DEVELOPMENTS IN THE FOURTH QUARTER OF 2011

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth moderated amid escalation of the European sovereign debt crisis

The world economic and financial conditions continued to experience stress in the fourth quarter of 2011, following the escalation of the sovereign debt crisis in Europe. Global growth was modest as economic activity moderated amid weaker sentiments and higher uncertainty especially in the major economies. In the advanced economies, private sector activity was constrained by high unemployment, weak housing markets and ongoing fiscal issues. In Asia, growth moderated due to weaker external demand. Domestic demand, however, continued to support economic activity.

International financial market conditions turned more volatile as markets were affected by continued policy uncertainty and sovereign downgrades of several core euro area countries. Specifically, fiscal concerns led to a widening of sovereign spreads that reached record-highs for many euro area economies, including Italy and Spain. Furthermore, banking concerns emerged, as European banks with high exposures to troubled sovereign debt faced renewed funding stress, increasing the risk of significant disruptions of credit flows to support economic activity. In response to the deterioration in market conditions, six major central banks announced coordinated measures to provide liquidity support to the global financial system, including lowering interest rates on existing US dollar swap agreements. In addition, the European Central Bank (ECB) also decided to adopt further monetary easing measures, including long-term refinancing operations to support the provision of credit to the real economy. These policy actions provided some respite to the financial markets. European leaders announced a set of measures to stem the contagion, including a 50% write-down on the value of private sector-held Greek debt and the expansion of the European Financial Stability Facility (EFSF) to €1 trillion from €440 billion, in part through leveraging. In December, European leaders agreed to an intergovernmental fiscal compact, aimed at improving fiscal discipline in the region. However, the European sovereign debt crisis remains unresolved given the uncertainties surrounding the implementation of these plans. Markets remained volatile amid increasing uncertainty and rapid changes in sentiments. Markets were further jolted by the downgrade of 9 of the 17 euro area economies by a credit rating agency on fiscal sustainability concerns. Subsequently, the EFSF was also downgraded from AAA to AA+.

The **US** economy expanded at an annual rate of 1.6% (3Q 11: 1.5%) in the fourth quarter. On an annualised basis, the economy grew by 2.8% (3Q 11: 1.8%) due mainly to inventory restocking. Private consumption improved modestly, with an expansion in purchases of motor vehicle and nondurable goods. Consumer spending was supported by a drawdown in personal savings and an increase in credit amid a marginal improvement in sentiments. Private fixed investment grew at a slower pace of 3.3% (3Q 11: 13%), as the moderation in equipment and software spending and a decline in structure investment offset the increase in residential construction activity. Growth was also constrained by a negative contribution from net exports and a contraction in government spending amid a sharp drop in defense spending. Headline CPI rose at a more moderate pace of 3.3% (3Q 11: 3.8%) due to lower fuel prices.

Growth in the **euro area** economy weakened as domestic demand was affected by ongoing sovereign debt crisis. This was reflected in the decline in consumer spending in both the core and peripheral economies amid a continued deterioration in private sector sentiments. Higher unemployment and additional austerity measures in the affected economies further weighed down domestic economic activity. Inflation remained high, with consumer prices rising at a rate of 3% (3Q 11: 2.7%), attributed mainly to elevated energy prices.

In the **UK**, real GDP grew at a faster pace of 0.8% on an annual basis (3Q 11: 0.5%). On a quarter-on-quarter basis, however, the economy contracted by 0.2% (3Q 11: 0.6%) following a decline in manufacturing and construction activity during the quarter. In addition, domestic demand continued to be weighed down by fiscal austerity measures, weaker sentiments and higher consumer prices. Inflation remained high at 4.7% (3Q 11: 4.7%), attributable to higher energy tariffs and the increase in the value-added tax rate in January 2011.

The **Japanese** economy declined by 1% on an annual basis (3Q 11: -0.5%). On a seasonally adjusted annualised basis, the economy contracted sharply by 2.3% (3Q 11: 7.0%), following continued weakness in the external sector. Exports declined by 1.7% (3Q 11: 1.2%), due primarily to weakening global demand for consumer electronics and machinery, and exacerbated by the persistent strength of the Japanese yen. On the domestic front, household spending remained sluggish as disposable incomes and wage growth continued to decline amid weak confidence. Core consumer prices (excluding fresh food) returned to negative growth at -0.1% (3Q 11: 0.2%).

Advanced Economies: Real GDP Growth

	2010		2011		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
US[1]	2.4	3.0	1.8	2.8[a]	1.7
Japan[1]	-0.6	3.3	7.0[r]	-2.3[a]	-0.9[a]
UK	1.7	2.1	0.5	0.8[p]	0.9[p]

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

Source: National authorities

Monetary policy remained accommodative in the advanced economies, with more measures undertaken amid increasing signs of weakening growth prospects. In the US, the **Federal Open Market Committee** (FOMC) maintained the federal funds rate at 0-0.25%. In the euro area, heightened strains in the financial markets and increasing downside risks to the economic outlook prompted the **ECB** to reduce its key policy rate by 25 basis points (bps) each time in November and December, lowering the policy rate to 1%. The ECB also announced additional credit support measures to provide liquidity to the banking sector and support lending activity in the region. This included the introduction of 3-year refinancing operations and a reduction in the reserve ratio. In view of the weak state of the economic recovery, the **Bank of England** expanded its quantitative easing measures by increasing the size of its asset purchase programme in October and February by a total of £125 billion to £325 billion while keeping its policy rate at 0.5%. Similarly, the **Bank of Japan** (BoJ) increased the total size of the Asset Purchase Programme by ¥5 trillion to ¥55 trillion for the purchase of Japanese government bonds to continue its support of the nation's economic recovery. The BoJ also further extended the ¥1 trillion loan programme to financial institutions in areas affected by the natural disasters in March for another 6 months, ending in April 2012.

Regional Countries: Real GDP Growth

	2010		2011		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
PR China	9.8	10.4	9.1	8.9	9.2
Singapore	12.0	14.5	5.9	3.6[a]	4.8[a]
Hong Kong SAR	6.6	7.0	4.3	3.0[p]	5.0[p]
Chinese Taipei	6.5	10.7	3.4	1.9[a]	4.0[a]
Korea	4.7	6.2	3.5	3.4[a]	3.6[a]
Indonesia	6.9	6.1	6.5	6.5	6.5
Philippines	6.1	7.6	3.6[r]	3.7	3.7

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

Source: National authorities

In **Asia**, economic activity moderated in the fourth quarter amid slower external demand and manufacturing activity. Nevertheless, domestic demand was sustained, supported by favourable labour market conditions, continued access to financing, rising income and high commodity prices. **Singapore**'s economy expanded at a slower rate of 3.6% (3Q 11: 5.9%), as activity in the manufacturing sector moderated, particularly in the electronics and biomedical sub-sectors. Growth in **PR China, Hong Kong** and **Chinese Taipei** moderated due to slower export activity. In **Chinese Taipei**, growth was also dampened by a contraction in investment. **Korea**'s economy expanded by 3.4% (3Q 11: 3.5%) supported by domestic demand. **Indonesia**'s economic growth was sustained at 6.5% (3Q 11: 6.5%), due largely to continued investment activity and resilient private consumption. The **Philippines'** economy grew by 3.7% (3Q 11: 3.6%), supported mainly by private consumption.

Headline inflation in the region moderated on slower increases in food and energy prices, but remained elevated during the quarter. Amidst heightened uncertainties in the global economy and easing inflationary pressures, several central banks in the region began to shift their policy focus towards supporting economic growth. **Bank Indonesia** cut its benchmark interest rate by a total of 75bps in October, November and February 2012 to 5.75%. The **Bank of Thailand** cut its key policy rate by a total of 50bps to 3.00% in November and January to mitigate the impact of severe flooding on the economy. **Bangko Sentral ng Pilipinas** also lowered its key policy rate by 25bps to 4.25% to support economic activity amid a benign inflation outlook. The **People's Bank of China** reduced the required reserve ratio by 50bps, bringing the reserve requirement ratio to 21% to improve bank lending activity and support growth. Inflation, nevertheless, remained a key concern in several countries. The **Reserve Bank of India** raised its policy rate by 25bps to 8.50% in October. In addition, the Bank also increased its rates on non-resident rupee deposits and foreign currency loans to contain the sharp rupee depreciation in November. In January 2012, it reduced its cash reserve ratio by 50bps to 5.50% while keeping its key policy rate unchanged to ease liquidity in the banking system. The **Bank of Korea** kept its policy rate unchanged at 3.25% in February after raising its policy rate three times in the first half of 2011.

Prices of **crude oil**[1] remained elevated, averaging USD109 per barrel (p/b) during the quarter (3Q 11: USD112 p/b). The fluctuation of prices within a relatively wide range of USD101 to USD115 during the quarter reflected the tension among conflicting forces, emanating from economic risks and geopolitical tensions. Weakening growth prospects lowered demand for oil, exerting downward pressure on prices. At the same time, a potential sanctions on imports of Iranian crude oil raised concerns over supply disruptions. At the end of the quarter, crude oil prices closed at USD107 p/b.

The **foreign exchange markets** remained volatile due to continued risk aversion in the global financial markets. In the beginning of the quarter, most major and regional currencies appreciated against the US dollar. In October, the appreciating trend for the euro and the pound sterling against the US dollar was supported by investor expectations of a comprehensive solution to the European sovereign debt crisis. However, following the policy measures announced on 27 October, the trend reversed due to renewed concerns over the implementation of the measures and the announcements of possible downgrades for several euro area economies by major credit rating agencies. Of significance, the euro fell to a 15-month low towards the end of the year. The yen continued to strengthen against the US dollar despite intervention measures by the national authorities in October following safe-haven flows into the Japanese currency. For 2011 as a whole, the euro declined by 3.2%, while the yen rose by 5.5% against the US dollar. In Asia, the Indian rupee recorded the largest depreciation among the regional currencies in 2011, weakening by 15.6%.

Going forward, global growth prospects have become increasingly uncertain. Developments in the sovereign debt crisis in Europe will continue to affect sentiments worldwide, with real implications on economic activity. The actions undertaken by the national authorities in the coming months will be crucial in determining the outcome of the crisis and subsequently, the impact on growth.

[1] Refers to Brent one-month futures on the Intercontinental Exchange (ICE).