently, financial market shocks occurring in advanced economies directly depressed financial markets within emerging markets. The tight liquidity in advanced economies and worsening asset quality boosted investors' motive to pull some of their funds out of emerging markets (deleveraging process). Furthermore, financial market shock pushed up investor's risk perception against the assets belonging to emerging markets, prompting investors to shift their investment from those of emerging markets to other less risky financial assets (safe haven), especially to US government bonds. Such capital flow reversals

Table 1.2 Macro Indicators of PIIGS and U.S

Countries	Fiscal Deficit/GDP (%)		Government Debt/GDP (%)		GDP (%)		Current Account/GDP (%)		S&P Rating	
	2010	2011f	2010	2011f	2010	2011f	2010	2011f	2010	2011
Portugal	-9.1	-5.9	88.7	101.8	1.3	-2.2	-9.9	-8.6	A-	BBB-
Italy	-4.5	-4.0	99.4	100.4	1.3	0.6	-3.3	-3.5	A+	A
Ireland	-32.0	-10.3	78.0	98.8	-0.4	0.4	0.5	1.8	A	BBB+
Greece	-10.4	-8.0	142.8	153.1	-4.4	-5.0	-10.5	-8.4	BB+	CC
Spain	-9.2	-6.1	48.7	56.0	-0.1	0.8	-4.6	-3.8	AA	AA-
U.S	-10.3	-9.6	68.3	72.6	3.0	1.5	-3.2	-3.1	AAA	AA+

f= forecast
Source: WEO and Bloomberg

Table 1.3 The Ownership of PIIGS Debt Securities

Millions of US Dollar

Countries	Total Government Bonds	Held by European Banking						Held by Non-European Banking		
		Belgium	France	Germany	Italy	Spain	Switzerland	Japan	UK	US
Portugal	27,688	1,818	5,370	7,878	471	6,498	122	461	1,759	805
Ireland	16,530	710	2,616	2,836	539	144	99	762	4,647	1,814
Italy	221,057	11,299	82,266	44,482	-	10,056	5,178	24,800	8,517	10,269
Greece	32,162	1,288	7,230	11,279	1,434	375	285	116	2,080	1,479
Spain	95,643	3,708	27,060	26,406	6,360	-	2,921	9,893	6,084	5,304

Source: BIS, Consolidated Banking Statistics (September 2011)

shocked the stock and bond markets in emerging markets and strained exchange rates (see Chapter 2: The Development in the Global Financial Market and Commodities).

The weakening economic recovery in Europe and the US, along with the natural disaster in Japan affected emerging markets. The lessening economic activity was translated into a drop in import demands from advanced economies. This brought about the 2011 world trade volume to advance by a mere 6.9%, well below the previous year growth of 12.7% (Table 1.1). The weakened global trade was also reflected in the lessening trade activities (export and import) in emerging markets, including in Asian region (Chart 1.1). Shrinking trade within emerging markets in Asia was also affected by the decline in production activities in Japan, due to tsunami disaster, whose raw materials supplied by such countries. Trade in European emerging markets also slowed down as the impact of the weakening economy in the region (Chart 1.2).

As a consequence of the global economic slowdown, inflationary pressure in the second half of 2011 began to fall. Inflationary pressure once rose, especially during the first quarter, as global demand remained robust. Such an inflationary pressure jump was also contributed by oil price hike due to geopolitical crises in the MENA region, which was followed by increases in other commodity prices. The prices of food commodity also rose up briefly because of supply constraints due to unfavorable weather conditions. However, as global economy reverted to its slowdown pace during the second half of 2011, the lessening of the supply constraints mentioned above pushed commodity prices down again and this eventually led to the easing of inflationary pressure.

To face the global economic dynamics, advanced economies tended to maintain accommodative policies, while, emerging markets, which initially applied relatively tight policies, started resorting to more accommodative policies as the end of the 2011 was approaching. The accommodative monetary policy of

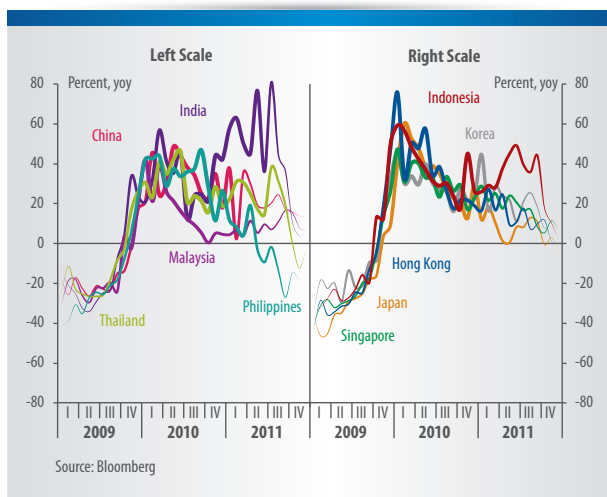


Chart 1.1 Trade Activities in Asian Countries

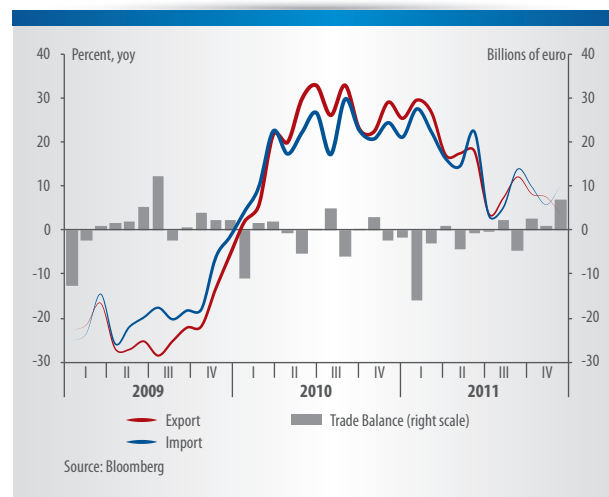


Chart 1.2 Trade Activities in European Countries

advanced economies was aimed to drive economic activities in a bid to exit the crisis. In case of emerging markets, robust economic activities and soaring inflationary pressure in early 2011 were met with a tight monetary policy. However, as global economic growth decelerated and inflationary pressure went down in the second half of 2011, emerging markets economies kept their policy interest rate from hiking, even some of them began to drop their interest rates.

1.2 ECONOMIC DEVELOPMENT IN ADVANCED ECONOMIES

Despite a generally sluggish development, global economy travelled into two different periods of time throughout 2011. The first period came in the first quarter of 2011 when optimism over global recovery started to grow as a number of positive developments in advanced economies emerged. Such positive developments were the improving consumption level in the US and Japan as well as the surging trade surplus of Germany and France. At the same time, a relatively high growth was also seen in emerging markets. Then came the second period when such positive developments shrank due to the emergence of a variety of factors that worked against economic recovery, such as the natural catastrophes in Japan at the end of first quarter, the worsening sovereign debt crisis in eurozone throughout the third and fourth quarters, and the spark of concern over a hampered US economic recovery which was caused by the debt limit issue during the third quarter. All of those matters significantly affected the weakening global economic development and triggered turbulence in global financial market.

In the first quarter 2011, the economic recovery process within advanced economies proceeded with positive developments. Such a better than expected recovery process was mainly driven by the improving private sector consumption in the US and Japan. Such a consumption improvement partly served as a positive result of fiscal and monetary stimulus policy which was implemented by US and Japan in the post 2008 global financial crisis. Additionally, an improving Japan's external performance and a rise in investment mood in the US also took a contributing part to the growing optimism over global economic recovery.

Economic performance within eurozone also showed positive developments. At the first quarter, the external

sector performance of Germany and France successfully claimed significant trade surpluses. Such trade surpluses in both countries appeared to be a driving force behind the economic recovery within eurozone in the midst of sweeping sovereign debt crisis over the euro's peripheral countries and fiscal consolidation actions held under austerity program, which put a strain on the pace of economic growth. However, this economic recovery process was still loomed by an inflationary pressure threat due to recovering global demand and escalating global prices of energy and food.

Except the rising consumption, Japan's economy contracted during the first quarter as an impact of natural disaster. The March 11, 2011 earthquake and tsunami took its toll on electricity supply cuts and infrastructure damages. This condition hampered the activities in manufacturing production, and then affected the flow of global supply-chain. Japan's export performance, previously grew in a modest pace, weakened further because of low export level in automotive products, semiconductor and electronics. On the other hand, household consumption was also in trouble as a suspicion over a possible contamination of fresh food due to nuclear reactor leakage arose. In the wake of all those emerging problems, Japan's economic performance contracted within a 1% range (Chart 1.3).

Between the start of the second quarter and the end of 2011, economic performance of advanced economies began to slow down, which was especially felt in the US and eurozone. The factor contributing to the slowing down of the US economy was a reversion to the weakening of private consumption since the beginning

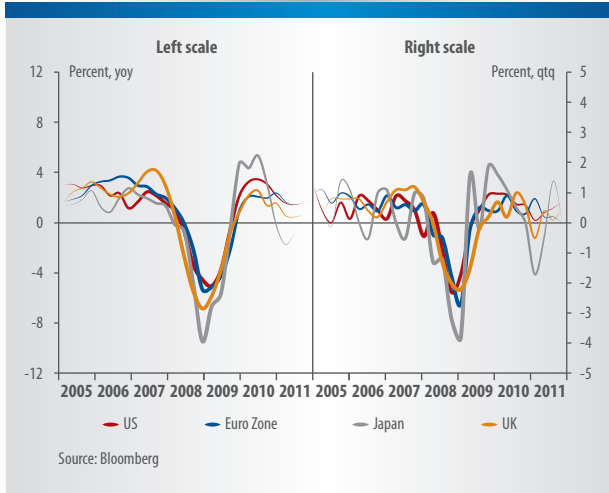


Chart 1.3 Advanced Economies GDP

of the second half of 2011. This was related to the increasing pressure on household's income due to resumption of sluggish labor market as reflected in the downward spiralling of wages (Chart 1.4). Aside from that, a high unemployment rate, the property sector that had yet to recover, and the ongoing deleveraging process within household sector, were all the factors constraining activities in private sector consumption. Such a weakening consumption was reflected in, among others, the declining trend in the amount of retail sales, which was even experiencing contraction (Chart 1.5). This condition was further deteriorated as the government stimulus package ended, amid public confidence that had yet to rise significantly. This weak private consumption resulted in slower economic growth. The prospect of US economic slowdown sent negative sentiment to financial markets, which were already overwhelmed with worries over the US public debt which was about to hit the debt ceiling. Such concerns over the US fiscal sustainability eventually led to global financial market turmoil, which was further exacerbated after S&P downgraded US credit rating from AAA to AA+ on August 5, 2011.

In the middle of sovereign debt crisis, economic growth in eurozone remained positive and yet went a little bit slow during the second half of 2011. This was connected with growth weakening in PIIGS countries which in turn led to the decline in trade volume within eurozone. This cost Germany and France a drop in their external performances. However, private sector consumption resumed to swell in both countries since the third quarter as inflationary pressure took a descending turn. At the same time, intensifying investment activities in building construction for

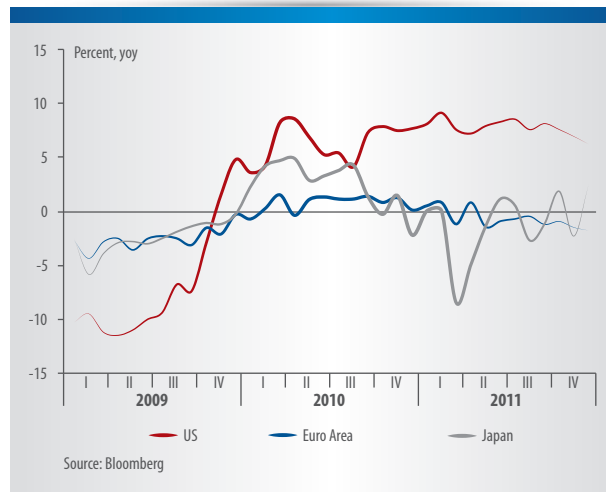


Chart 1.5 Retail Sales in Advanced Countries

manufacturing and machinery industries were able to compensate for the waning external performances. Germany and France growth remained solid up to the end of the year. The economic growth of the other members of eurozone, unlike that of Germany and France, was still weak. And the worst of all, Greece and Portugal saw their economies contracted.

In the second half of 2011, Japan's economy started to expand, albeit moderately. By the third quarter, the economy began to show a revival after contracted in the preceding period. In general, manufacturing activities in Japan started to show some indications of recovery. However, such an expansion was hampered by several factors, such as the lingering uncertainties within other advanced economies, which cost Japan declining demand and export competitiveness due to yen appreciation, as well as supply constraints in

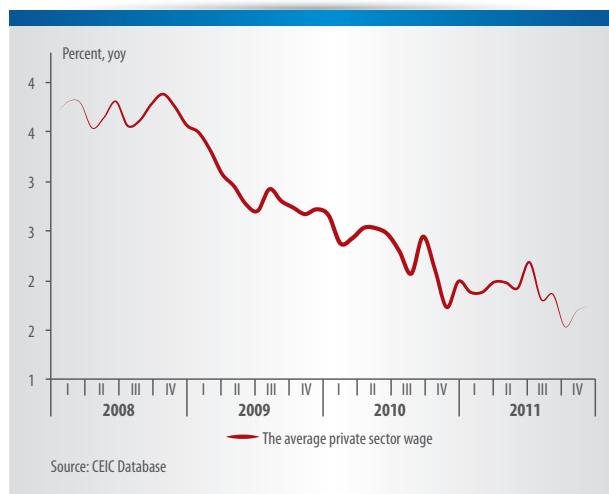


Chart 1.4 Wage in the US



Chart 1.6 Advanced Countries Inflation Rate

automotive and electronic components from Thailand due to massive flooding. Japan's export fell significantly, hurting its trade balance. Moreover, Japan's expansion was also thwarted by decline in government capital expenditure and weak private consumption.

There were occasions in which inflationary pressure in advanced economies rose at the beginning of the year and then reversed its course and headed downward in the second half of 2011. The threat of rising inflation in advanced economies emerged early in the year along with improving domestic demand and international commodity prices hike. However, inflationary pressure gradually receded as domestic demand weakened and commodity prices, especially the non-oil, decreased (Chart 1.6).

1.3 ECONOMIC DEVELOPMENT IN EMERGING MARKETS

Like the economic development experienced by advanced economies, emerging markets also saw their economic performance slowed though still kept up its high level. Private consumption, investments and exports in China and India grew robust in the first quarter. The contagious effect of natural disaster in Japan on the flow of supply-chain to Asia was felt to a relatively limited extent. In Latin America, economic growth remained high, mainly driven by Brazil and Argentina, as the pressure threat on exchange rate appreciation loomed on the horizon.

Entering the second quarter, the economic growth of emerging markets began to slow down. The impact of tight policies in some emerging markets and the contagious effect of weaker economic activity in major advanced economies as reflected in the decline in the export of emerging markets started to materialize, albeit limitedly (Chart 1.1). However, the declining demand for exports from advanced economies was slightly compensated for by the rising inter-regional trade within emerging markets along with their persistently strong domestic demand. Such a robust domestic demand and increased inter-regional trade among themselves constituted a driving force for emerging markets to maintain a robust growth until the end of 2011. In Latin America, Brazil's economic growth began to slow. Such a slowdown was contributable to the deteriorating economic condition

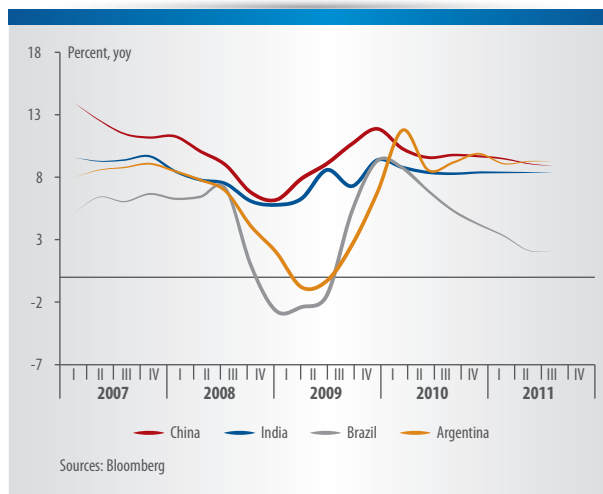


Chart 1.7 Emerging Markets GDP

in the US and European countries which are the main trading partners of Brazil. This was further made worse by the weakening of the country's competitiveness because of the appreciation of Brazil exchange rate. Furthermore, the country's investment performance was also flagging as an effect of the Brazilian government's policy to dampen credit expansion.

Inflation rate within emerging markets in 2011 remained quite high. High inflationary pressure related to the continuously strong domestic demand in emerging markets (Chart 1.8). However, this strong domestic demand was slightly hampered by the lessening global food prices, resulting in the slowing of the pace of inflation in emerging markets since the second half of 2011.

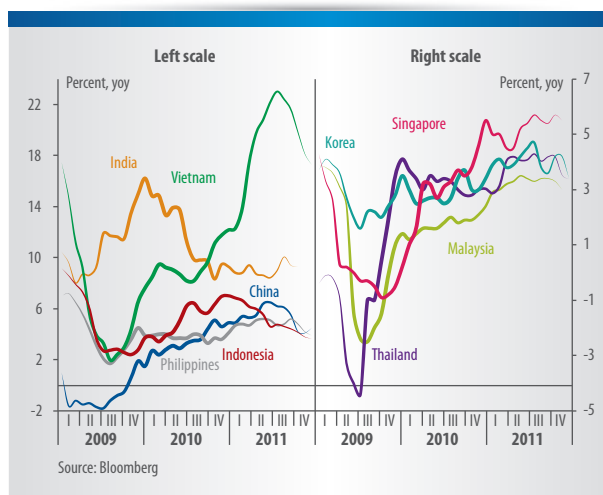


Chart 1.8 Asian Emerging Markets Inflation Rate

1.4 GLOBAL POLICY RESPONSES

Facing global economic dynamics, advanced and emerging markets implemented different policies. Advanced economies generally maintained their accommodative monetary policies to encourage economic activities. Meanwhile, emerging markets adopted tight monetary policy, especially during the first half of 2011, to fight a high inflation level. However, approaching the end of the year, emerging markets opted to hold their policy rate, even some of them cut their policy rate as inflation rate declined (Chart 1.9).

The resumption of slowdown in advanced economies along with increasing instability in financial market prompted the authorities in advanced economies to maintain accommodative policy. Throughout 2011, US Federal Reserve had not altered its policy rate which stood at 0.25% amid a looming inflation threat. Such a persistent level of policy rate, effective since 2008, was preserved due to the condition in US economy which remained unstable and the prevailing expectation over a merely temporary price fluctuation (Chart 1.9). In addition, to complement fiscal expansion, that launched previous year, monetary stimulus was introduced through the second Quantitative Easing (QE-2) between November 2010 and September 2011 with a funding worth 600 billion US dollar. This QE-2 was a part of a series of previous monetary stimulus policy of US Federal Reserve, namely QE-1, implemented between November 2008 and June 2010 with around 2 trillion US dollar worth of fund.

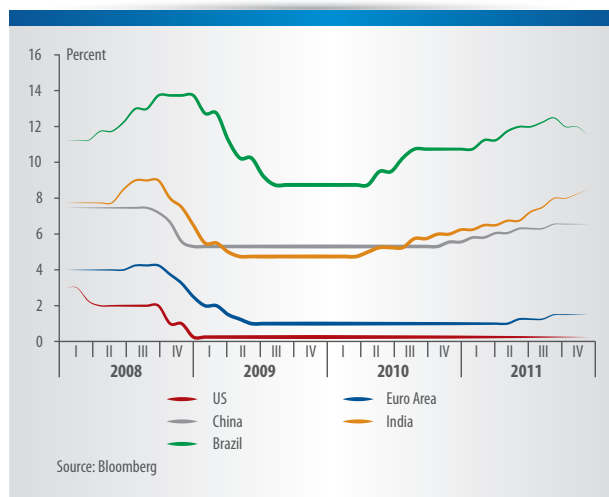


Chart 1.9 Policy Rates

The accommodative fiscal and monetary policy in the US had not achieved any success in boosting activities in real sector as expected. The expansionary fiscal policy was only capable for preventing the US economy from falling much deeper. However, this policy had a positive effect only in the short-run as reflected in the resumption of the weakening consumption activities in the aftermath of the fiscal stimulus period. Furthermore, a stimulus in the form of tax deduction for businesses also did not help much to drive business sector expansion.

In the meantime, the extra loose monetary policy was also unable to bring the US economy to a more stable recovery path. An extremely low interest rate and liquidity injection, directly put into both the banking and corporation sectors, were also proven unsuccessful to either drive activities in the real sector or improve labor absorption in a stable and significant way. QE-2 strategy gained a success in lowering interest rate for a long-term. However, this condition subsequently failed to boost real sector activities as expected.

Both accommodative fiscal and monetary policies were less effective in bolstering economic activities under a condition ruined by an extremely low business confidence level. The issue currently faced by the US economy was no longer that of lack of liquidity like what happened during the 2008 global financial crisis. Instead, then the current issue was the idle economic capacity controlled by non-financial private corporation sector as a consequence of the low level of business confidence of future US economic condition.

Across eurozone, the sovereign debt crisis which spilled over into banking sectors had not been resolved yet. This gradually threatened eurozone core. Throughout the region, financial market tension was also accompanied by economic turbulence following the implementation of fiscal consolidation program in various members of the eurozone. Furthermore, fragile financial institutions performance and the slow progress in improving the balance sheet of such institutions in the region helped worsening negative market expectation. This condition seemed to overshadow the positive efforts made by the countries' governments to revitalize their financial condition. With such fragility-laden financial institutions, the action taken by the government to carry out a drastic austerity program only helped negative expectation against economic recovery prospect in the region to grow.

The monetary policy in European region throughout 2011 tended to accommodate inflationary pressure and sovereign debt crisis development. Early in the year, European Central Bank (ECB) raised its policy rate to combat the more than targeted rate of inflation within eurozone. However, in the second quarter 2011 the ECB policy turned over its course by lowering policy rate upon the escalation of sovereign debt in the eurozone which had grown wider and worse.

In response to this, in contrast to the policy taken by advanced countries, the policy pursued by the authorities in emerging markets was more diverse. Central banks in Asia generally implemented monetary tightening to calm inflationary pressure and overheating economy. Inflationary pressure rose during the first quarter 2011 which was caused by oil prices hike. At the same time, a surge in food prices put an increasing strain to inflationary pressure.

Other than raising policy rate, a number of emerging markets applied monetary tightening by raising banks' Reserve Requirement and implementing macroprudential policy. Such a policy served as a compliment to interest rate policy aiming at dampening the threat from asset price bubble and surging credit. Monetary tightening was aimed to manage liquidity that tends to rise as an effect of rapid foreign capital inflows to emerging markets. China, Brazil, Peru, Turkey, Vietnam, the Philippines and Malaysia raised their banks' Reserve Requirement; moreover a number of countries increased the reserve requirement for more than once throughout 2011. Meanwhile, Taiwan and Vietnam also raised the minimum liquidity ratio (a kind of reserve requirement) for non-bank financial institutions.

Finding it not enough to raise policy rate and reserve requirement, China and Brazil also used other policies to restrain capital inflows. China banned business sector to borrow from foreign banks in renminbi denomination. On the other hand, in Brazil, the authorities raised financial operation tax on foreign loans, introduced deposit placement requirement and cut government expenditure as a part of an inflation control strategy.

As inflation pressure descended in the second half of 2011 some central banks lowered their policy rate. Central banks in Indonesia and Brazil cut their policy interest rate near the end of 2011 after observing the prospect of declining inflationary pressure.

Lowering policy rate was also expected to boost economic growth. Meanwhile, Argentina and Mexico maintained their ease monetary policy as domestic price development was still under control. In addition, Argentina also put a priority on boosting economic growth rather than applying inflation control measures in a gear up to October 2011 elections.

1.5 INTERNATIONAL COOPERATION

Throughout 2011, a number of international cooperation forums focused on fundamental issues related to the weakening global economy and the efforts to crush the negative effects of such deterioration. In Asia Pacific, the focus of ASEAN+3 forum was on how to preserve the regional stability through the establishment of a crisis prevention facility and the empowerment of crisis resolution facility¹. Still in the region, EMEAP and SEACEN forums emphasized on the responses of central banks to the current global economic condition, increases in commodity prices, and destabilising of capital flows. Meanwhile, cooperation held by BIS, IMF, and G20 forum consisted of policies and international coordination to anticipate global challenges.

The ASEAN+3 cooperation forum maintained regional stability through the establishment of crisis prevention facility and reinforcement of crisis resolution facility. Responding to any massive liquidity need to anticipate a possible financial crisis which might occur globally and spread quickly, in 2011 ASEAN+3 countries agreed to establish a crisis prevention facility (CPF). This CPF was established to complement the region's existing crisis resolution facility of Chiang Mai Initiative Multilateralization (CMIM). Referring to the statement made by the ASEAN+3 Finance Ministers, the discussion on CPF would focus on facility design including funding through CMIM (both for crisis resolution and CPF), further collaboration with IMF and the role of ASEAN+3 Macroeconomic Research Office (AMRO) as an independent surveillance unit in CMIM.²⁻³ In this context, the discussion over formal framework on the empowerment of the collaboration of CMIM, as

1 In addition to being active in a number of inter-ASEAN cooperation forum, Indonesia also holds cooperation with dialogue partner countries, especially through the cooperation with ASEAN+3 countries of China, Japan and South Korea.

2 Joint Ministerial Statement of the 14th ASEAN+3 Finance Ministers' Meeting, Hanoi, Vietnam, 4 May 2011

3 Independent surveillance unit formed by ASEAN+3 countries

a regional financial arrangement (RFA), with IMF to create an integrated Global Financial Safety Net (GFSN) is now underway.

Inter-central bank cooperation forum in the region was also aimed at responding to current global condition. Monetary authorities grouped in both EMEAP and SEACEN generally agreed to increase cooperation to anticipate and minimize the risks of global economic deterioration against economic and financial system stability⁴. Furthermore, the agreement also said that central banks in the region were encouraged to make other actions such as to improve monitoring and surveillance activities, implement global regulatory requirement and macroprudential regulation framework. In the meantime, during the EMEAP meeting an agreement was reached over the need to tighten cooperation and expand information sharing to support the effectiveness of monetary policy in dampening the impact of the second round of global commodity prices hike against inflation and wage.

The agenda of discussion in G20 forum was directed over policy coordination within the G20 member countries to achieve the Strong Sustainable and Balanced Growth (SSBG) Framework as well as to increase international coordination to anticipate various global challenges. In 2011, G20 forum, helped by IMF and other international institutions, proceeded with policy coordination process among G20 members in order to reach SSBG framework. This comprised of providing indicative guidelines within the Mutual Assessment Process (MAP) framework in order to tackle issues on global imbalances. To support the strong medium-term growth foundation, G20 forum also formulated the plan to form a sound fiscal consolidation, to encourage private sector demand among countries with a surplus in their current account and weak private sector demand, to establish structural reform to boost growth and job creation in all over G20 members.

As far as the ongoing global issue was concerned, G20 member countries pledged a commitment to making efforts to overcome global issues and minimize the spillover effect of domestic economic policy which may affect other countries as well. European countries committed to resolving the region's sovereign debt crisis. The US vowed to implement a short-term policy package through government investments, tax

incentives and more focus employment policy in line with a medium-term fiscal consolidation plan. While Japan committed to moving into a reconstruction program in its earthquake affected areas. Countries with a relatively strong government financing (Australia, Canada, China, Germany, South Korea and Indonesia) agreed to turn their fiscal policies into a stabilization measure in case of any deterioration in global economy occur by holding their medium-term fiscal target. Meanwhile, countries that use fixed exchange rate system and foreign exchange reserves larger than their contingency needs agreed to decelerate their foreign exchange reserve accumulation in order to make a more flexible exchange rate adjustment, while still considering their own needs to put down any capital flows fluctuations besides assuring themselves that they will not go with any competitive devaluation policy. Countries with current account surpluses were expected to push their domestic demand up in order to boost growth and support financial stability.

Under the International Monetary System (IMS) reform framework, G20 Forum focused on measures to tackle the roots of the global imbalance issue in order to create a more stable and efficient monetary system. Various issues discussed and agreed consisted of those covering the management of fluctuating capital flows, global liquidity, strengthening IMF surveillance, and a number of steps to strengthen the financial sector reform commitment (on the development of local stock exchange and bonds market in domestic currency denomination).

To respond to G20's demand to observe the external impact of domestic policy on five countries with systemic characteristic (China, Euro Area, Japan, UK and the US), IMF launched its product called "Spillover Report" in mid 2011. This product was made in order to reduce the gap between the domestic and global surveillance. An increase in surveillance quality will also be complemented by the improvement in the GFSN through the availability of a sufficient short-term liquidity facility for any countries hit by systemic crisis. This is expected to mitigate the high cost of crisis and prevent systemic liquidity crisis. A number of GFSN improvement alternatives include regional financial cooperation development, collaboration improvement between RFA with the IMF, and improvement of IMF financing instrument framework and modalities.

In a bid to recover global financial system stability, G20 leaders pledged a commitment to continuing the

⁴ SEACEN Expert Group (SEG) Meeting on Capital Flows in August 2011

global financial sector's reform. A number of issues which were put on the reform agenda included the reinforcement of macroprudential policy aiming at minimizing the risk within the financial system by cutting its procyclical and contraction effect on financial activity, improving the quality of banking capital and liquidity, regulating financial institutions which would have a systemic impact, and improving compliance to international standard.

Meanwhile, the discussion focus of BIS meeting at the end of 2011 was about the implication of increases in

debt against monetary and fiscal policy. The high level of debt (public and private sector) may lead to the increasingly reduced effectiveness of monetary and fiscal policy. Increased debt will trigger an alteration in monetary policy transmission in relation with heightening sensitivity of aggregate demand against interest rate change. Besides that, any rising public debt may erode the effectiveness of monetary policy if fiscal authorities have no credible plan to lower their public debt to a controllable level.

Table 1.4 Global Monetary and Macroprudential Policy

Policy	Advanced Economies	Emerging Economies
Monetary Policy		
Interest Rate	<p>Monetary policy in advanced economies tend to be accommodative. They didn't increase the policy rate.</p> <p>* ECB had raised the interest rate, but then lowering the rate at the end of the year</p> <p>* RBA and RBNZ were also easing the interest rate</p>	<ul style="list-style-type: none"> Monetary policy stance in emerging economies tend to be tight 13 countries (Brazil, Chile, China, Colombia, Philippines, Hungary, India, Korea, Malaysia, Peru, Russia, Thailand, Vietnam) increased the policy rate even more than once. However, a number of countries started to ease the policy rate, such as Brazil, Indonesia and Turkey towards the end of the year.
Quantity	<p>Quantitative easing continued</p> <p>* The US went on the QE2 until June 2011 and applied a twist operation (\$ 400 billion)</p> <p>* ECB ran with Long Term Refinancing Operation, Main Refinancing Operation and Covered Bond Purchase Program</p> <p>* Japan expanded the size of its asset purchase program</p> <p>* ECB, Fed, BOE, BOJ, SNB did joint USD liquidity operation (3 million US dollars)</p>	
Exchange Rate	SNB (Switzerland) set a minimum rate of EURCHF for 1.20	Singapore adjusted the SGD band to facilitate a gradual appreciation
Macroprudential Policy		
Reserve Requirement		<ul style="list-style-type: none"> Number of countries (Brazil, China, Philippines, Malaysia, Peru, Turkey, Vietnam) increased banking reserve requirement. Two countries (Taiwan and Vietnam) increased the reserve requirement of non-bank financial institutions
Restriction on Transactions		<ul style="list-style-type: none"> Korea: (1) restraining and monitoring derivative transactions Prohibiting banks to buy foreign currency bonds held by domestic borrowers Banning equity short selling
Financial Safety Net		<ul style="list-style-type: none"> China and Korea increased the BSA



Chapter II

GLOBAL FINANCIAL AND
COMMODITY MARKET



GLOBAL FINANCIAL AND COMMODITY MARKET



Global financial market performance in 2011 was marked by price shocks stemming from growing negative sentiment surrounding the uncertain global economic recovery. The economic recovery process became more uncertain due to the deteriorating sovereign debt crisis in the eurozone as well as the growing fiscal burden in the US that undermined domestic recovery. In addition, natural disasters in Japan as well as geopolitical unrest in the MENA region further exacerbated the uncertainty. In emerging markets, heightening uncertainty sparked turbulence on financial markets coupled with increasing volatility in capital flows as well as exchange rate shocks.

The dynamics of the global economy have a strong influence over international commodity market performance. Optimism for global economic recovery at the beginning of the year helped drive up international commodity prices. Furthermore, the prices of commodities escalated due to disruptions in supply, for instance the supply of oil was interrupted by geopolitical tensions in the MENA region, and food supplies were disrupted by unfavorable weather condition. Subsequently, when the global economy slowed in the second semester of 2011, commodity prices also trended downwards. International commodity prices were also affected by speculative activities on certain items.



2.1 GLOBAL FINANCIAL MARKET

In general, global financial market performance deteriorated in 2011, as reflected by a decline in financial asset prices and increased volatility (Chart 2.1, 2.2 and 2.3). The significant slump in asset prices affected financial markets in the advanced economies experiencing a sovereign debt crisis as well as financial markets in emerging markets. In fact, shocks on emerging countries financial markets were also accompanied by destabilizing foreign capital flows, particularly in the event of a sudden reversal, which had a harmful impact on the exchange rate as well as monetary management.

Despite a slight deterioration, overall global financial markets showed promising signs at the beginning

of the year, including in advanced economies that were clawing their way out of the crisis. In addition, global liquidity remained excessive (Chart 2.4) as a result of unresolved global imbalances as well as accommodative fiscal and monetary policy introduced to stimulate an economic recovery, which also accelerated prices on global financial markets, particularly in emerging market economies.

Excessive global liquidity could not be fully absorbed by languid advanced economies that were undergoing financial system consolidation. A persistently weak economic outlook was reflected by stagnant credit growth due to a decline in economic activity as well as bank consolidation amid deteriorating crisis conditions. Consequently, relatively slow money growth (M2) was reported in advanced economies at around 17% compared to the position in 2007. Notwithstanding, base money (M0) grew by around 106% in line with the accommodative monetary and fiscal policy stance adopted in developed countries. Therefore, excess global liquidity surged into the financial markets of emerging markets, which generated relatively high yields with a lower level of risk. In addition, global investors also tended to place their funds in other higher-risk instruments, including futures contracts on commodity markets.

A deluge of capital flows to emerging markets remained in 2011 despite slight ebb on the previous year. Capital flows to emerging markets in Asia were the most dominant, reaching 372 billion US dollar or around 40% of total capital flows to all emerging market economies (Chart 2.5). In spite of their dominance, capital flows to emerging markets in Asia declined by 24% in 2011

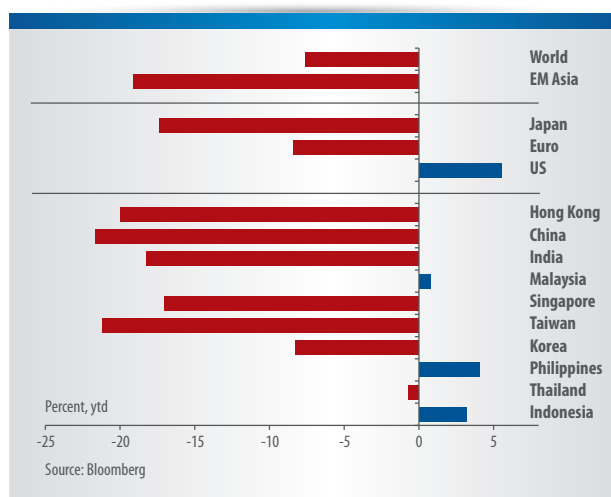


Chart 2.1 2011 Global Stock Price

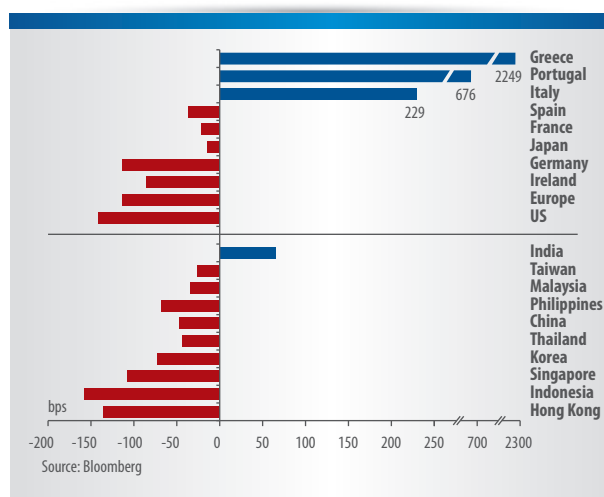


Chart 2.2 2011 Global Bond Yield

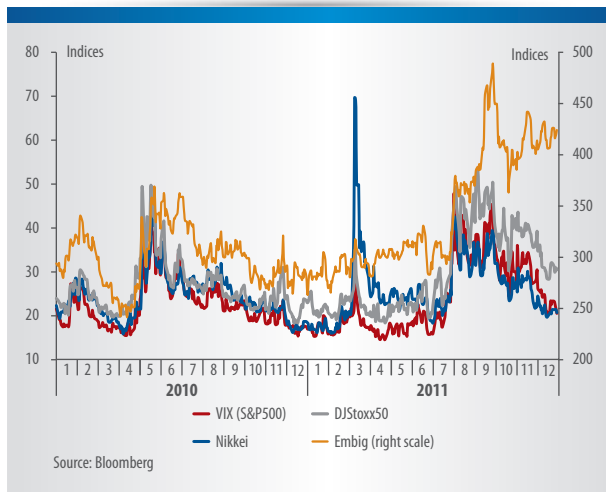


Chart 2.3 Global Financial Market Volatility

compared to the preceding year as a result of bank deleveraging in Europe amid the escalation sovereign debt crisis in the region. In line with the historical pattern, the majority of capital flows to emerging markets in Asia were absorbed by China and India. Meanwhile, capital flows to emerging markets in other parts of the world also experienced a decline, with the exception of emerging markets in Europe, where a slight increase was recorded. This increase was attributable to privatisation in Poland as well as a surge in foreign investment in government bonds in Turkey and Hungary.

According to types of investment, excluding foreign direct investment (FDI), capital flows to emerging market economies experienced a decline for all types of investment. Flows of FDI surged by 17% compared to 2010 due to the favourable performance of emerging

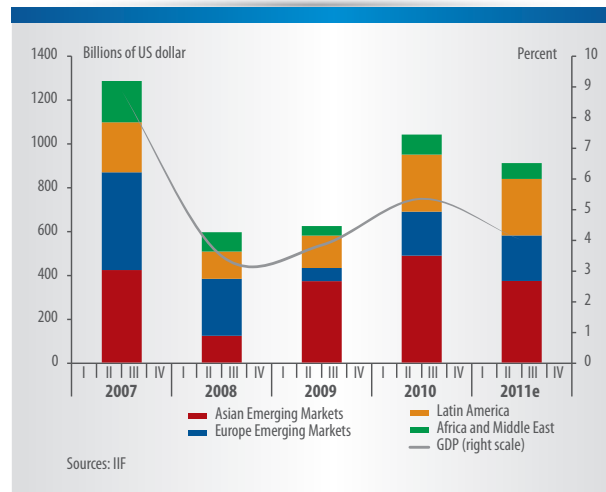


Chart 2.5 Capital Flows to Emerging Markets

markets along with a persistent deterioration in the crises affecting advanced economies. Foreign loans declined somewhat, in terms of bank and non-bank loans, while the investment portfolio fell 77% from 193 billion US dollar in 2010 to just 44 billion US dollar in 2011.

The volatility of capital flows and financial market dynamics were linked to the escalating sovereign debt crisis in eurozone, as reflected by a number of risk indicators, including Credit Default Swaps (CDS) in Portugal, Ireland, Italy, Greece and Spain (PIIGS) that increased steeply in 2011 (Chart 2.6) and exacerbated the spread of government bond yields between PIIGS and Germany (Chart 2.7). Furthermore, heightened uncertainty risk encouraged global investors to become more risk averse to assets in emerging market economies, which manifested in investors diverting

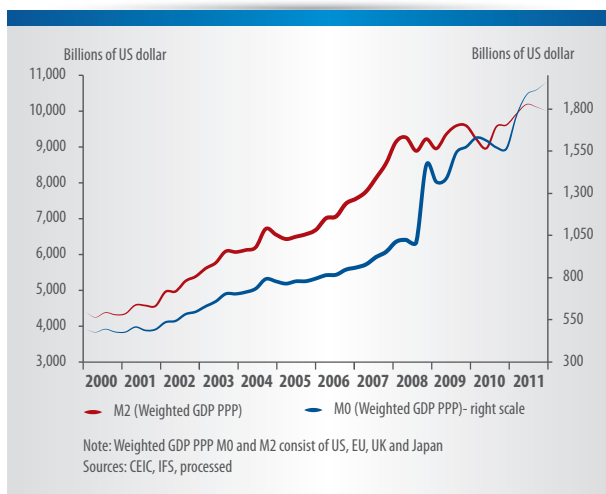


Chart 2.4. Global Liquidity



Chart 2.6 CDS of PIIGS Countries

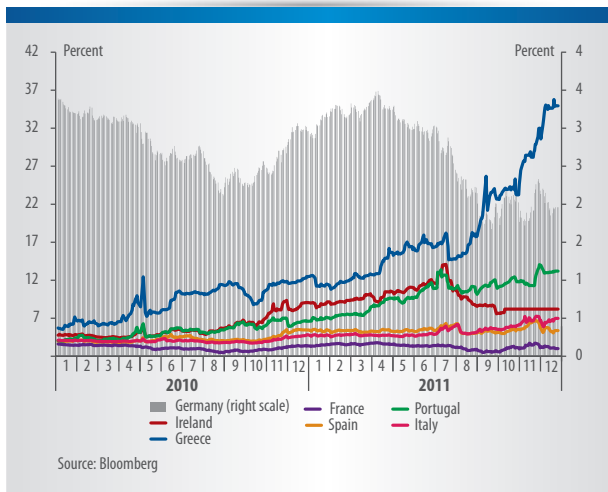


Chart 2.7 Yield Spread of PIIGS Bonds and Germany Bonds

their funds from high-risk assets to perceived safer assets (flight to quality). In addition, foreign investors also withdrew their funds from emerging markets in order to overcome tight liquidity and deteriorating asset quality on financial markets in advanced economies (impact of the deleveraging process).

US Treasury Bills (US T-Bills) became the safe haven assets because only countries considered safe and low-risk with a liquid market can issue such bills. Consequently, although risk-averse global investors increased and liquidity on other financial markets dried up, safe haven assets actually went up in price, accompanied by currency appreciation where liquidity was maintained.¹ Accordingly, gold also became a safe haven asset.

The deleveraging process, coupled with flight to quality, caused asset prices to tumble. This action by foreign investors precipitated a sudden capital reversal from financial instruments in emerging markets and compounded exchange rate depreciatory pressures.² Financial markets and global capital flows were much more fluctuative in 2011 as a result of more intense and more frequent bearish sentiment as well as flight to quality actions.

1 Rinaldo, A and P. Söderlind (2010): "Safe Haven Currencies", Review of Finance, vol.14 (3), Pp. 385-407 and Habib, MM and L Stracca (2011), "Getting beyond Carry Trade: What Makes a Safe Haven Currency?" European Central Bank Working Paper 1288.

2 An escalation of the sovereign debt crisis, capital reversal and exchange rate depreciation in emerging market economies were the result of short-term negative market sentiment. Notwithstanding, the long-term trend continued to show global capital flowing to emerging market economies that are performing well and have a more attractive risk-return.

Three distinct periods of negative sentiment were recorded in 2011 prompting shocks on global financial markets and capital reversal in emerging markets (Chart 2.8). The first period occurred in March 2011, triggered by the natural disasters that struck Japan, which caused significant damage to infrastructure and production facilities, as well as the outbreak of geopolitical tensions in the MENA region that impacted the skyrocketing of oil prices. Those two events induced negative sentiment of slower global economic growth and aggravated inflationary pressures. The second period of negative sentiment returned in May 2011 as a result of the downgraded credit rating of Greece (Portugal's credit rating had already previously been downgraded), signalling the spiralling depth of the sovereign debt crisis. The third period of negative sentiment was the most protracted and resulted in a massive capital reversal from emerging market economies in August – October 2011. Negative sentiment emerged following the growing public debt burden in the US, as well as the propagation of the sovereign debt crisis in the eurozone (from peripheral to core countries, namely Italy and Spain). The sovereign debt crisis also spread to the banking sector (particularly in France) due to high bank exposure to PIIGS government bonds. Nonetheless, uncertainty regarding crisis resolution as well as doubts over the future of the eurozone were the most salient catalysts of mounting volatility on global financial markets (Diagram 2.1).

Despite a general decline, the performance of international financial markets was varied, even garnering optimism at the beginning of 2011. Stock prices on the stock markets of emerging market economies in Asia, in general, slumped in comparison

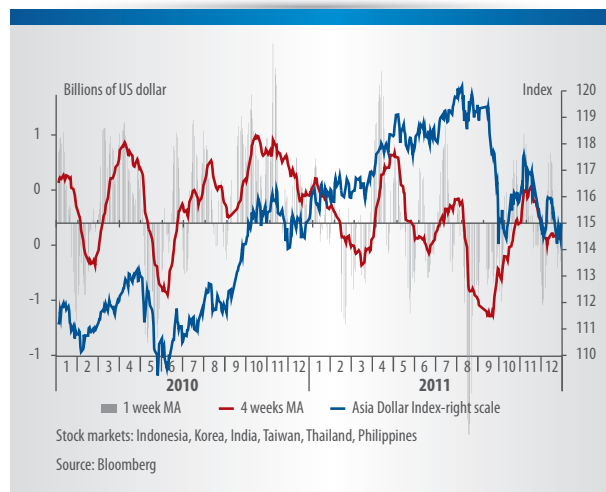


Chart 2.8 Foreign Capital Flows in Asian Emerging Stock Market

Financial market turmoil was caused by negative sentiment that appeared to follow some events or shocks as follows:

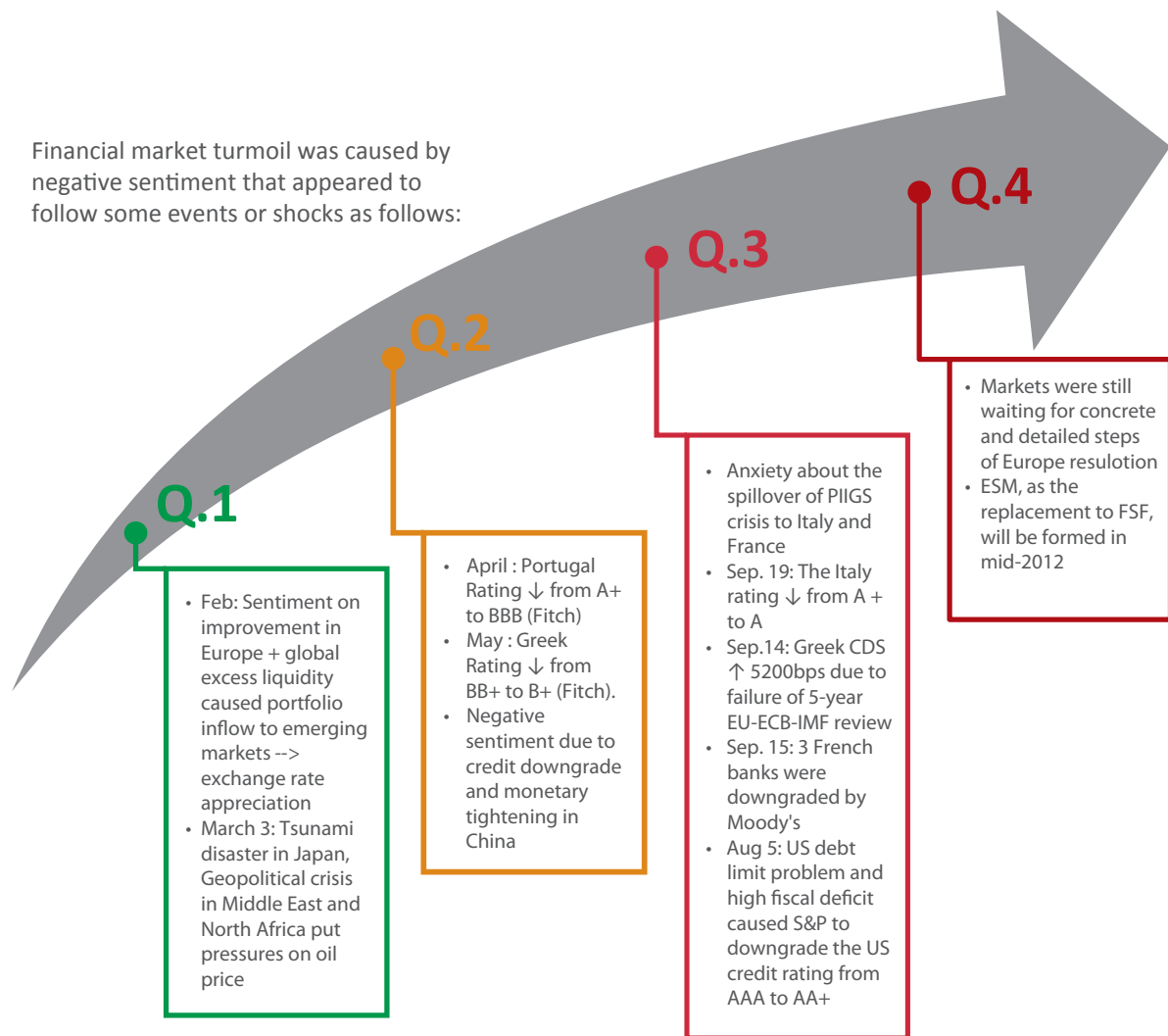


Diagram 2.1 Timeline of Global Economy in 2011

to the preceding year. Bearish sentiment in March and May 2011 led to stock price corrections; however, stock prices quickly rebounded to follow an upward trend after the sentiment had subsided. Nevertheless, when negative sentiment reared its ugly head again in August 2011, stock prices tumbled by 23% and had not fully recovered by yearend. In the eurozone, stock prices in crisis-hit countries tended to slide; increased dramatically since August 2011 (Chart 2.9 and 2.10). Stock prices in the US followed a similar pattern to those in emerging market economies. When stock prices tumbled in August 2011, prices in the US dropped by 14%. However, the US stock market posted the best performance in 2011 in comparison to stock markets in Europe, Japan and even Asia.

Developments on global bond markets also indicated similar performance. Heightened risk factors in the second half of the year led to government bond prices tumbling in nearly all countries in 2011, with the exceptions of the US and Germany that have become safe haven assets for global investors.

The interbank money market was not isolated from the escalating sovereign debt crisis. Although global liquidity increased rapidly, liquidity on the bank money markets in advanced economies remained relatively tight (Chart 2.11) due to the crisis impacting the banking sectors in the eurozone as well as large exposure to government bonds from crisis-hit countries. The decline in bond prices led to a heavy

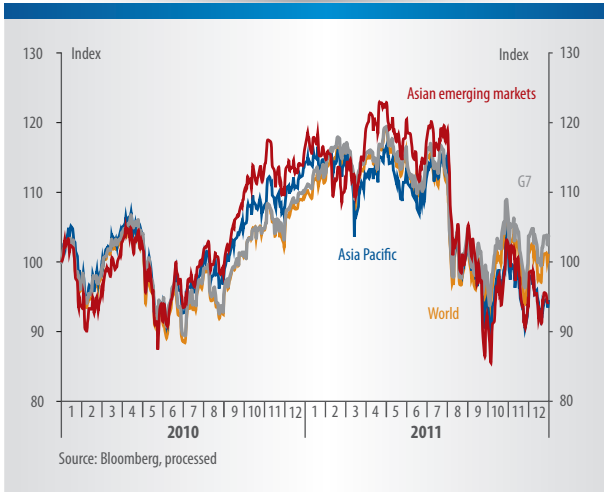


Chart 2.9 Global Stock Price Index

capital charge burden on the banks, which in turn disrupted bank performance and led to insolvency problems. Escalating bank risk was reflected by the widening spread between the highest and lowest lending rates among banks, which also indicated a tighter interbank money market (Chart 2.12).

Global financial market shocks also affected the performance of foreign exchange markets in a number of countries. When global economic performance was improving, the exchange rates of global currencies strengthened against the dollar. Conversely, intense depreciatory pressures, in general, accompanied the various shocks on global financial markets. This phenomenon is in line with the characteristics of the US dollar as a safe haven currency as well as US T-Bills as safe haven assets. Consequently, intense uncertainty



Chart 2.10 Asia Stock Price Index

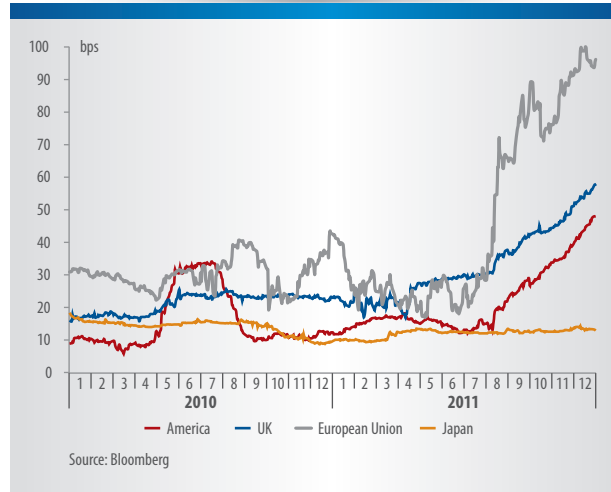


Chart 2.11 LIBOR Spread-Overnight Indexed Swap (OIS) of Advanced Economies

pressures on global financial markets in 2011 led to global currencies depreciating against the US dollar, however, currencies in Asia remained strong (Chart 2.13).

2.2 GLOBAL COMMODITIES MARKET

Similar to the financial markets performance, commodity prices on global markets also fluctuated in the face of pressures that tended to intensify in the first half of 2011 but dissipate in the second half. Commodity prices, oil/gas and non-oil/gas, soared as a result of strong global demand in the first half of 2011 in line with optimism surrounding the global economic recovery (Chart 2.14). Commodity prices continued to soar on account of disruptions to supply in Japan that

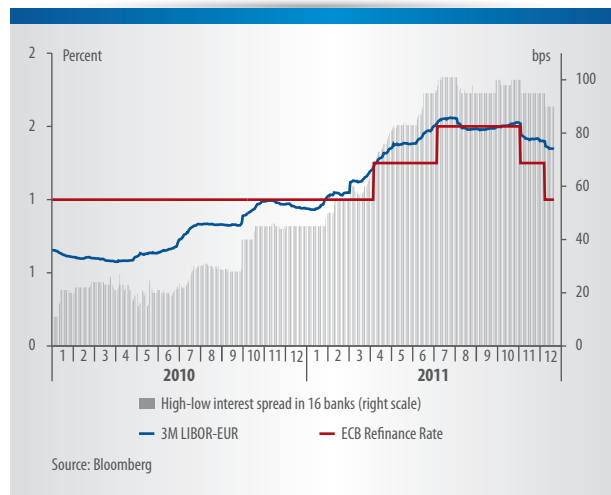


Chart 2.12 High-Low Lending Interest Spread in Eurozone



Chart 2.13 Dollar Index and Asia Dollar Index

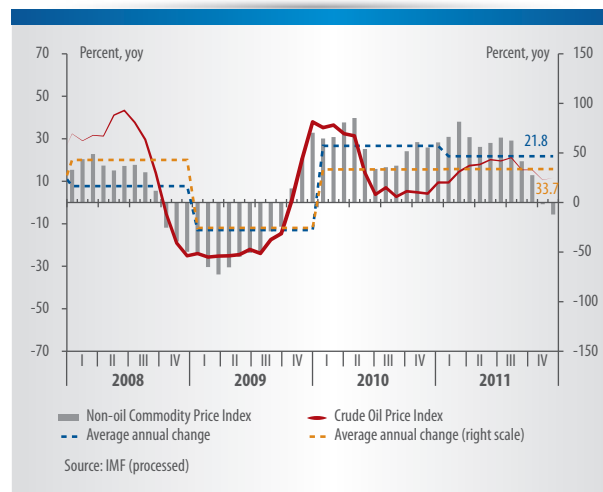


Chart 2.14 Global Commodity Price Index

was stricken by natural disaster. This significantly disrupted the global supply-chain for the international manufacturing industry, which drove up the prices of manufactured products. Oil prices also shot up after geopolitical unrest in the MENA region disrupted global oil supply. The soaring oil price, which is a production input, raised the prices of other goods. Furthermore, unfavourable weather conditions also pushed up the prices of agricultural products (foodstuffs) and mining products.

In the second half of 2011, commodity prices tended to decline in line with the global economic slowdown, primarily in advanced economies, which undermined demand for global commodities. On the supply side, a number of supply constraints encountered in semester I 2011 were resolved in the second half of 2011. This backdrop of weak demand and limited supply persisted

up to yearend, with the exception of oil and gold commodities that became the preferred investment option (speculation) for global investors.

Weak global demand was also reflected by slower growth in world trade volume. Optimism surrounding stronger economic performance at the beginning of the year raised estimates of world trade volume in 2011 (forecasts for January, April and June 2011 in Table 2.1). However, continued deterioration in the global economy forced the outlook for world trade volume to be revised down to 6.9%. Export and import transactions in advanced and emerging market economies further corroborated the decline in world trade volume throughout 2011 (Chart 2.15).

The implementation of trade regulations was also suspected of contributing to slower growth in world

Table 2.1 The Dynamics of Growth Prospects Throughout 2011

Subject	Percent					
	Oct-10	Jan-11	Apr-11	Jun-11	Sep-11	Jan-12
WTV (goods and services)	7.0	7.1	7.4	8.2	7.5	6.9
Import						
Advanced Economies	5.2	5.5	5.8	6.0	5.9	4.8
Emerging and Developing Economies	9.9	9.3	10.2	12.1	11.1	11.3
Export						
Advanced Economies	6.0	6.2	6.8	6.8	6.2	5.5
Emerging and Developing Economies	9.1	9.2	8.8	11.2	9.4	9.6
Commodity Prices						
Oil ¹	3.3	13.4	35.6	34.5	30.6	31.9
Nonfuel ²	-2.0	11.0	25.1	21.6	21.2	17.7

¹ Simple average of prices of UK Brent, Dubai and West Texas Intermediate crude oil

² Average based on world commodity export weight

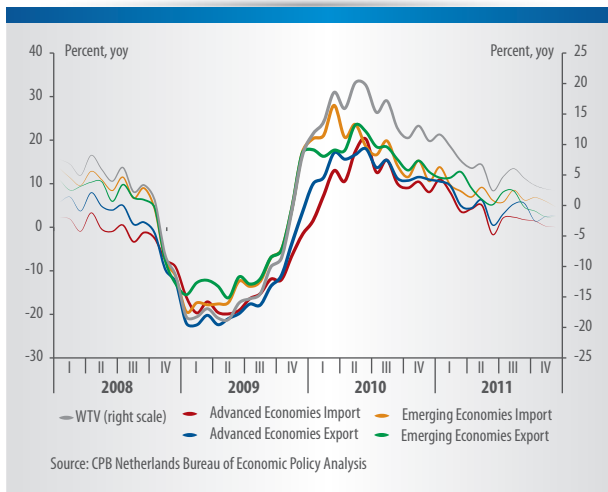


Chart 2.15 World Trade Volume Growth

trade volume. The World Trade Organization (WTO) signalled an increase in the number of regulations issued in various countries in 2011 compared to those issued in previous year that undermine international trade. Nonetheless, the WTO also expected the impact of these regulations to be relatively minimal, and certainly smaller than the impact of regulations promulgated in 2010. This was in line with the scope of sectors affected by such policies, which in 2010 were dominated by sectors involved in cross-border trade and broader trading partners.

In addition to the interaction of fundamental factors through supply and demand, speculative activity also affected commodity prices. Speculation is possible on a commodity because trade on the commodities market is not merely physical but also performed through trade delivery contracts. Sales contracts are conducted on various global commodity markets such as the London Metal Exchange, Chicago Mercantile Exchange and New York Mercantile Exchange. Commodity traders are not only limited to producers and consumers but can also involve financial market players like hedge fund managers and money market dealers. Therefore, commodity markets currently represent an alternative investment opportunity, especially when financial market conditions are less than conducive.

OIL PRICES

Oil prices increased by an average of 32.0% in 2011.³This upward price trend began in the fourth quarter of 2010 in response to strong global demand

3 IMF oil price; average price of UK Brent, Dubai and West Texas Intermediate.

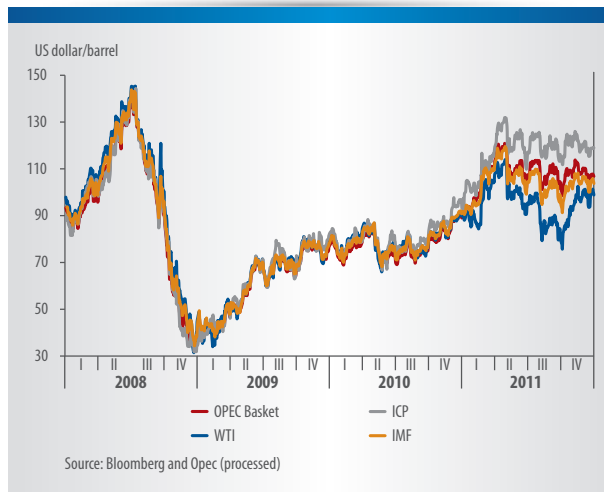


Chart 2.16 Oil Price Development

in line with solid global economic growth and smaller oil reserves (Chart 2.16). At the beginning of 2011, the unfolding political and security situation in Libya (MENA region) disrupted global oil supply in the midst of persistently robust global economic performance, which drove the oil prices to a level above 110 US dollar per barrel. Efforts to stabilise the oil prices, including utilising OPEC's reserve capacity, only succeeded in reducing the West Texas Intermediate (WTI) crude oil prices. Meanwhile, the price of light/sweet crude oil supplied by Libya remained stubbornly high.

The soaring oil prices was also caused by a decline in the stock of refined petroleum products, particularly gasoline, and by stronger demand for refined products after the maintenance period (Chart 2.17). Demand for crude oil strengthened in anticipation of heightened summer demand. The catastrophic earthquakes

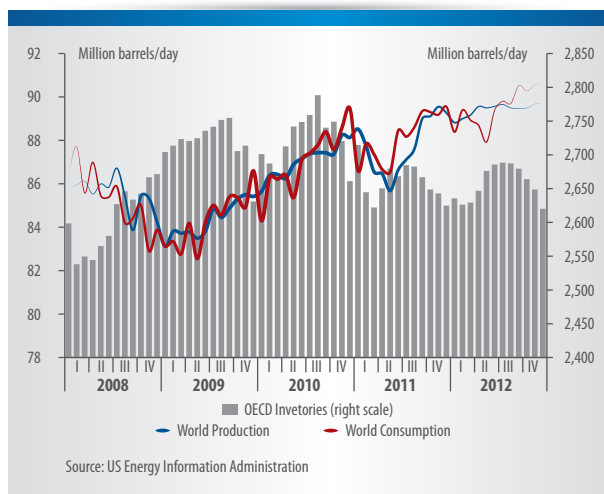


Chart 2.17 Oil Supply and Demand

and tsunami affected refineries in Japan and further exacerbated concerns over oil supply disruptions. Additionally, US dollar depreciation against trade partner currencies also contributed to the soaring oil prices.

The global oil prices began dropping again in May 2011 over concerns of a global economic downturn. Weak global economic conditions were signalled by the escalation of the sovereign debt crisis, which was expected to curb global demand. However, the oil prices unexpectedly resurged at the beginning of June 2011 when OPEC failed to agree upon raising their production quota in order to stabilise prices. Fortunately, the US Energy Information Administration (EIA) successfully reduced the oil prices by releasing reserves, albeit only temporarily.

Concerns over the outlook of the global economy as well as greater risk aversion by investors against high-risk assets, including specific commodities, helped lower the oil prices in general. The oil prices fell quite steeply to its lowest point in 2011 at a level of 75.7 US dollar per barrel, which is actually lower than the average level recorded for 2010 at 79.5 US dollar per barrel. The plunge in the oil prices was due to excess supply in the US. Approaching yearend 2011, the downward oil price trend reversed and began rising again because of disruptions to the supply-chain in the US as well as a reheating of geopolitical tensions in the MENA region, in addition to strong demand from Asia. The rising oil price was also the result of speculative activity, principally by players on financial markets seeking to invest their excess liquidity.

The resurgence in the oil prices in the middle of the fourth quarter of 2011 was coherent with stronger global financial markets accompanied by greater investor risk appetite, primarily on commodity markets. Accordingly, commodity markets became an alternative and promising investment considering the relatively high yields and controlled risks. The Commodity Research Bureau (CRB) index performed in line with the yield of US Treasury Bills as a safe haven asset. This provides evidence that commodities can also be exploited as an investment outlet (Chart 2.18).

Widespread speculation on commodity markets was also demonstrated by the proliferation of non-commercial sales contracts. The large number of such contracts with a net long position indicated that market players, especially speculators, expected the oil prices

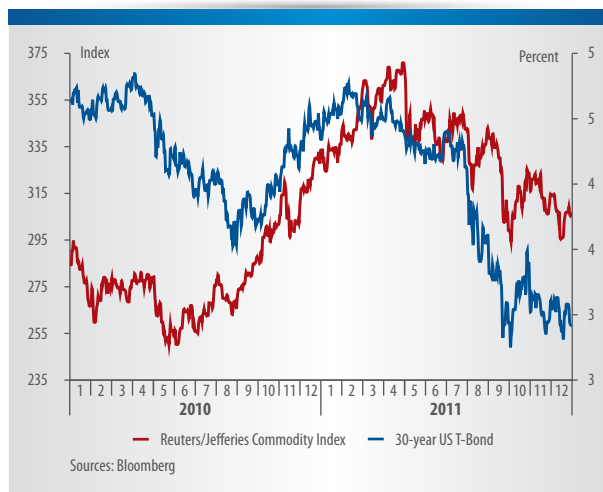


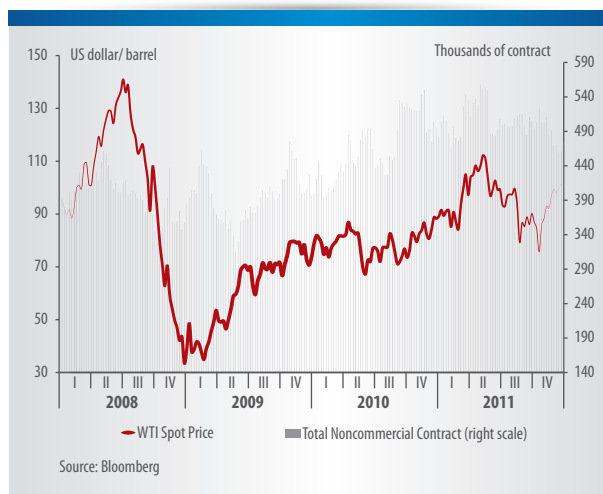
Chart 2.18 CRB Commodity Index and US T-Bond Yield

to continue rising in the future⁴. Merchants (producers), managed money, swap dealers and retailers were responsible for most oil futures transactions. Based on historical data, the net long position of such market players has an undeniable influence on the future WTI oil prices. Therefore, an increase in such contracts indicates abundant global liquidity entering commodity markets, in particular for WTI oil (Chart 2.19 and 2.20).

NON-OIL COMMODITY PRICES

Similar to the oil prices, non-oil commodity prices also soared at the beginning of 2011 supported by strong demand in line with solid global economic performance. In addition, tight supply due to

⁴ The share of non-commercial contracts was around 30% of total WTI contracts. A long position on forward contracts indicates investor expectations of further oil price hikes.



Char 2.19 Noncommercial Contract of Oil

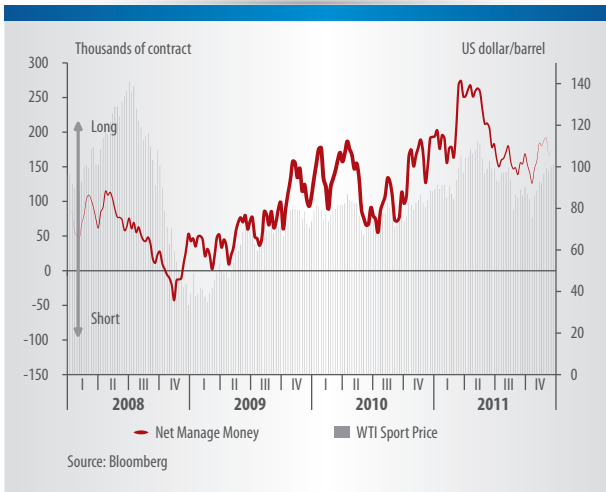


Chart 2.20 Speculation and Oil Prices

unfavourable weather condition and US dollar depreciation also spurred commodity price hikes.

Rising non-oil commodity prices slowly began to abate in the middle of 2011 and have tended to decline since the end of quarter I 2011 due to fundamental factors as well as sentiment. The escalating sovereign debt crisis in Europe undermined global demand and helped lower commodity prices.

The prices of metal commodities experienced a decline stemming from weaker global demand (Chart 2.21). Chinese import demand, as one of the main metal importers, fell significantly as a result of tighter domestic monetary policy, which suppressed demand in the country. Demand for metal commodities from other countries also waned in light of a slowdown in global economic activity.

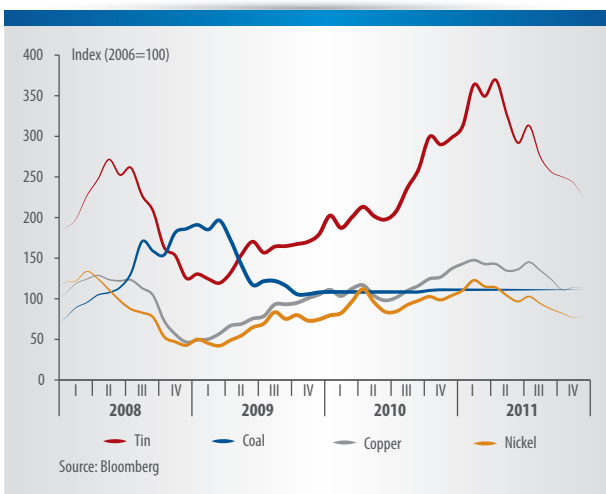


Chart 2.21 Mining Commodity Prices

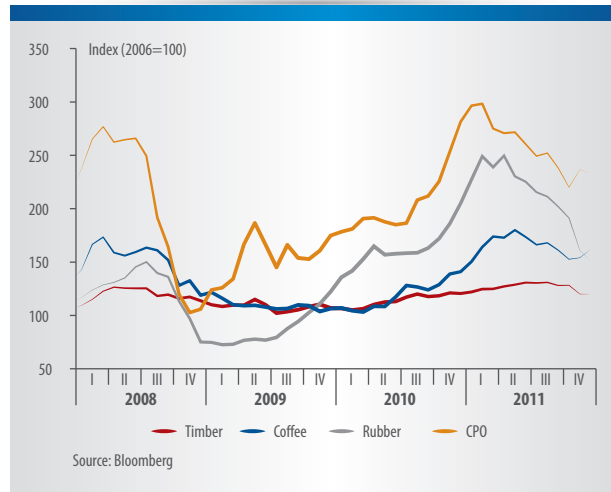


Chart 2.22 Agriculture Commodity Prices

Meanwhile, on top of weak demand, agricultural commodity prices also declined as a result of restored supply. More favourable weather conditions returned and successful harvests augmented stock levels as well as the future supply of agricultural products. The prices of agricultural commodities, primarily coconut, crude palm oil (CPO) and rubber, declined due to weak demand (Chart 2.22). Demand from Japan for agricultural products fell significantly due to the earthquakes and tsunami that destroyed large swathes of the country in March 2011. This successfully suppressed agricultural commodity prices and, coupled with US dollar appreciation, further reduced prices.

Despite following a downward trend, commodity prices began climbing again in July 2011 as a result of shocks on financial markets triggered by sentiment for weaker global economic prospects. Investors diverted their

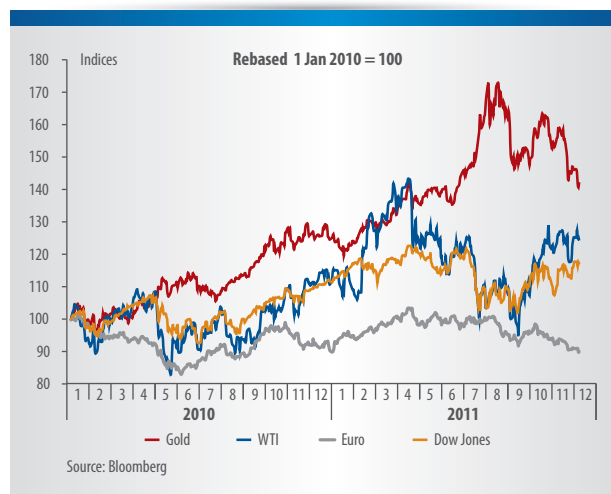


Chart 2.23 Gold Price and Financial Market

funds to safe haven assets, including commodities like gold. The role of gold as a safe haven asset was reflected by shifts in the gold price, which continued to climb as the oil prices and financial assets were corrected (Chart 2.23). Furthermore, the escalating gold price was also in line with the increase in non-commercial contracts for gold commodities (Chart 2.24). This apparent flight to quality raised the price of gold to its historical peak of 1,900 US dollar per troy ounce. This extremely significant hike in the average price of oil affected average commodity prices as a whole. However, the gold price returned to more normal levels in the following month and commodity prices in general also declined.

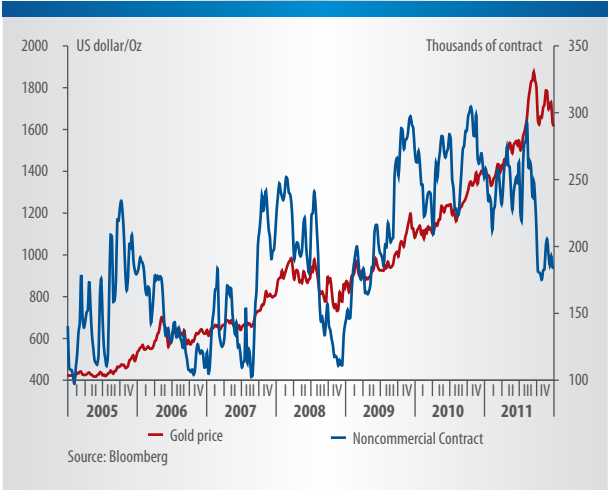


Chart 2.24 Gold Price and Non-commercial Contract