

DEVELOPMENTS IN THE FIRST QUARTER OF 2011

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth continued at a modest pace while conditions in the international financial markets were volatile amid heightened uncertainty

The improvement in the global economy continued at a modest pace in the first quarter of 2011 amid heightened risks to global growth, including geopolitical tensions and Japan's natural disasters. In the advanced economies, growth remained modest while Japan's growth was affected by the 11 March earthquake. Conditions in the international financial markets during the quarter were affected by the tensions in the Middle East and North Africa (MENA) region which contributed to strong increases in global oil prices and the ongoing sovereign debt concerns in the euro area, particularly Portugal. Towards the latter part of the quarter, the impact of Japan's crisis on volatility in the foreign exchange market resulted in the first G-7 co-ordinated intervention since 2000. Economic activity in the emerging economies continued to remain robust, underpinned by resilient domestic demand and augmented by stronger-than-expected export performance. As inflationary pressures become the main focus for the emerging economies amid fears of supply shocks, central banks in these economies continued to tighten monetary policy during the quarter to manage inflation expectations amid continued surges in capital inflows into the emerging economies.

The **US** economy grew at a modest pace of 1.8% in the first quarter (4Q 10: 3.1%) due to weaker domestic demand and higher imports. While personal consumption growth continued to be supported by higher financial net wealth, improving employment prospects and better credit conditions, the pace moderated during the quarter due to unusual bad weather conditions and higher gasoline prices. Private fixed investment rose by 0.7% (4Q 10: 6.8%), following continued weakness in construction activity that offset the acceleration of capital spending on equipment and software investment. The drag to growth also came from contraction in government spending and higher

imports in tandem with rising oil prices. Inflation grew at a faster rate of 2.1% (4Q 10: 1.3%) due to higher energy and food prices.

In the **euro area**, real GDP expanded at a stronger pace of 0.8% on a quarter-on-quarter basis (4Q 10: 0.3%). On an annual basis, the economy grew by 2.5% in the first quarter (4Q 10: 2%). Growth was supported by improvements in both exports and domestic demand in the core economies, in particular Germany and France. In Germany, the recovery in domestic demand was supported by better labour market conditions and improved consumer and business sentiments, while exports benefited from stronger global demand. In contrast, economic activity in the peripheral economies continued to be affected by weak domestic demand, which was weighed down by fiscal austerity measures. On the inflation front, consumer prices rose at a faster pace of 2.5% (4Q 10: 2%), due to higher energy and food prices.

The **UK** economy experienced a quarter-on-quarter expansion of 0.5% (4Q 10: -0.5%) in the first quarter. On an annual basis, GDP grew at a faster pace of 1.8% (4Q 10: 1.5%). The stronger growth during the quarter was supported by an improvement in the services sector, in particular business services and finance. Private consumption and exports rebounded in January after bad weather conditions severely affected economic activity in December 2010. The improvement in economic indicators, however, moderated thereafter as the temporary effects waned. Consumer confidence continued to weaken following the impact of fiscal austerity measures, concerns over the economy's growth prospects and higher consumer prices. Inflation grew at a faster rate of 4.1% during the quarter (4Q 10: 3.4%), driven by higher commodity prices and the increase in the value added tax in January.

Economic activity in **Japan** during the first quarter moderated due to the impact of the natural disasters on 11 March and the subsequent nuclear crisis. The disruption in

Advanced Economies: Real GDP Growth

	2010			2011	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
US ¹	3.7	3.1	2.9	1.8 ^a	Moderation in growth due to weaker domestic demand and higher imports.
UK	-0.4	1.5	1.3	1.8 ^p	Growth supported by improvement in the services sector, in particular business services and finance.
Euro area	0.8	2.0	1.7	2.5 ^p	Growth supported by improvements in both exports and domestic demand in the core economies, in particular Germany and France.

¹ Annualised basis

^a Advance estimate

^p Preliminary

Source: National authorities

power supply and the damage to infrastructure have led to uncertainty in production activity for manufacturers and thus, the world given the importance of Japan in the global production chain for E&E and automobiles. The moderation in exports that have taken place pre-crisis was further exacerbated by the crisis, with a negative exports growth in March (Feb: 9%) due to lower shipments of automobiles, semiconductor products and electronics. For the quarter, exports were up only by a modest 2.7% (4Q 10: 10%). On the domestic front, household spending declined further by 3.2% during the quarter (4Q: -1.4%) as household sentiments were affected by the nuclear crisis. Deflationary pressures continued to persist as core consumer prices (excluding fresh food) declined, albeit at a slower pace of 0.2% (4Q 10: -0.5%).

In the US, the **Federal Reserve** (the Fed) maintained the federal funds rate at 0 - 0.25% and the USD600 billion purchase of longer-term Treasury securities, which was targeted for completion by the end of the second quarter of 2011. During the first quarter, the **European Central Bank** (ECB) signalled that it will raise interest rates in response to rising inflationary pressures. Subsequently, on 7 April, the ECB increased its key policy rate by 25 basis points to 1.25%. In contrast, in balancing between higher inflation and a fragile economic recovery, the **Bank of England** (BoE) decided to leave its policy rate unchanged at 0.5% and maintained the size of its asset purchase programme at £200 billion. The **Bank of Japan** (BoJ) maintained its overnight policy rate at a

range of between 0 - 0.1% during the quarter. However, in response to the natural disasters, the central bank announced a liquidity injection totalling ¥55.6 trillion into the banking system as a short-term measure to ensure stability in the financial markets. In addition, the BoJ doubled the size of its asset purchase programme to buy government and corporate bonds to ¥10 trillion. In April, the BoJ introduced a one-year ¥1 trillion lending programme at a rate of 0.1% to assist companies in the affected areas. It also announced that it will broaden the range of eligible collateral for money market operations in order to ensure sufficient financing capacity for the financial institutions in the affected areas.

Economic activity in the **Asian** region remained strong in the first quarter. Although growth moderated compared to the previous quarter, the performance was generally better than expected as growth continued to be underpinned by resilient domestic demand and augmented by the improvement in external demand. The improvement in export performance was mainly due to growing demand from the regional economies and the US, particularly for electrical and electronics products. The impact of the production disruptions in Japan on regional exports has been mixed so far. While Chinese Taipei and Singapore experienced slower exports to Japan in March due to lower shipments of E&E parts and components, Korea benefited from increased Japanese demand for oil and steel products as well as disaster-related items such as food and bottled water. Meanwhile, domestic demand conditions in the regional

economies remained favourable, as indicated by continued expansion in bank lending and retail sales. Growth in **Singapore** expanded by 8.5% (4Q 10: 12%), led by expansion in the manufacturing sector, particularly the electronics and precision engineering clusters. **PR China** registered a growth of 9.7% (4Q 10: 9.8%) driven by continued expansion in the manufacturing sector. In **Korea**, the economy expanded by 4.2% (4Q 10: 4.7%), attributed mainly to higher exports and sustained private consumption expenditure. The **Chinese Taipei** economy expanded by 6.2% (4Q 10: 6.9%), due mainly to higher private consumption activity amid a sustained strong export performance. **Indonesia**'s economy grew by 6.5% during the quarter (4Q 10: 6.9%). The growth was broad-based, led by private consumption, investment and exports. In **Hong Kong SAR**, the economy registered a higher growth of 7.2% (4Q 10: 6.4%), driven mainly by an improvement in exports and sustained strong private consumption.

An acceleration in inflation, mainly driven by higher food and energy prices, had prompted

policy responses from central banks in the region during the quarter as the balance of risks shifted towards containing inflation. These responses include the increases in policy rate in PR China, India, Indonesia, Korea, Philippines, Chinese Taipei, Thailand and Vietnam. Similarly, in an effort to ensure price stability in the medium term, the **Monetary Authority of Singapore** re-centred the exchange rate policy band upwards in April. In economies that faced excessive volatility in capital flows, macroprudential measures were used to complement monetary policy in addressing financial vulnerabilities and concerns. **Bank Indonesia** raised its foreign exchange holdings reserve requirement, while the **People's Bank of China** increased its reserve requirements on statutory banks. The **Central Bank of the Republic of China** (Taiwan) limited banks' holdings of non-deliverable forwards (NDFs) and options in the local currency. Additionally, in response to rising inflationary pressures, several authorities in the region implemented a range of administrative measures to counter inflation (Korea, Thailand and Indonesia).

Regional Countries: Real GDP Growth

	2010			2011	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
PR China	11.9	9.8	10.3	9.7	Supported by robust domestic demand, in contrast to negative contribution from external demand.
Singapore	16.4	12.0	14.5	8.5 ^a	Growth led by expansion in the manufacturing sector.
Hong Kong SAR	8.0	6.4	7.0	7.2	Driven mainly by improvement in exports and sustained strong private consumption.
Indonesia	5.6	6.9	6.1	6.5	Growth supported by expansion in private consumption, investment and exports.
Chinese Taipei	13.6	6.9	10.8	6.2 ^a	Due mainly to higher private consumption and sustained strong export performance.
Korea	8.5	4.7	6.2	4.2 ^a	Attributed to higher exports growth and sustained private consumption.

^a Advance estimate

Source: National authorities

Prices of **crude oil**¹ continued to trend upwards in the first quarter, averaging USD94 per barrel (4Q 10: USD85 per barrel). Heightened concerns over supply disruptions following political unrest in a number of countries in the MENA region had pressured crude oil prices higher. The sustained upward trend in the quarter was also supported by expectations of rising demand, driven by the ongoing global economic recovery. Towards the end of the quarter, crude oil prices remained above USD100 per barrel, registering an increase of 16.8% from the start of the year. On 29 April, crude oil prices rose to USD113.93, the highest level since September 2008.

In the **foreign exchange markets**, both the euro and the pound sterling appreciated against the US dollar during the quarter, following better economic prospects in the core euro area economies as well as market expectations of an earlier-than-expected rate increase by both the ECB and the BoE. The yen also continued to strengthen against the US dollar, reaching a record high of ¥76.25 on 17 March, reflecting market speculation of large repatriation of funds into Japan following the recent earthquake extrapolating from experience of the Kobe earthquake in 1995. This led to a coordinated foreign exchange intervention by the G7 economies on 18 March, following which the yen retreated to ¥81.16. Most regional currencies also strengthened against the US dollar in the quarter following continued capital flows into the region, driven by the region's relatively favourable growth prospects. However, the

pace of appreciation was limited by some increase in risk aversion in view of growing uncertainty from rising global commodity prices and the potential impact of the disaster in Japan on the global supply chain. On 29 April, the Chinese yuan traded at a 17-year high of 6.4905 per US dollar while the Singapore dollar reached a new record high of SGD1.2232 per US dollar on 2 May.

Going forward, while the baseline forecast remains intact, downside risks to the sustainability of global growth have increased given the high degree of uncertainty arising from the strong increases in global oil prices, the impact of Japan's disaster on the global production network and the lingering concern on fiscal issues in the advanced economies. The nascent global recovery may be affected if oil prices remain elevated for a sustained period. In addition, the full extent of the impact of the Japan crisis on the global supply chain as well as the global economy remains unclear given the fact that Japan is a global producer of many important parts and components for the E&E and automobile industries. The ongoing fiscal issues in both the euro area and the US are likely to create significant volatility in the global financial markets given investors' concerns over the sustainability of fiscal framework in these economies. These, together with elevated levels of uncertainty, would increasingly pose a complex set of challenges for the monetary policy setting environment as monetary authorities aim to achieve a balance between keeping inflation low and stable whilst promoting growth and maintaining financial stability.

¹ Refers to West Texas Intermediate one-month futures on NYMEX