

## DEVELOPMENTS IN THE SECOND QUARTER OF 2011

### INTERNATIONAL ECONOMIC ENVIRONMENT

#### Global growth moderated amidst heightened uncertainties in the international financial markets

Global economic activity experienced a slower expansion in the second quarter of 2011, amidst increased uncertainties over global growth prospects. The moderation in growth was due partly to a slowdown in global manufacturing and trade activities following the natural disasters in Japan that led to significant disruptions in the global supply chain. In addition, high commodity prices also weighed in on private consumption in most economies. In the advanced economies, growth momentum slowed as the economies continued to face headwinds from slower improvements in labour market conditions, elevated fuel prices and rising concerns over fiscal sustainability. This had spillover effects on external trade and affected growth in the emerging economies. Conditions in the international financial markets deteriorated during the quarter due mainly to fiscal issues in the US and the euro area. Concerns over the European sovereign debt crisis intensified following increased possibility of a debt default by Greece. The slow progress in official agreement to address the issue further strained market confidence. Concerns over Portugal's fiscal sustainability came into the spotlight which eventually resulted in a bailout package of €78 billion in May. The crisis triggered rating downgrades for several economies. In the US, the government was hit by the possibility of a shutdown in April and subsequently, possible default if the debt ceiling is not raised by 2 August. Notwithstanding these uncertainties, monetary authorities, particularly in the emerging economies, continued to tighten policy interest rates during the quarter to contain inflationary pressures, driven mainly by elevated food and energy prices.

In July and August, financial market conditions became increasingly volatile following heightened concerns over the sovereign debt issues in the advanced economies and possibility of a weaker global economic recovery. On 21 July, European leaders managed to agree on several

measures to contain the Greek crisis, including a planned €109 billion new bailout package as well as involvement of the private sector on a voluntary basis. Despite the move, the crisis worsened, following market perception of the uncertainty in the adequacy of the new measures to address Greece's solvency issue and lack of concrete details on some of the measures being outlined. The crisis spread to Italy and Spain, precipitating an increase in sovereign yields in these economies. In the US, the government averted a potential debt default following Congress' approval to raise the debt ceiling but the deficit reduction plan was deemed insufficient to achieve medium-term fiscal sustainability. On 5 August, S&P downgraded the US sovereign debt rating to AA+ and maintained a negative outlook. The decision exerted further stress on an already fragile market confidence amid renewed concerns over the potential risk of a double-dip recession, following the release of weak economic indicators in the US. On 7 August, policymakers from the G7 economies pledged to jointly introduce necessary measures to maintain confidence and preserve financial market stability. In addition, the ECB announced that it would actively implement its Securities Market Programme to stem contagion.

The **US** economy grew at a modest pace of 1.3% in the second quarter (1Q 11: 0.4%) due to a moderate expansion in domestic demand. On an annual basis, the economy expanded at a slower pace of 1.6% (1Q 11: 2.2%). Consumption recorded a broad-based slowdown largely due to a contraction in motor vehicles and parts. The global supply chain disruption had resulted in lower auto production and subsequently, higher automobile prices and removal of discounts. In addition, consumer confidence deteriorated due to high gasoline prices, slower improvement in job market conditions and volatile equity market performance. However, private fixed investment grew at a faster rate of 5.8% (1Q 11: 1.2%), following a rebound in construction activity and modest growth in capital spending on equipment and software. Government spending

declined as fiscally-constrained state and local governments continued to cut spending and employment. Inflation rose at a faster rate of 3.4% (1Q 11: 2.1%) due mainly to higher energy and food prices.

The **euro area** economy expanded at a slower pace during the quarter, following the waning of temporary factors which boosted growth in the previous quarter. The moderation in growth was also attributed to a slower improvement in both domestic and external demand. Growth in private consumption was affected by higher inflation and weaker sentiment following an escalation of the sovereign debt crisis due mainly to mounting investors' concerns over a potential restructuring of Greek debt. In the peripheral economies, domestic demand continued to be weighed down by fiscal austerity measures. On the inflation front, consumer prices rose at a faster pace of 2.7% (1Q 11: 2.5%), due mainly to higher energy and commodity prices.

In the **UK**, real GDP growth slowed to 0.2% in the second quarter (1Q 11: 0.5%). On an annual basis, the economy expanded at a slower pace of 0.7% (1Q 11: 1.6%). The moderation in growth was due partly to temporary factors including an additional bank holiday in April and the after effects of the Japanese tsunami which affected production activity during the quarter. Domestic demand continued to be weighed down by fiscal austerity measures, weak sentiments and higher consumer prices. Inflation increased at a faster rate of 4.4% during the quarter (1Q 11: 4.1%), driven by higher commodity prices and the increase in the value-added tax in January 2011.

The **Japanese** economy continued to decline by 1.3% on an annualised basis (1Q 11: -3.6%) in the second quarter, resulting from the supply-side shocks and a decline in exports caused by the natural disasters in March. On an annual basis, the economy contracted by 1.0% (1Q 11: -1.0%). In April, power shortages continued to disrupt production activity, resulting in slower exports. However, the rate of decline eased in May reflecting a gradual recovery in production capacity. During the quarter, exports declined by 5.3% year-on-year (1Q 11: +6.5%). On the domestic front, household spending continued

to fall although there were signs of some improvements in consumer sentiment. Towards the latter part of the quarter, gradual recovery in production activity led to improving household and business sentiments. As a result, consumer spending declined at a slower rate of 0.6% (1Q 11: -1.0%), reflecting increased consumer willingness to spend. On the inflation front, core consumer prices (excluding fresh food) rose by 0.5% (1Q 11: -0.2%) due to increase in energy prices.

#### Advanced Economies: Real GDP Growth

	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
US <sup>1</sup>	3.8	3.9	0.4	1.3 <sup>a</sup>	1.1
UK	1.5	0.6	1.6	0.7 <sup>p</sup>	1.2
Japan <sup>1</sup>	-0.5	6.2	-3.6	-1.3 <sup>p</sup>	-2.8

<sup>1</sup> Annualised basis  
<sup>a</sup> Advance estimate  
<sup>p</sup> Preliminary

Source: National authorities

Monetary policy in the advanced economies remained accommodative. In the US, the **Federal Reserve** (Fed) maintained the federal funds rate at 0-0.25% during the quarter. The Fed also completed its purchases of USD600 billion of long-term Treasury securities under the QE2 programme at the end of June but would maintain its existing policy of reinvesting principal payments from its securities holdings. During the quarter, the **European Central Bank** (ECB) increased its key policy rate by 25 basis points to 1.25% in April and signalled that it would continue to raise interest rates to counter rising inflationary pressures. Subsequently, on 7 July, the ECB raised its policy rate by a further 25 basis points to 1.5%. However, on 4 August, the ECB announced that it will restore its provision of 6-month loans, to address renewed tensions in financial markets. In contrast, balancing between higher inflation and a fragile economic recovery, the **Bank of England** 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 0 - 0.1%. In response to the natural disasters, BoJ introduced a one-year

¥1 trillion lending programme at a rate of 0.1% to assist companies in the affected areas and established a ¥500 billion fund for banks for equity investments and lending purposes. In August, the BoJ expanded its asset purchase programme by ¥5 trillion to ¥15 trillion to further support the recovery of the economy. The fixed-rate lending program, which was established in December 2009, was also raised by ¥5 trillion to ¥35 trillion. Meanwhile, the Swiss National Bank cut its interest rate target range to between 0–0.25% from 0–0.75% in an unscheduled emergency meeting in August. The move was to counter the strong pressure on the Swiss franc as a safe haven currency following the debt crisis in Europe and the U.S.

Regional Countries: Real GDP Growth					
	2010		2011		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
PR China	10.3	11.1	9.7	9.5	9.6
Indonesia	6.1	5.9	6.5	6.5	6.5
Hong Kong SAR	6.7	7.4	7.5	5.1 <sup>P</sup>	6.3
Chinese Taipei	12.9	13.2	6.5	4.9 <sup>A</sup>	5.7
Korea	7.5	8.0	4.2	3.4 <sup>A</sup>	3.8
Singapore	19.4	17.9	9.3	0.9	5.1

<sup>P</sup> Preliminary  
<sup>A</sup> Advance estimate  
Source: National authorities

After a robust growth in the first quarter, economic activity in **Asia** moderated in the second quarter. Growth in the region was mainly affected by the global supply chain disruptions following production interruptions in Japan. This was reflected in the slower expansion in production and exports. Nevertheless, sustained domestic demand continued to underpin growth in most regional economies. Private consumption remained resilient, supported by continued access to financing, favourable labour market conditions and rising wages. In **PR China**, growth moderated to 9.5% (1Q 11: 9.7%) following slower expansion in the agriculture and manufacturing sectors. In **Hong Kong SAR**, the economic expansion slowed to 5.1% (1Q 11: 7.5%), attributable to moderation in exports and government expenditure. In **Chinese Taipei**, GDP growth moderated to 4.9% (1Q 11: 6.5%)

due to a slower growth in private consumption and lower contribution from net exports. In **Korea**, the economy expanded at a slower rate of 3.4% (1Q 11: 4.2%) due to moderation in exports amid continued weakness in investment activity. **Singapore's** economy recorded a weaker-than-expected growth of 0.9% in the second quarter (1Q 11: 9.3%), due mainly to a deceleration in the manufacturing sector, primarily reflecting the decline in the volatile biomedical manufacturing cluster. **Indonesia's** economic growth was sustained at 6.5% (1Q 11: 6.5%), supported by continued expansion in domestic consumption, investment and exports.

Headline inflation remained elevated in the regional economies due to higher food and energy prices. An uptrend in core inflation in some regional economies during the quarter also indicated increasing demand pressures. Amidst sustained economic growth and elevated inflationary pressures, several regional central banks continued to normalise or tighten their policy interest rates. The **People's Bank of China** raised its benchmark interest rates by 25 basis points each in April and July, bringing the 1-year lending rate to 6.56% and increased major banks' reserve requirement ratio by a cumulative 150 basis points to 21.5% in the second quarter. The **Bank of Thailand** increased its 1-day repurchase rate by 25 basis points each in April, June and July to 3.25% to contain inflation expectations amidst robust domestic demand. Similarly, **Bangko Sentral ng Pilipinas** (BSP) raised its overnight reverse repurchase rate by 25 basis points to 4.50% in May. The BSP also raised banks' reserve requirement by 50 basis points each in June and July to contain excess liquidity condition from leading to upward price pressures. The **Reserve Bank of India** increased its repurchase rate by a total of 125 basis points in May and June to 8.00%. The **Bank of Korea** (BoK) also hiked its base rate by 25 basis points to 3.25% in June on expectations of further price pressures from sustained economic growth and higher inflation expectations. As part of its move to mitigate the impact of volatile capital flows, the BoK introduced additional macro-prudential measures to restrict financial institutions from investing in locally-issued foreign currency-denominated bonds. In August, BoK decided to maintain its policy rate at 3.25% for a second

month as the US sovereign rating downgrade and European debt crisis heightened concerns over the global economic recovery. In addition, Korea's Financial Services Commission decided to ban short-selling of shares for three months starting on 10 August to maintain market stability following a 17% loss in the equity market over six trading days.

**Crude oil prices**<sup>1</sup> remained elevated with a higher quarterly average of USD102 per barrel in the second quarter of 2011 (1Q 11: USD94 per barrel), despite corrections in the last two months of the quarter. After rising to USD113.9 per barrel at the end of April, the highest level since September 2008, the upward trend in oil prices began to reverse in May. Oil prices recorded a significant decline in the first week of May as a result of a huge sell-off due to a number of weaker-than-expected economic releases, pointing towards expectations of slowing oil demand from the US. Oil prices declined further to a four-month low of USD91 per barrel following an announcement by the International Energy Agency on 23 June of its release of 60 million barrels from the strategic petroleum reserves, with half of the amount to be contributed by the US. However, the impact was temporary, and towards the end of the quarter, oil prices rose again, ending the quarter at USD95.4 per barrel.

In the **foreign exchange markets**, most major currencies appreciated against the US dollar in the early part of the quarter. The euro, in particular, strengthened in April following the

policy rate hike by the ECB. However, the trend reversed in May as increasing concerns over the sovereign debt crisis in Europe and signs of weaker global growth prospects led to heightened global risk aversion. The euro and the pound sterling ended the quarter lower against the US dollar. The yen continued to strengthen against the US dollar in the quarter, benefiting from its role as a safe haven currency amid heightened investor risk aversion in the global financial market. In August, Japan decided to intervene unilaterally in the currency market to ease the pressure on yen. The yen fell by 4.1% against the dollar following the intervention, surpassing the 3.9% drop at the previous joint intervention with G-7 on March 18. Regional currencies, on the other hand, were supported by continued capital inflows and a relatively stronger growth outlook during the quarter. However, the pace of appreciation was limited by the increase in global risk aversion since May. On 1 August, the Singapore dollar traded at a new record high of SGD1.2015 per US dollar, while the Chinese yuan rose to a 17-year high of 6.3940 per US dollar on 12 August.

Going forward, global growth is expected to remain positive supported by economic activity in most of the emerging economies and the improvement in the global supply chain. The overall global recovery, however, will continue to be constrained by the structural weakness in the advanced economies. In addition, prolonged uncertainty in the financial markets could also weigh down on real economic activity.

<sup>1</sup> Refers to West Texas Intermediate one-month futures on NYMEX