DEVELOPMENTS IN THE THIRD QUARTER OF 2011

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth continued to expand amid escalation of the European sovereign debt crisis

The global economy continued to face a challenging environment. While the impact from disruptions to the global supply chain stemming from Japan's natural disasters had receded significantly, new challenges have emerged. Against this background, global economic activity continued to expand, albeit at a modest pace, in the third quarter of 2011. Manufacturing activity rebounded amid a steady recovery from global supply chain disruptions. Nevertheless, the momentum was weaker than expected with sentiments dampened by fiscal-related concerns amid heightened volatility in the global financial markets. In the advanced economies, growth continued to be constrained by high unemployment, sluggish housing market and weakening sentiments amid rising policy uncertainties. Growth remained resilient in most Asian economies, supported by domestic demand and a gradual recovery in global production.

Conditions in the international financial markets deteriorated as developments in the advanced economies led to heightened risk aversion during the quarter. This was reflected in a sharp fall in equity markets, a sudden reversal of capital flows from the emerging market economies and the increased demand for liquid and 'safe haven' assets. Yields of the 10-year US Treasury bond reached historical lows while the sharp appreciation of the Japanese yen and the Swiss franc prompted the authorities to implement strong measures to stem further appreciation of their currencies. There has been a series of high profile events that affected investor confidence. In August, heightened financial market volatility was due mainly to intensified concerns over fiscal issues in the US, in particular uncertainties surrounding the debt ceiling debate which subsequently resulted in the downgrade of US sovereign credit rating. Market confidence was further affected in September by renewed concerns over a potential Greek sovereign debt default. Despite European leaders' announcement of a second bailout package plan for Greece on 21 July, financial markets remained highly volatile given uncertainties surrounding the plan and growing concerns over contagion risk to the other euro area economies. In particular, Italy and Spain experienced sovereign rating downgrades while their long-term bond yields rose to record highs. In addition, banks in the region that had large exposures to troubled sovereign debt faced renewed funding stress. In October, global financial conditions improved slightly on investors' optimism that European leaders will agree on a comprehensive solution to the debt crisis, prompting a rebound in equity markets and a rise in the yields on Treasuries.

In the third quarter, growth of the **US** economy was sustained at 1.6% in annual terms (2Q 11: 1.6%). On a seasonally adjusted annualised basis, the US economy grew at a faster pace of 2.5% (2Q 11: 1.3%) as supply chain disruptions associated with the natural disasters in Japan diminished while headwinds from higher oil prices moderated. Consumption spending rose, reflecting a rebound in motor vehicle sales and an increase in services amidst a drawdown in personal savings. However, the pace of consumption spending remained modest due to a decline in real wage and financial net wealth. Private fixed investment grew by 17.4% (2Q 11: 6.3%) following higher growth in capital spending on equipment and software which offset a negative contribution from private inventory investment. Net exports continued to support growth following an expansion in exports that offset higher imports. Inflation rose by 3.8% (2Q 11: 3.4%) due mainly to higher food, housing and apparel prices.

Growth in the **euro area** moderated to 1.4% (2Q 11: 1.6%) on an annual basis while on a quarter-on-quarter basis, growth was sustained at 0.2%, supported by a rebound in economic activity in the core economies, Germany and France. Growth in the region, however, remained modest due to weak domestic demand as private sector sentiments in both the core and peripheral economies were affected by the intensification of the sovereign debt crisis during the quarter. In several of the affected economies, the announcement of additional austerity measures further weighed on domestic economic activity. Inflation remained high, with consumer prices rising at a rate of 2.7% (2Q 11: 2.8%), due mainly to elevated energy prices.

In the **UK**, real GDP growth moderated to 0.5% on an annual basis (2Q 11: 0.6%). On a quarter-on-quarter basis, however, the economy expanded at a faster pace of 0.5% (2Q 11: 0.1%) following the rebound of activity in the production and services sectors which were impacted by temporary factors in the previous quarter. Nevertheless, domestic demand continued to be weighed down by fiscal austerity measures, weaker sentiments and higher consumer prices. Inflation increased at a faster rate of 4.7% (2Q 11: 4.4%), driven by higher energy prices and the increase in the value-added tax in January 2011.

In **Japan**, the economy recorded a flat growth on an annual basis in the third quarter (2Q 11: -1.1%). This represented an improvement in economic activity after two consecutive quarters of negative growth since the beginning of the year. On a seasonally adjusted annualised basis, the economy expanded at a faster pace of 6% (2Q 11: -1.3%), supported by the rebound in exports and domestic demand. Exports registered a strong growth of 27.4% (2Q 11: -18.4%) following the recovery in shipments of automobiles and auto parts. On the domestic front, private consumption continued to improve, supported by better consumer confidence. Core consumer prices (excluding fresh food) rose by 0.2% (2Q 11: -0.3%) due to higher energy prices.

Monetary policy in the advanced economies remained accommodative. In the US, the **Federal Open Market Committee** (FOMC) maintained the federal funds rate at 0 - 0.25% and decided to keep it at low levels at least through mid-2013. In addition, the FOMC announced a maturity extension programme, which consisted of purchasing USD400 billion of longer-term Treasury securities while selling an equivalent amount of short-term securities. In the euro area, the **European Central Bank** (ECB) raised its policy rate on 7 July by 25 basis points to 1.50% to counter rising inflationary pressures. However, amid the increased downside risks arising mainly from stress in the financial markets, in October, the ECB introduced longer-term refinancing facilities and announced a new €40 billion covered bond purchase programme to provide additional liquidity to the financial sector. Subsequently, on 3 November, the ECB reduced its policy rate by 25 basis points to 1.25% in view of the weaker growth outlook. **The Bank of England** (BoE) maintained its policy rate at 0.5% during the quarter.

Advanced Economies: Real GDP Growth

	2010		2011		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
US[1]	2.5	2.4	0.4	1.3[r]	2.5[a]
Japan[1]	2.9	-2.7	-2.7	-1.3[r]	6.0[p]
Euro area	2.1	1.9	2.4	1.6	1.4[p]
UK	2.6	1.3	1.6	0.6[r]	0.5[p]

[1] Annualised basis
[r] Revised
[a] Advance estimate
[p] Preliminary

Source: National authorities

However, it announced further quantitative easing measures in October as it increased the size of its asset purchase programme by £75 billion to £275 billion to support the weak economic recovery in the UK. **The Bank of Japan** (BoJ) kept its overnight policy rate in the range of 0 – 0.1% and in August and October, it expanded its asset purchase and fixed-rate lending programmes to a total of ¥20 trillion and ¥35 trillion, respectively. The BoJ also extended its ¥1 trillion loan programme to financial institutions in areas affected by the natural disasters for another six months until April 2012.

Economic activity in **Asia** continued to grow in the third quarter amid recovery in the global supply chain network. Regional exports were supported by demand from within Asia and other emerging economies, while commodity-exporting economies continued to benefit from elevated commodity prices. Domestic demand remained resilient in the region as favourable labour market conditions and rising wages sustained private consumption, while improving capacity utilisation rates provided some support for investment activity. **Singapore's** economic growth accelerated to 5.9% (2Q 11: 1.0%), as a rebound in the biomedical manufacturing cluster supported the economy amid continued weakness in electronics-related manufacturing. **Indonesia's** economy was sustained at 6.5% (2Q 11: 6.5%) supported by a broad-based expansion across domestic demand and exports. **Korea's** economic growth was also sustained at 3.4% (2Q 11: 3.4%) supported by government spending. In **PR China**, economic growth moderated to 9.1% (2Q 11: 9.5%) due to slower expansion in the manufacturing and services sectors. **Hong Kong's** economy grew at a slower pace of 4.3% (2Q 11: 5.3%) due mainly to a decline in exports. **Chinese Taipei's** economy moderated to 3.4% (2Q 11: 5.0%) due to contraction in capital expenditures and slower private consumption.

Regional Countries: Real GDP Growth

	2010		2011		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
PR China	9.6	9.8	9.7	9.5	9.1
Singapore	10.5	12.0	9.3	1.0[r]	5.9[a]
Korea	4.4	4.7	4.2	3.4[r]	3.4[a]
Chinese Taipei	10.7	7.1	6.2	5.0	3.4[a]
Indonesia	5.8	6.9	6.5	6.5	6.5
Hong Kong SAR	6.9	6.4	7.5	5.3[r]	4.3[p]

[p] Preliminary
[a] Advance estimate
[r] Revised

Source: National authorities

Inflationary pressures in the region remained elevated. Headline inflation continued to increase in PR China, and Korea due to higher food prices, while in Hong Kong, it was driven mainly by increases in housing rentals. Core inflation rates also trended up in several economies such as Hong Kong, Indonesia, Korea and Thailand, reflecting underlying demand pressures. Amidst sustained economic growth and elevated inflationary pressures, several regional central banks continued to normalise or tighten their policy interest rates in the third quarter. The **People's Bank of China** raised its policy rate by 25 basis points to 6.56% in July to contain inflationary pressures. The **Reserve Bank of India** increased its repurchase rate by a total of 100 basis points in July, September and October to 8.50% on similar concerns. Furthermore, while keeping its benchmark interest rates unchanged, the **Bangko Sentral ng Pilipinas** raised the banks' reserve requirement ratio by 100 basis points to 21% in July to better manage liquidity. However, in October, central banks in the region began to reassess the balance of risks between supporting growth and curbing inflation given heightened uncertainty in the global economy. Amid moderating inflationary pressures and increasing signs of a slowdown in the global economy, **Bank Indonesia** cut its benchmark interest rate by a total of 75 basis points to 6.00% in October and November. The **Bank of Thailand** kept its 1-day repurchase rate unchanged for the first time this year, after raising its policy rate six times since January, including 25 basis points each in July and August, given an uncertain global outlook and widespread flooding in the country.

Crude oil prices[1] moderated in the third quarter, averaging USD90 per barrel (2Q 11: USD102 per barrel). The decline in oil prices was driven by expectations of weaker demand due to growing concerns over uncertain global growth prospects. Furthermore, improved supply conditions following the restart of oil production in Libya also helped to push crude oil prices lower. By the end of the quarter, crude oil was trading at a 12-month low of USD79 per barrel. However, in October, the downward trend in oil prices reversed as a result of optimism about the announcement of more credible measures by European leaders to resolve the ongoing sovereign debt crisis. On 18 October, crude oil prices rose to USD88.30 per barrel.

The **foreign exchange markets** around the world experienced considerable volatility during the third quarter as positions were adjusted by investors in light of the various high profile events affecting the world economy. The US dollar appreciated against most major and regional currencies. The US dollar's strength was supported by flight-to-liquidity flows due to concerns over the sustainability of global growth. The euro weakened during the quarter following intensification of the European sovereign debt crisis. Similarly, the increased risk aversion resulted in the depreciation of regional currencies against the US dollar. With the exception of the renminbi, the significant depreciation experienced by most regional currencies in September had erased the appreciation recorded earlier this year. The Japanese yen, on the other hand, strengthened against the US dollar due to safe haven flows. Despite a temporary decline following a unilateral intervention by the Bank of Japan in early August, the yen traded near its historical high, ending the quarter at ¥77 per US dollar.

Global growth outlook has become significantly more uncertain following heightened downside risks that are exacerbated by the continued fragilities in the advanced economies. In particular, the possible escalation of the ongoing fiscal concerns in the advanced economies could add further strains to the international financial system and undermine the prospects for continued global growth.

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