



Chapter 11

The Global Economy and International Cooperation

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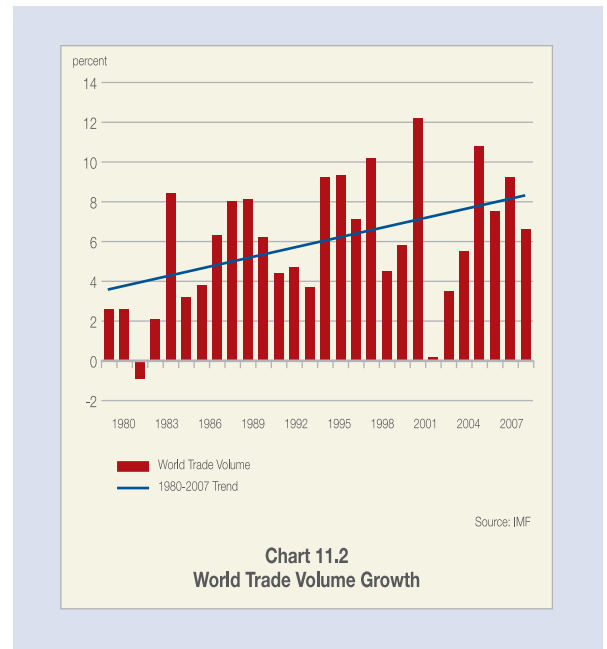
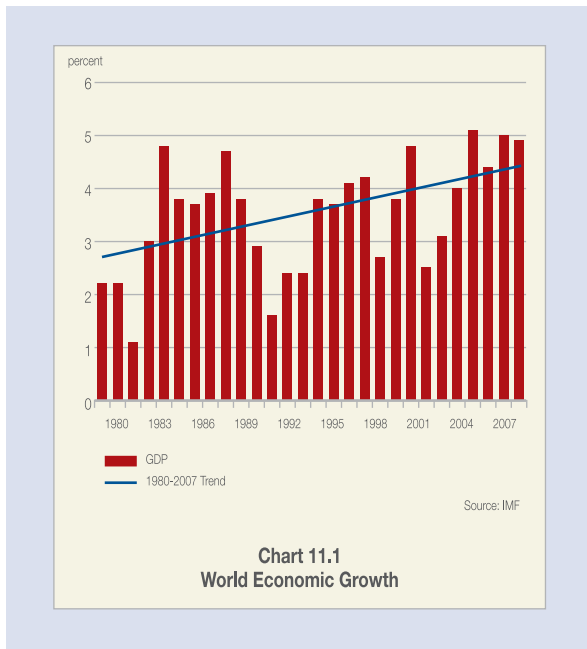
Compared to 2006, the global economy was sluggish in 2007, as reflected by decelerating growth and a slowdown in trade activity. This was principally attributable to a downturn in economic expansion in developed countries, particularly the USA, which continue to suffer from the subprime mortgage fiasco. However, slower growth in developed countries was offset by persistently high economic growth in emerging market countries. Against this propitious backdrop, the global economy recorded 4.9% growth; exceeding the long-term growth trend. The mortgage debacle in the US also triggered shocks in the global financial market. Meanwhile, the commodity market was affected by fuel price hikes followed by price increases in other commodities, mainly staple food commodities. Soaring commodity prices spurred intense inflationary pressures, further compounded by strong domestic demand in developing countries. As a result, global monetary policy stance remains relatively tight. Domestically, Indonesia has endeavored to improve competitiveness and financial system resilience by active involvement in international cooperation; through bilateral, regional and multilateral forums. Several noteworthy achievements include the agreement to form the ASEAN Economic Community in 2015 and the signing of economic cooperation with Japan. Meanwhile, the multilateralization process through the Chiang Mai Initiative has progressed and continues to anticipate various potential financial crisis scenarios.

Global Economy

The pace of global economic growth slowed in 2007 compared to that of the previous year. Slower economic growth was due to a downturn in developed countries from 3.0% in 2006 to 2.6%, particularly in the US, which experienced a drastic decline from 2.9% to 2.2%. However, a group of developing countries continued to perform well, reporting higher growth (7.8%) than the previous year (7.7%). This prevented a sharper decline in global economic growth. High growth in developing countries was due to buoyant expansion in China and India. Consequently, the global economy grew by 4.9% in 2007 (Table 11.1). Compared to the long-term growth trend, such growth is relatively high; only slightly below that in 2006 of 5.0% (Chart 11.1). In line with the lackluster global economy, global trade activity of goods and services between countries also demonstrated a declining growth trend. Global trade volume only grew by 6.6% in the past year of 2007, below the 9.2% recorded in 2006 (Chart 11.2).

Global economic performance was also marked by the broadening subprime mortgage crisis originating in the US and soaring global commodity prices. The subprime mortgage turmoil began mid 2007, discernible by the failure of several subprime mortgage lenders. The crisis was triggered by an increasing number of borrowers failing to repay their mortgages. Compounding the problems of the subprime mortgage borrowers, many investors, including global investors, who had invested funds into subprime mortgages and their derivatives, suffered huge losses. Such developments led to a widespread crisis of confidence in financial assets related to subprime mortgages among others, which resulted in a credit squeeze. The crisis affected the global financial market and caused prices on the U.S. stock exchange and other global equity markets to fall. Furthermore, the crisis effect multiplied to financial markets in developing countries.

Separate to the shocks emanating from subprime mortgages, global financial market performance,



in general, remained strongly influenced by excess liquidity. Excess liquidity encouraged greater portfolio investment in the global financial market, therefore financial asset prices increased significantly, particularly in the first semester of 2007. The perception of global

investors concerning investment risk in developing countries also improved and consequently investment to financial assets in emerging market economies resurged. However, the bullish global financial market quickly reversed following the subprime mortgage catastrophe, which prompted capital flight to quality and brought down exchange rates and financial asset prices.

Table 11.1
Key World Economic Indicators

Key Indicators	percent		
	2005	2006	IMF Estimation 2007
World Output¹⁾	4.4	5.0	4.9
Developed Countries	2.5	3.0	2.6
United States	3.1	2.9	2.2
Euro Zone	1.5	2.8	2.6
Japan	1.9	2.4	2.1
Other Developed Countries	3.2	3.7	3.8
Developing Countries¹⁾	7.0	7.7	7.8
Africa	5.9	5.8	6.0
Asia	9.0	9.6	9.6
China	10.4	11.1	11.4
Latin America	4.6	5.4	5.4
Middle East	5.6	5.8	6.0
World Trade Volume²⁾	7.5	9.2	6.6
Commodity Prices	29.3	14.3	29.0
Energy Commodities	41.1	7.2	43.6
Crude Oil	44.5	8.0	46.6
Non-energy Commodities	12.9	26.7	7.6
Inflation²⁾			
Developed Countries	2.3	2.3	2.1
Other Developing Countries	5.2	5.1	5.9

Source: IMF, CEIC, Bloomberg

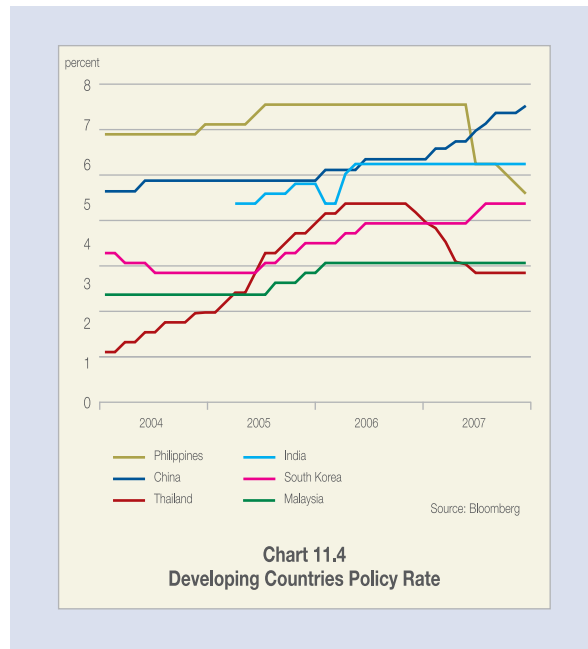
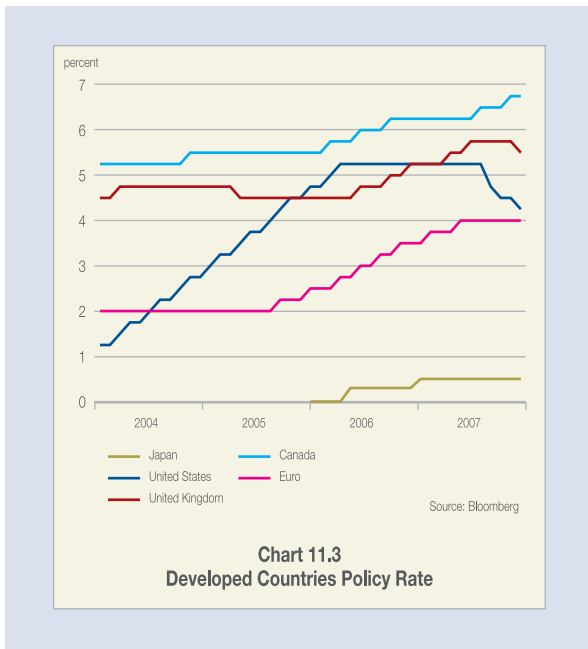
1) WEO Update, January 2008

2) WEO October 2007

The global economy was also affected by the rising oil price followed by the prices of other basic commodities. The crude oil price soared and almost broke the psychological barrier of \$100 per barrel by year end¹. The current oil price trend has deviated from its historical tendency, which generally witnessed a decline in the fourth quarter. The escalating oil price was due to the fundamental factor of growing demand, yet the supply remained relatively limited. Furthermore, increasing speculative transactions also exacerbated the high oil price. Notwithstanding, the high oil price also affected the prices of various commodities on the international market, thus in general commodity prices tended to rise too.

Sky-rocketing prices of various basic commodities triggered relatively intense inflationary pressure, mainly in developing countries. The inflation rate in developing countries reached 5.9% from 5.1% in 2006. Meanwhile, inflation in developed countries was relatively well

1 Price of WTI crude oil.



maintained despite strong inflationary pressures stemming from soaring commodity prices by year end. The tight monetary policy stance adopted over the last several years by developed countries helped dissipate the inflationary pressures affecting such countries.

Persistent inflationary pressures have encouraged the continuation of tight monetary policy. Most central banks raised their interest rates, as carried out by the European Central Bank and the Bank of England (Chart 11.3 and 11.4). However, in the second semester, the intensity of the policy to raise interest rates went down, with several central banks, including the Federal Reserve (Fed), even beginning to lower their rates (Chart 11.3). The Fed's decision to cut its rate was taken to stimulate economic growth that had been sluggish due to the subprime mortgage fiasco. Besides, the reduction of interest rates was also aimed at minimizing instability and the relatively tight financial market due to a crisis of confidence and credit tightening.

US Economy

The state of the US economy, which has tended to weaken over the past two years, deteriorated further in 2007, primarily due to the subprime mortgage crisis. Economic activities began to increase and expand in the second and third quarter but lost momentum because of the subprime mortgage failure in the third quarter. This undermined growth in the fourth quarter

and, consequently, GDP growth reached just 2.2%; a dramatic decline from the 2.9% achieved in 2006.

The economic slowdown was caused by waning investment and weaker consumption. On top of the subprime mortgage turmoil, weaker investment and consumption were due to the policy to raise the interest rate, which was implemented in 2004-2006. Weaker consumption was evidenced by the lower consumer confidence index. The index, which remained above 100 during the first semester of 2007 –indicating consumer optimism and its implication on rising consumption– quickly reversed to become pessimistic; indicated by a drop in the index to 88.6 by year end. Deteriorating consumer confidence was also the result of rising unemployment, therefore, public expectations for income and consumption tended to decrease.

The decline in consumption, however, did bare some positive impacts, namely a reduction in imports which narrowed the current account deficit. Nevertheless, the shrinking current account deficit was also affected by US dollar depreciation against other global hard currencies. In turn, the smaller current account deficit contributed positively to US economic growth, and helped minimize the effects of global imbalance.

The subprime mortgage catastrophe ignited significant shocks, thus aggravating U.S. financial market performance. The crisis represented the nadir of the

deteriorating housing sector trend in the US, which has been ongoing since mid 2005 and was followed by the inability of borrowers to repay their subprime mortgages due to the rising interest rate. As a consequence, a number of lenders suffered huge losses, with several prominent lenders closing down. In addition, the crisis caused the share prices of companies related to subprime mortgages to tumble. As a result, the stock price index in the US plummeted. The Dow Jones Industrial Average Index that had reached a level of 14,000 (July 2007) was sharply corrected to 12,846 (August 2007), which coincided with the subprime mortgage debacle. Numerous foreign investors whom had invested in subprime mortgages precipitated the spread of the crisis to the global financial market.

Although domestic demand waned, inflationary pressures remained strong originating from soaring energy and international commodity prices. High commodity prices triggered a significant rise in consumer level prices, reaching 4.1% from 2.5% in 2006. However, core inflation decreased slightly from 2.6% in 2006 to 2.4%.

More conducive core inflation provided the Fed an opportunity to reduce its rate and therefore stimulate economic expansion. Unrelated to the persistently intense inflationary pressures, the Fed began reducing its Fed Fund Rate after maintaining it at 5.25% since mid 2006. The decision to reduce the Fed Fund Rate was taken to avoid a potential economic recession in the US. At the FOMC Meeting in September 2007, the Fed decreased its rate by 50bps to 4.75%. Further reductions were made at FOMC meetings in November and December (by 25 bps each month), therefore, by the end of 2007 the Fed Fund Rate was 4.25%. To mitigate the impacts of the subprime mortgage crisis that tightened liquidity in the financial market, the Fed –in cooperation with several central banks– injected huge amounts of liquidity into the money market including US dollars into the Euro Zone money market. The efforts taken were effective and successful in alleviating interest rate volatility in the money market.

The Euro Zone²

The Euro Zone economy is strongly influenced by developments in the US, including the recent shocks stemming from the subprime mortgage fiasco. The

² Countries included in the Euro Zone are Austria, the Netherlands, Belgium, Finland, Ireland, Italy, Germany, Luxemburg, France, Portugal, Spain and Greece.

economic slowdown in the US was followed by a similar downturn in the Euro Zone, where economic growth in 2007 slumped to 2.6% from around 2.8% in the previous year. Slower growth affected all countries in the Euro Zone, with a significant decline in Germany, which experienced a contraction in growth from 2.9% in 2006 to 2.5%. Economic growth in the Euro Zone slowed due to weaker consumption and exports. Weak consumption was also reflected by declining consumer confidence and retail sales figures. Falling export growth was associated with lower demand for exports from the US, as a main trade partner of the Euro Zone, and appreciation of the euro meant that exports from the zone became relatively expensive.

Inflation in the Euro Zone tended to increase in line with the high oil price. Throughout 2007, the inflation rate remained relatively stable at around 2.0% until the third quarter. By the end of 2007 inflation had shot up to 3.1%, which well exceeded the inflation rate in 2006 (1.9%). In addition to the record high oil price, inflationary pressure also emanated from the significant leap in food prices. By country, inflation increased extraordinarily; from 1.4% in 2006 to 3.1% in Germany and from 2.7% to 4.3% in Spain.

The ECB responded to relatively intense inflationary pressure by continuing its higher interest rate policy, however, the increase slowed somewhat compared to 2006. In 2007, the ECB only raised its interest rate twice by 25 bps each time: in March 2007 to 3.75% and in June to 4.0%.

Japanese Economy

In line with the sluggish global economy, the Japanese economic growth also slowed down. GDP grew by just 2.1%; falling from 2.4% in 2006. Lackluster growth was due to weaker consumption (not government consumption) and exports. Weak exports were associated with the slowdown in the US economy; consequently, demand for Japanese products also diminished. Meanwhile, investment experienced contraction –despite less contraction than previously– therefore undermining economic expansion. Only government expenditure increased, which stimulated some economic growth.

Prices in Japan indicated slight improvement. The prices of domestic corporate goods showed a slight increase, yet CPI inflation remained at around 0%.

The producer price index increased from 1.8% in 2006 to 2.6%, driven by high energy prices. However, producers and the corporate sector did not fully pass on the rising energy prices to their customers as economic conditions remained inauspicious. This caused CPI inflation to increase slightly, more specifically to 0.7% compared to 0.3% in the previous year.

In line with relatively weak economic activity, the Bank of Japan continued its low interest rate policy. The interest rate remained at a very low level, namely 0.50%, despite a 25-bps hike early in the year. The relatively low interest rate in Japan has encouraged carry trade by investors looking to gain profit from the spread differential between Japan's interest rate and the interest rates in other countries.

Economic Performance in Latin America

The economy of the Latin America Zone maintained strong growth despite its close linkages to the weak U.S. economy. The Zone as a whole recorded 5.4% growth, the same as during the previous year. Individually, several countries surpassed this aggregate rate; however, a number of countries also began to show signs of a slowdown. The countries with higher growth rates include Brazil, Chile and Peru. Brazil is the largest economy in the region and grew impressively from 3.7% to 5.2%, meanwhile Chile and Peru grew respectively from 4.0% to 5.3% and from 7.6% to 9.0%. Robust growth in these three countries was driven by consumption, investment and exports. Significant export growth was encouraged by relatively high demand for exports from China. The portion of exports from these countries to China is dominant, with the largest for Chile.

On the other hand, several countries, such as Argentina, Colombia, Mexico and Venezuela, performed sluggishly. The aggregate GDP of Argentina slowed slightly from 8.5% in 2006 to 8.3% due to a small decline in consumption and exports. Despite the decline in GDP growth, economic growth in Argentina remained relatively high. Meanwhile, the significant decline in the Mexican economy was primarily attributable to diminishing consumption expenditure, as well as contracting investment and net exports. GDP growth in Mexico dropped from 4.8% to 3.3%.

As transpired in most developing countries in general, the inflation rate in the Latin America Zone also soared. In fact in several countries, such as Argentina and Chile, serious inflation issues arose. Inflation in Argentina reached 8.5%, induced by strong domestic demand. However, inflation improved compared to 2006, reaching 9.8%. Inflation in Chile sky rocketed from just 2.6% to 7.8% due to price hikes in housing and transportation. Another country in this zone that experienced high inflation was Venezuela; sparked by government social expenditure (welfare payments and other social expenditure) which could not be balanced by the required rise in commodity supply.

Asia Pacific (excluding Japan)

The economy in the Asia Pacific region (excluding Japan) improved relatively. Developing countries in Asia experienced a slight rise in growth from 7.7% in 2006 to 7.8%. China, with a robust growth rate, was once again the main catalyst of growth in the region. China's GDP grew by 11.4% in 2007, higher than previous year of 11.1%. Economic growth in China was driven by high domestic demand and exports.

Economic growth continued in Australia, New Zealand and the ASEAN-4 group of nations (Indonesia, Malaysia, Thailand and the Philippines). The economies of ASEAN-4 grew from 5.4% in 2006 to 5.6%. With the exception of Thailand, the ASEAN-4 nations successfully recorded increased economic growth. Regarding Australia and New Zealand, they recorded growth from 2.8% to 3.9% and 1.6% to 3.0% respectfully. Strong economic growth in the ASEAN-4 nations, Australia and New Zealand was chiefly spurred by consumption and investment. Particularly for the ASEAN-4 group, economic growth was also supported by burgeoning exports.

Newly industrialized Asian economies, including South Korea, Singapore, Hong Kong (SAR) and Taiwan (Province of China), reported an economic downturn with their economies slowing from 5.3% in 2006 to 4.9%. Slow growth in this group was mainly due to sluggish economic growth in Hong Kong and Singapore. Lackluster economic growth in Hong Kong was caused principally by dwindling investment, meanwhile in Singapore the slowdown was due to stagnant exports. Economic growth in South Korea remained relatively stable compared to previous

Table 11.2
International Capital Flows

Description	billion \$		
	2005	2006	2007
Current Account Balance	274.1	380.2	419.5
External Financing, <i>net</i> :			
Private Capital Flows, <i>net</i>	519.6	572.8	620.3
Equity Investment, <i>net</i>	254.3	229.3	265.1
Direct Investment, <i>net</i>	200.6	167.3	212.9
Portfolio Investment, <i>net</i>	53.7	62.0	52.2
Private Creditors, <i>net</i>	265.3	343.6	355.2
Commercial Banks, <i>net</i>	145.7	202.3	188.5
Non Banks, <i>net</i>	119.5	141.3	166.6
Government Capital Flows, <i>net</i>	-64.2	-65.0	3.3
IFIs	-38.6	-32.9	1.9
Bilateral Creditors	-25.6	32.1	1.3
Resident Lending/Other, <i>net</i>	-287.3	-334.1	-286.8
Reserves (- = increase)	-442.2	-554.0	-756.2

Source: IIF, Capital Flows to Emerging Market Economies, 21st October 2007.

years, while higher economic growth was successfully recorded in Taiwan.

Inflation in the Asia Pacific region tended to increase due to the high prices of international commodities as well as strong domestic demand. Immense inflationary pressures befell China, where the economy grew rapidly, as well as affecting the newly industrialized Asian economies. The highest leap in inflation occurred in China (from 2.8% in 2006 to 6.5%), followed by Singapore (from 0.8% to 4.4%), Taiwan (From 0.7% to 3.3%), South Korea (from 2.1% to 3.6%) and finally Hong Kong (from 2.6% to 3.8%). Amid the rising inflation rate trend in the region, inflation in other economies, such as Australia and the ASEAN-4 countries, declined.

To curb the inflation rate, monetary policy in the Asia Pacific region tended to be tight. The People's Bank of China adopted a tight monetary policy stance by raising the interest rate and minimum reserve requirement. The interest rate of working capital credit with a 1-year tenure was raised six times from 6.12% to 7.47% (an increase of 135 bps); meanwhile the minimum reserve requirement was raised 10 times so by the end of 2007 it was up to 14.5% from around 9.0%. The Bank of Korea increased its interest rate twice –each time by 25 bps– up to 5.0%, and in Taiwan the interest rate was raised four times from 2.75% to 3.38%.

Table 11.3
Developments in Major Global Currencies

Country - Currency	Changes from year 2006		Average 2007*
	ptp	Average	
European Union - Euro	10.54	9.10	1.37
Canada - Dollar	14.37	5.30	1.07
UK - Poundsterling	1.33	8.59	2.00
Sweden - Crown	5.57	8.34	6.76
Japan - Yen	6.18	-1.24	117.78
Denmark - Crown	9.53	8.39	5.44
Argentina - Peso	-2.91	-1.33	3.12
Brazil - Real	16.69	10.55	1.95
Chile - Peso	6.64	1.57	522.21
Mexico - Peso	-0.83	-0.20	10.93
China - Yuan	6.51	4.58	7.61
Hong Kong - Dollar	-0.28	-0.43	7.80
India - Rupee	10.95	8.76	41.35
Korea - Won	-0.65	2.67	929.30
Malaysia - Ringgit	6.27	6.29	3.44
Philippines - Peso	15.87	10.09	46.09
Singapore - Dollar	6.15	5.16	1.51
Taiwan - Dollar	0.50	-1.01	32.86
Thailand - Baht	15.94	14.74	32.32
South Africa - Rand	2.05	-4.14	7.05

Source: Bloomberg

(+) Appreciation

(-) Depreciation

* Each currency is quoted against \$, except UK-Poundsterling and Euro which are GBP/USD and EUR/USD.

Financial Market

In 2007 the global financial market moved dynamically amid the shocks stemming from the subprime mortgage crisis in the US. In general, the condition of the global financial market remained conducive (bullish), supported by abundant global liquidity and better perceived risk for developing economies. Such conditions encouraged global investors to diversify their portfolios into financial assets in emerging economies. Investment in emerging economies became a more attractive alternative along with improving economic performance and stability. This brought capital inflows –in the form of FDI, portfolio and loans– into emerging market countries.

Capital inflows to emerging market economies increased in 2007, reaching \$620 billion, which represents a \$48 billion increase over the previous year (Table 11.2). Investment in the form of equity investments was dominated by surging FDI, whereas portfolio investment decreased slightly when compared to the previous year. Such was the impact of subprime



mortgage turmoil which shocked the global capital market. Furthermore, a shift in the direction of capital flows occurred in 2007 with more capital flowing to emerging market economies in Europe than in Asia.

Foreign Exchange Market

The foreign exchange market was affected by the weaker US dollar exchange rate against other global hard currencies (Table 11.3). This was associated with weaker fundamentals in the US economy. Besides, the currencies of developing countries appreciated due to high capital inflows from global investors to countries offering relatively more interesting returns on investment compared to the industrial countries. Moreover, the role of developing countries in contributing to global economic growth has become more important and is supported by the larger trade volume among emerging market countries.

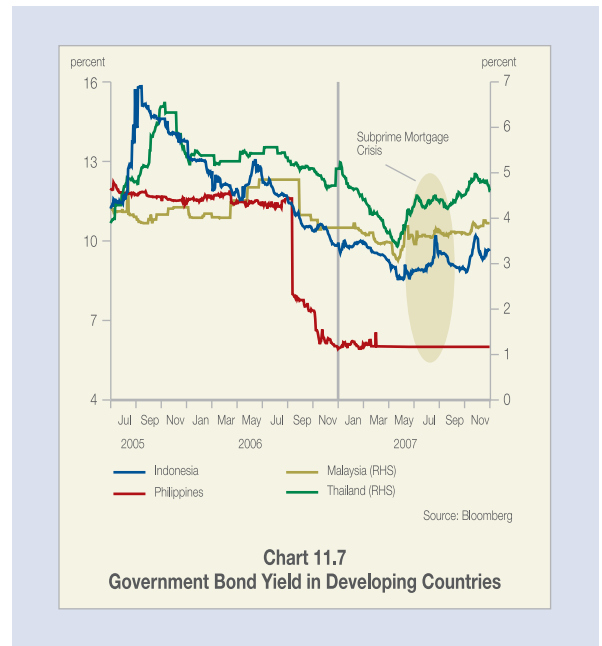
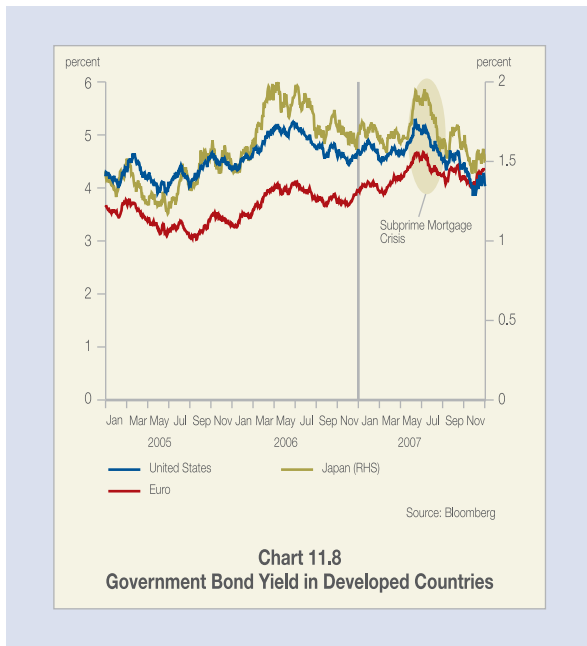
Despite some depreciation, the US dollar did appreciate on several occasions. Ironically, significant appreciation eventually transpired at the same time as the subprime mortgage catastrophe developed in the US, when global investors shifted their investment portfolio to low-risk assets, namely U.S. Government Securities. This triggered a capital reversal in the US, therefore, the US dollar strengthened against almost all global currencies, except the yen. The yen strengthened against the US dollar as investors intensified their carry trade activity (withdrawals of loans in Japan with low interest rates to



be invested in other economies providing higher returns on the investment) and withdrew their funds back to Japan, thus strengthening the yen. After volatility had subsided, the US dollar returned to its depreciatory trend, yet with relatively higher volatility in accordance with increased uncertainty surrounding the upcoming fallout of the subprime mortgage debacle and the increasing trend of oil price.

Financial Market

Abundant global liquidity brought positive impacts on the global financial market, particularly the capital market. The share price index of various global equity markets, particularly in emerging market economies, increased impressively despite global financial market shocks stemming from the subprime mortgage crisis. The significant increases in the share price index of developing countries were also attributable to the improved risk perception of global investors towards developing countries. A sharp increase was recorded in China's (Shanghai) share price index that leapt almost 100% in 2007 to reach 5266. Furthermore, this was followed by a sharp increase in the share price index in Indonesia, Hong Kong, South Korea and Malaysia that increased by 51.5%, 41.3%, 32.3% and 30.7% respectively. Meanwhile, the price indices of key global stock exchanges also recorded an increase –except for the Japan Stock Exchange– even though the increase was not as high as in the emerging market countries.



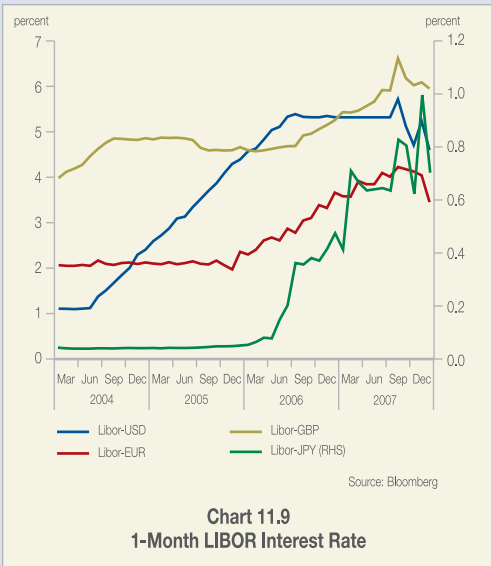
As the subprime mortgage crisis developed in July of 2007, the share price indices of key global stock exchanges were corrected sharply. This was preceded by tumbling share prices in the U.S. –the Dow Jones Industrial Average index was corrected by around 8.2%. The share price indices in Europe and Japan also declined (Chart 11.5); in Europe declining by 10%-14% in less than two months (July-August 2007). The share price indices in France, UK and Germany were corrected respectively by 14.0%, 12.8% and 10.3%; meanwhile the Dow Jones Stoxx 50 index was corrected by 10.9%. Other key global exchanges, i.e. Japan, were also affected with the Nikkei 225 index falling by 16.4%.

Heavier impacts were eventually felt in the financial markets of developing countries with relatively smaller exposure to subprime mortgages. Aside of being impacted by negative sentiment regarding falling share prices on key global stock exchanges, share price correction in developing economies was triggered by portfolio adjustments made by global investors in reaction to the subprime mortgage crisis. Generally, global investors shifted riskier assets –including financial assets issued by developing economies– to safer assets to correct their investment risk profile and also practiced profit taking to cover their investment losses in other locations. As a consequence, Asian share price indices dropped. From July-August 2007, the share price indices in South Korea, Hong Kong,

Singapore, Indonesia, Malaysia, Thailand and the Philippines were corrected by between 14% and 24%³ (Chart 11.6).

The performance of the global bonds market was influenced by a shift in yield that followed different directions in developed and developing countries. The yield of government bonds in developing countries tended to decrease –its price went up– in the first semester, caused by strong flows of foreign investment to government bonds. The subprime mortgage failure struck in the second semester, which sparked a capital reversal preceded by domestic bonds sales by foreign investors, therefore, bond yield increased (Chart 11.7). Conversely, the reverse occurred on the government bonds yield in developed countries. A more attractive yield in developing countries was one reason that investors reduced their placements on bonds in developed countries, consequently, during the first semester the yield of bonds in developed countries tended to increase. However, as the market was beset by the subprime mortgage debacle and risks increased bonds issued in developed countries, for which the risk is relatively lower, became once again investors preference and thus causing the yield to go down (Chart 11.8).

³ The level of share price index correction as an impact of the subprime mortgage crisis, which peaked at the end of July 2007, was calculated by comparing the highest index in July 2007 (pre-crisis) to the lowest index in the period of July-August 2007.

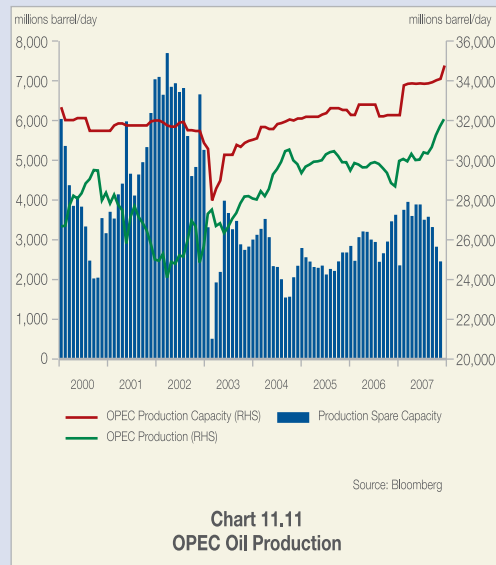
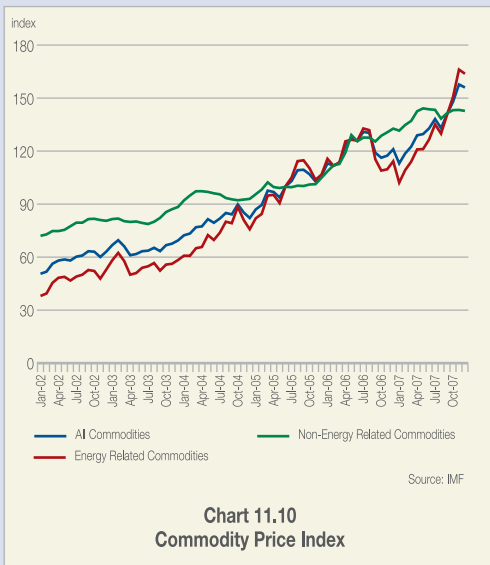


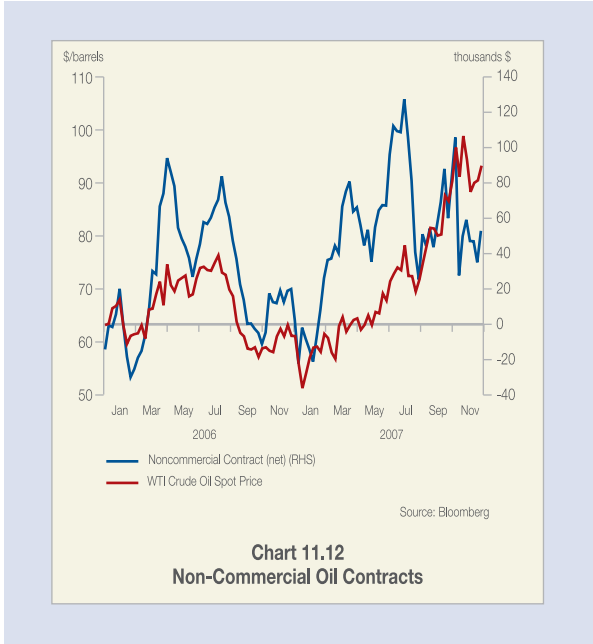
Meanwhile, the performance of the inter-bank money market was influenced more by interest rate policy. Along with the Fed's decision to reduce the interest rate in the second semester of 2007, the US dollar denominated London Inter-bank Offered Rate (LIBOR) interest rate also trended downward. The euro denominated LIBOR rose in line with the interest rate policy set by the ECB (Chart 11.9). However, the rising interest rate was not transmitted to the long-term interest rate, which tended to decline.

A noteworthy issue in the performance of the money market was the significant jump in the interest rate in August 2007. The subprime mortgage turmoil tightened market liquidity and drove up the interest rate. The rise in the interest rate of the money market occurred while the interest rate policy remained unchanged. In addition to the rise, the dynamics of the interest rate became relatively more volatile. However, the interest rate returned to normal after several central banks jointly injected liquidity to reduce shocks in the money market.

Commodity Market

Commodity market performance was characterized by a price dynamic that tended to rise in the past year of 2007. Escalating commodity prices were triggered by the soaring global price of crude oil in accordance with the fundamental factor of imbalanced supply and demand as well as speculative transactions. The record high oil price also pushed up the prices of natural gas and coal, which are included in the energy commodities group. The price index of energy commodities increased by 43.6% over the previous year (point-to-point), but on average rose just 10.4%. Spiraling energy commodity prices also drove up the prices of non-energy commodities, primarily food commodities. In fact, the rising price index of non-energy commodities, which averaged 14%, exceeded the escalation in energy commodity prices (Chart 11.10).





Oil & Gas Commodity Market

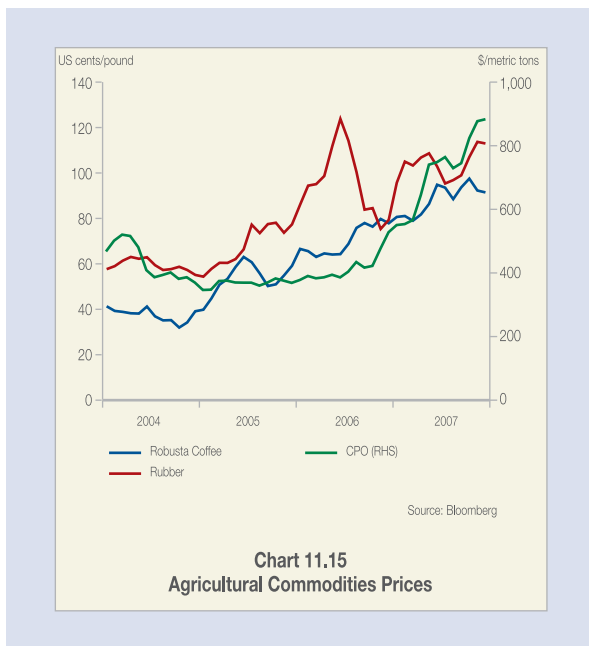
The price of oil sky rocketed in 2007 reaching record highs of \$98,9 per barrel. This price trend -principally at year end- shifted the oil price dynamic from its historical pattern which generally witnessed a decline at the end of a year. The high oil price was due to strong demand –chiefly from China– which was not balanced by a sufficient boost in supply. In effect, efforts to raise supply to satisfy the strong demand reduced the spare capacity. Consequently, the oil price was vulnerable to negative sentiment and increasing risk (Chart 11.11).

Moreover, geopolitics risk in the Middle East remains an ongoing issue.

In addition to fundamental factors, the soaring oil price was also the result of speculative transactions that benefited from oil price fluctuations. Speculative transactions are likely to increase, as indicated by the performance of non-commercial contracts (Chart 11.13), the diminishing potential investment profit in the financial market and US dollar depreciation. Another factor that encouraged speculative transactions was the subprime mortgage catastrophe that intensified investment risk in the financial market. Such transactions are a causal factor of the continued increase in the oil price at year end, which shifted the dynamics of the oil price from its historical pattern (Chart 11.13).



The oil price increased both on average and point-to-point. The price of WTI oil spiraled from \$61 per barrel at end of 2006 to \$98.7 per barrel in November 2007; the highest on record. By the end of 2007, the oil price closed at \$96 per barrel, indicating a point-to-point increase of 57.2%. In terms of the annual average, the price of WTI oil rose from 9.5% from \$66.1 per barrel in 2006 to \$72.3 per barrel. The prices of OPEC oil and Minas oil also followed a similar trend as WTI oil. In line with the oil price trend, the gas price, which is also an



energy commodity, increased by 25.7% (point-to-point) and by 3.0%⁴ on average (Chart 11.14).

Non-oil/gas Commodity Market

The prices of non-oil/gas commodities rose in 2007, among others, driven up by the soaring oil price. Prices in the manufacturing industry were pushed up as the intrinsic production process is directly linked to oil, which is a production input. Other commodities that felt the direct impacts of the high oil price were agricultural commodities; in particular food prices (Chart 11.15).

Rising food commodity prices were mainly the result of greater alternative energy utilization. The high oil price accelerated the conversion of energy sources from oil to alternative fuels such as biofuel and biodiesel, for which the main ingredients are food stuffs, such as corn, sugarcane, CPO and soybean. With the increase in biofuel/biodiesel usage, demand for the related food stuffs also increased, therefore their prices went up too. Furthermore, growing demand for agricultural commodities stimulated production of the respective commodities. One such effort included supplemental plantation land; even at the expense of other commodities, such as wheat. As a consequence, the supply of wheat decreased and its price increased. Furthermore, extraordinary weather –droughts triggered by global warming– has constrained agricultural production, decimated crops and hampered the supply

⁴ Based on LNG export price from Indonesia to Japan.



of agricultural commodities, which have intensified inflationary pressures on related prices.

The prices of metal commodities also increased, mostly in the first semester of 2007. Higher prices were induced by stronger demand –mostly from China– to support production activities. However, during the second semester prices of metals declined owing to waning demand in accordance with a slowdown in production activity in developed countries. Such a decline was also caused by the termination of numerous tenure trading contracts as risks magnified following the shocks in the financial market due to the subprime mortgage fiasco. Falling prices helped compensate the price hikes that occurred in the first semester. Therefore, taken holistically for the year there was little change (Chart 11.16).

International Cooperation

The increasing dynamics of the global economy necessitated closer international cooperation to boost the competitiveness of economies in the region and maintain financial stability. In 2007, international cooperation noted remarkable progress and produced several critical initiatives, which are currently ongoing. To raise competitiveness, important bilateral and regional cooperation has been agreed, such as the signing of the Indonesia-Japan Economic Partnership Agreement (IJ-EPA) and the agreed formation of the ASEAN Economic Community (AEC)

in 2015. Meanwhile, to bolster financial stability in the region, efforts to improve network effectiveness have been agreed such as through the Bilateral Swap Arrangement (BSA) as well as efforts towards multilateralization through the Chiang Mai Initiative (CMI) and strengthening the surveillance system. These measures taken are aimed at improving cooperation effectiveness as part of a regional self-help mechanism to prevent and manage future potential crises. In the multilateral forum, efforts to maintain financial stability focused on strengthening international financial institutions through the implementation of institutional reforms and good governance.

Boosting Economic Competitiveness in the Region

Efforts to improve competitiveness through bilateral and regional cooperation have been implemented including the liberalization of regulations on trade and other related sectors. Such endeavors were materialized through the IJ-EPA and the planned formation of AEC in 2015. IJ-EPA is the first comprehensive bilateral agreement implemented by Indonesia. Meanwhile, commitment to AEC aims to improve the competitiveness of the ASEAN Zone through the formation of single market and production base.

Indonesia-Japan Economic Partnership Agreement (IJ-EPA)

Bilateral cooperation reached an important historical turning point through the signing of an economic partnership between Indonesia and Japan in August 2007. IJ-EPA was initially developed in 2005 and has placed Indonesia on an even keel with other rival nations in the Japanese market⁵. The IJ-EPA covers a wide range of topics, for which the ultimate objective is to strengthen economic partnership between the two countries, namely through capacity building, liberalization and reinforcing relationships in terms of trade and investment. The contract encompasses various sectors, such as the trade of goods and services, as well as investment and the movement of natural persons, including intellectual property rights.

To Indonesia, Japan is a trading partner and a key source of enormous direct foreign investment. The potential advantages to Indonesia from the cooperation

incorporated in the IJ-EPA include the discontinuation of major import duties on Indonesian exports to Japan. The agreement is also expected to foster investment from Japan and also strengthen the reform process ongoing in Indonesia's human resources, particularly capacity building. This will also be made possible through Japan's aid program, such as through technical assistance for skills and technology from various aspects, especially associated with product standardization. Meanwhile, for Japan, the IJ-EPA is considered important due to Indonesia's position as the largest economy in ASEAN and, furthermore, Indonesia has abundant natural resources that are highly coveted by Japan.

ASEAN Economic Community 2015

Regionally, in its 40th anniversary year, ASEAN embarked upon a new historical pillar in economic cooperation. On 13th January 2007 in Cebu, the Philippines, ASEAN leaders agreed to expedite the formation of the ASEAN Economic Community (AEC); brought forward from 2020 to 2015. This reflects ASEAN determination to rapidly improve regional competitiveness in the global economy. To support this goal, in November 2007, ASEAN leaders signed two key documents to support the formation of AEC, namely the ASEAN Charter and the AEC Blueprint, including a strategic achievement schedule for each element. In addition to the Blueprint and ASEAN Charter, the ASEAN Baseline Report (ABR) was also developed to monitor the achievements towards AEC 2015 (Box: AEC 2015: Opportunities and Challenges for Indonesia).

The formation of AEC is expected to improve regional competitiveness in the global economy through the achievement of four strategic frameworks, including a single market and international production base, economic zone with high competitiveness, evenly distributed economic growth and global economic integration. Efforts to achieve a single market and international production base are performed by deepening regional integration through the liberalization of products and production factors to achieve optimal economies of scale. The liberalization process will demand national economic strengthening by ASEAN nations in order to boost their competitiveness and narrow the economic development gap. Consequently, the bargaining position of ASEAN will strengthen in the face of global competition. The high competitiveness

⁵ The EPA agreement between Indonesia and Japan was relatively protracted compared to other ASEAN nations like Singapore (2002), Malaysia (2005), the Philippines (2006), and Thailand (April 2007).

of ASEAN will also improve its bargaining position in various free-trade area negotiations with ASEAN trading partners, such as China, South Korea, Japan, Australia, New Zealand and India.

In achieving a single market and international production base, the liberalization of products and production factors will establish ASEAN as a free-flow zone for goods, services, investment and skilled workers as well as freeing up capital flow by 2015. A free-flow zone for goods will be achieved by reducing tariffs and non-tariff trade barriers. Meanwhile, improved market access and the implementation of non-discriminatory treatment between local and foreign business owners will lead to the free flow of services. The ASEAN cross-border free-flow zone for goods and services will raise production efficiency in the global supply chain. This will subsequently open more opportunities for cross-border investment in the region and, therefore, ASEAN will become an attractive investment target for global and regional investors. Advanced investment activities are going to require production factors, to be met through the cross-border free-flow of skilled workers and freer capital flows. Conversely, greater productivity from the increasingly sophisticated investment activities will also stimulate the flow of goods and services to be used as inputs or traded as end products.

AEC Blueprint

The AEC Blueprint comprises of a master-plan to achieve the four strategic frameworks of AEC 2015 by identifying elements, action plans and the implementation schedule. ASEAN as a single market and production base will be achieved through a gradual liberalization process. Competition regulations, consumer protection, intellectual property rights, infrastructure development, taxation and e-commerce are important elements in the establishment of ASEAN as a region with strong economic competitiveness. Regulation and policy development will be executed at the national level and also through regional cooperation, such as through standardization and synchronization. ASEAN as a region with equally distributed economic development will be accomplished through the development of small and medium enterprises, as well as by means of the Initiative for ASEAN Integration for CLMV (Cambodia, Lao PDR, Myanmar and Vietnam) countries, which aims to improve technology and capacity building for economic development.

A coherent approach in economic relations beyond the region and a more significant role in the global production network are two important elements in the attainment of ASEAN as a region fully integrated with the global economy. The action plan will be executed through negotiation on free-trade area agreements that should bare mutual benefits to the various ASEAN trade partners.

The schedule for the action plan is organized into four stages, namely 2008-2009, 2010-2011, 2012-2013 and 2014-2015. In the implementation of the AEC Blueprint, ASEAN also focuses attention on the differences in development level and member preparedness. In order to ensure agreed commitment, the principle of no back-loading of commitments has also been applied, and flexibility must be proposed at the beginning of the negotiations and universally agreed upon (pre-agreed flexibility).

In order to monitor and evaluate the implementation progress of the AEC 2015 Blueprint, the ASEAN Baseline Report (ABR) was established. Through the ABR, ASEAN leaders are aware of the achievement status of economic integration and are able to offer guidance to resolve any challenges to be overcome. The challenges in developing ABR include the lack of availability of a database for statistical economic and financial indicators of the liberalized economic sectors from all ASEAN country members.

ASEAN Charter

The ASEAN Charter represents the organization of the fundamental constitution of governmental cooperation among ASEAN member countries. The basic transformation executed through the ASEAN Charter is the provision of legal personality status for ASEAN cooperation; therefore, ASEAN may have a different identity to the identities of its member countries. Furthermore, the organizational structure of ASEAN has improved, as well as ASEAN's mandate and decision making mechanism. The refinements made include the formation of a Committee of Permanent Representatives to ASEAN that represent the member countries of ASEAN, and the formation of an ASEAN National Secretariat that is a national focal point whose purpose is to conduct coordination at the national level. With the transformation of the ASEAN Charter, ASEAN is expected to implement the agreement and better respond to various issues in the region in terms of

AEC and global issues that will become more complex in future.

Maintaining Financial Stability

To maintain financial stability, a comprehensive array of endeavors to strengthen organizational governance has been implemented regionally and globally. At the regional level, efforts include the betterment of liquidity assistance availability and strengthening surveillance. Efforts to enhance the effectiveness of liquidity assistance incorporate CMI multilateralization. Whereas regional surveillance will be enhanced through the establishment of a Monetary Financial Stability Committee (MFSC) at the EMEAP forum. Multilaterally, the implementation of an organizational reform agenda at the Bretton Woods institutions (IMF and World Bank) remained the key focus in the reporting year.

Boosting the Effectiveness of Regional Liquidity Assistance and Surveillance

A decade on since the Asian Crisis in 1997 represents a critical moment for the East Asia region (ASEAN+3)⁶ to evaluate the role of regional cooperation in maintaining financial stability in order to support sustainable economic growth. Reflected by experience gleaned from the crisis, ASEAN+3 have enhanced effective cooperation regarding a regional self-help mechanism to prevent and deal with future potential crises. Additionally, heavy losses due to the crisis and deeper financial integration in the region have encouraged ASEAN+3 to boost the effectiveness of surveillance cooperation and liquidity assistance through CMI multilateralization. However, it should be noted that such efforts are supplementary to the global liquidity assistance scheme instituted by the IMF.

CMI multilateralization is one endeavor to strengthen and ensure the availability of liquidity assistance, raise assistance value and simplify the withdrawal mechanism. Through multilateralization, it is expected that the region will jointly agree upon stronger commitment to initiatives to maintain regional stability. Commitment is on regional policy cooperation and coordination through improved surveillance in order to facilitate evolutionary regional financial cooperation. Currently, efforts to implement multilateralization are in the preparatory stages.

⁶ ASEAN+3 countries include the ten ASEAN member countries (Brunei Darussalam, the Philippines, Indonesia, Cambodia, Lao PDR, Malaysia, Myanmar, Singapore, Thailand, and Vietnam) plus China, Japan and South Korea.

Through the EMEAP forum, regional surveillance was strengthened by establishing MFSC in April 2007. MFSC is expected to support regional efforts in maintaining monetary and financial stability through the betterment of surveillance activities. Through MFSC, coordination and cooperation initiatives relating to crisis management on a regional scale were also implemented. In support of such implementation, EMEAP member countries agreed to complement surveillance in each country member with crisis management. Crisis management will focus on three categories, namely: (i) major operational disruptions (MOD); (ii) distressed financial institutions; and (iii) financial market disruptions. Crisis management was regionally integrated in November 2007, as an anticipatory step against impacts of externalities to the region, such as the subprime mortgage failure in the US. Furthermore, in the long term, cooperation will be underpinned through various international financial institutions and inter-regional coordination in accordance with crisis management.

Institutional Reform and Governance in the IMF

Globally, the IMF has been actively involved in discussions related to institutional reform and governance in the organization. IMF reforms are based on the Medium-term Strategy (MTS) that describes various strategies to improve IMF's role in the global economy. Implementation of MTS includes several key topics such as a new direction for surveillance, quota and vote representation for developing countries, as well as the role of IMF in developing and low-income countries.

New Direction for Surveillance

As a step to improve surveillance, IMF has refined the surveillance framework and placed focus on crises happening around the world. The crisis in the late 90s as well as various external shocks in the region up to 2007, indicate sub-optimal surveillance as a core function of IMF in detecting crises and external shocks. One reason is due to the implementation of the Decision on Surveillance over Exchange Rate Policies framework in 1977. In fact, in the last 30 years there have been significant changes in capital flows and integration in the financial market, such that the surveillance framework requires refinement. Consequently, in June 2007, a New Decision on Bilateral Surveillance was adopted to anticipate exchange rate management issues. Crucial changes

include additional principles that stipulate member countries must avoid promulgating domestic exchange rate policy that could lead to external instability. In addition to providing guidelines for surveillance activities, the new framework is expected to improve quality, transparency and the impartiality of surveillance implementation. The new framework follows three key principles, namely: (i) the absence of any new obligations to be met with persuasive dialogue remaining as primary key; (ii) attention given to the specific conditions of member countries; and (iii) flexibility regarding future economic development.

Quota and Vote Representation

Efforts to reform the quota and vote representation of member countries are crucial to improve the governance of IMF. Quota reforms are based on the desire to increase the vote representation of developing and low-income countries, particularly developing countries with an increasing role in the global economy. Reform issues were discussed and agreed upon at the G-20 meeting in September 2007.

Quota reform to accommodate the vote representation of low-income countries is achievable by raising the basic votes. The newly agreed upon formula for quota setting should be simple, transparent and accommodative relative to each member country's position in the global economy, which will precipitate a larger quota for developing countries. Several proposals for new formulae brought up several key aspects, such as using a filtration approach to determine the countries eligible to receive a quota increase, raising the basic vote to protect low-income countries, as well as foregoing any quota increase for underrepresented developed countries. Despite basic support from IMF member countries for the proposal to increase the quotas of developing countries, as of year-end 2007 no consensus had been reached.

Role of IMF in Emerging Market Countries and Low-Income Countries

One commitment included in MTS is IMF support to low-income country members. To this end, the IMF wrote off the debt of Liberia, which was included in the group of countries known as General Resource Account (GRA) protracted arrears⁷ (Liberia, Sudan and Somalia) using the voluntary assistance funds of member countries (SCA-1/deferred charges⁸). The initiative was based on the consideration that funds sourced from Poverty Reduction and Growth Facility-Heavily Indebted Poor Countries (PRGF-HIPC) and the Multilateral Debt Relief Initiative (MDRI) Trust⁹ are insufficient to write off the debts of such countries.

A decision was later made by the IMF to write off the debts of Liberia considering the country's policies being more conducive compared to that of other countries. Also taken into consideration is the fact that Liberia has a Gross Domestic Product of less than \$120, a foreign debt ratio of more than 760% and a foreign reserve of only \$4.2 million. Indonesia as a member of the IMF took part in this initiative.

7 Countries that have been behind schedule on their obligations to the IMF for more than six months.

8 SCA-1 is an account formed by IMF to anticipate and protect against the possibility of negative financial impacts due to a delay by member countries in repaying their obligations for more than six months (protracted arrears).

9 PRGF-HIPC Trust is a trust formed in February 2007 to allocate special assistance for eligible HIPC member countries, whereas the MDRI Trust was formed in accordance with 100% debt write off for Low-Income Countries, funded by three multilateral institutions (IDA, AfDF and IMF).

ASEAN Economic Community (AEC) 2015: Opportunities and Challenges for Indonesia

In November 2007, ASEAN entered a new era in regional economic cooperation through the signing of the ASEAN Charter and Blueprint of steps towards AEC 2015¹. That declaration legislated the definite commitment to ASEAN economic integration. In summary, AEC will represent the transformation of ASEAN into an economic zone where goods, services and skilled workers are free to move without borders and supported by freer flows of capital. The impact of the change is the formation of a new distribution configuration for production outputs and production factors in an intra-ASEAN economy.

Theoretically, economic integration provides the promise of better welfare for the countries within, through broader market access, greater efficiency and superior economic competitiveness, as well as more opportunities for the employment of human resources. This is further supported by various empirical research that shows a positive correlation between regional economic integration and economic growth. However, there are also several conflicting suggestions, where economic integration is often viewed as providing advantages only to certain countries.

In order to reap optimum benefits from integration, a comprehensive study is required to estimate the implications of integration on the national economy. The study is required to enable the government and all relevant national elements to develop the required strategic steps to be taken to ensure Indonesia can be actively involved as a 'player' and not merely as a 'marketing field' for other countries. In general, the opportunities and challenges of AEC for the national economy are described in the following paragraphs.

Opportunities for Indonesia

In terms of trade, AEC will bring numerous potential opportunities as an integrated ASEAN region will expand the market for Indonesian products. In 2006, the total population of ASEAN was 567.6 million with

a total Gross Domestic Product (GDP) of \$1.1 trillion (growth of 5.7%). An optimistic growth outlook has elevated ASEAN to a large market opportunity and potential production base. One prospective sector is electronics, which includes information technology and the communications industry. The electronics sector has a high level of industrial integration in ASEAN. This means that electronic products produced in ASEAN are processed among ASEAN member countries. This will make ASEAN a production base for electronic products. For Indonesia, among the eight priority sectors other than services², Indonesia has five leading sectors including agriculture, wood products, fisheries, rubber and electronics. Mapping these leading sectors is required in order to produce guidelines to improve Indonesia's competitiveness.

In terms of direct capital investment, regional cooperation to improve infrastructure (gas pipelines and information technology) will open more opportunities for Indonesia to improve its investment climate, particularly in expediting domestic infrastructure improvement programs.

With reference to attracting foreign capital, freer capital flows among ASEAN member countries will provide more opportunities for Indonesia to attract foreign capital inflows to the ASEAN region, invested in rupiah denominated assets.

Besides the opportunities outlined above, one critical aspect in the establishment of AEC is that integration will allow capacity building and higher quality institutions, regulations, and improved human resources in Indonesia, which will improve the competitiveness and efficiency of the domestic economy. Various ASEAN regional cooperation programs implemented in accordance with AEC are related to the need for synchronization, standardization and adherence to

1 On 13th January 2007, ASEAN leaders agreed to bring forward the formation of AEC from 2020 to 2015.

2 Eight priority sectors include agriculture, fisheries, health service products, rubber products, wooden products, textiles and textile products, electronics, information technology and communication as well as automobiles.

universally agreed Mutual Recognition Arrangements (MRA). For instance, the liberalization of skilled workers in ASEAN has to comply with standardized certification and competence for professionals in ASEAN. This will eventually lead to improvements in human resources in various Indonesian business sectors.

Challenges facing Indonesia

Efforts to benefit from the various opportunities offered by the emergence of AEC are not straightforward due to several challenges that require immediate attention.

Similar Comparative Advantage throughout the Region. Based on the mapping of comparative advantage in ASEAN member countries for goods in the priority integration sectors³, almost all countries have similar primary commodities in terms of agriculture, fisheries, rubber products, wood and electronics. Such similarity lowers the intra-ASEAN trade share, ranging from just 20%-25% of total ASEAN trade. Thus, a strategy to boost added value is required for Indonesian exports compared to other ASEAN countries. This also constitutes an impact assessment on import substitutes that might increase in line with the reduction of trade barriers in ASEAN. For intra-ASEAN trade, Indonesia's share is relatively low (26%) compared with Singapore (31.8%) and Malaysia (29%).

Several challenges also confront the services sector, for instance tourism. Tourism is one of the four service sectors that have been prioritized in the AEC Blueprint, along with airlines, health and e-ASEAN. Currently, tourism in ASEAN is dominated by Malaysia, Thailand, Singapore and Indonesia or ASEAN-4. Viewed from the competitiveness of the tourism industry, based on the "Travel and Tourism Competitiveness Table", it is evidenced that Singapore is the highest in ASEAN, followed by Malaysia, Thailand and then Indonesia. Development of intra-ASEAN tourism, dominated by ASEAN-4, indirectly stimulates tight competition among the four countries, particularly in terms of attracting tourists from ASEAN and non-ASEAN, as the four countries share similar characteristics regarding their tourism destinations. Based on the "Travel and Tourism Competitiveness Table", it is also clear that one limitation of tourism in Indonesia is inadequate marketing management, in terms of budget

(promotion cost) and the establishment of a tourism promotion center⁴.

High Non-Tariff Barriers. Among ASEAN countries, Indonesia has the most non-tariff barriers. Non-tariff barriers are partially evidenced by the numerous parties involved in export/import activities, particularly related to permits. In terms of permits, more than 22 government agencies issue more than 40 documents. In order to make the most of ASEAN economic integration, Indonesia should reduce the various barriers which cause inefficiency and high economic costs, therefore, lowering competitiveness. Inter-sector and agency coordination, particularly in terms of harmonizing the perceptions of the government and business players, as well as coordinating policy at the national and regional levels, should be improved.

Adjusting the National Agenda to AEC

Commitments. Due to the obligations inherent with the commitment according to the AEC Blueprint, Indonesia will have to adjust its national agenda, roadmap as well as domestic regulations in line with AEC commitments. This is required so that the strategic schedule of implementation can be applied according to domestic preparedness, as AEC implementation will be assessed through an AEC balanced scorecard with key performance indicators for all liberalization sectors (goods, services, investment, capital and skilled workers).

Improving the Awareness of Stakeholders regarding the Strategic Schedule towards AEC

2015. Hitherto, the understanding on AEC commitment and the implementation stages to be applied by Indonesia remains incomplete. Consequently, supplemental knowledge will allow the preparation process to be executed jointly by the relevant authorities as well as all stakeholders. The possible negative impacts of integration in the short term should be clearly socialized to the affected sectors in order to assist them through retraining, skill enhancement, or a gradual shift to different work. Intensive consultation with the affected group should avoid unwanted reactions.

3 There are 12 Priority Integration Sectors, for which integration has been brought forward to 2010, including agricultural products, airlines, automobiles, e-ASEAN, electronics, fisheries, health, rubber products, textiles and apparel, tourism, wooden products and logistical services.

4 One current promotional activity used is the 'Visit Indonesia Year 2008' program conducted through the creation and organizing of tourism events in the region based on the niches and image of tourism resources in each region.