DEVELOPMENTS IN THE THIRD QUARTER OF 2013

INTERNATIONAL ECONOMIC ENVIRONMENT

Continued economic expansion amid increased volatility in financial markets

The global economy continued to expand in the third quarter. In the advanced economies, emerging signs of improvements in economic growth suggested that a modest recovery is underway. Growth in Asia was sustained, albeit with some variation across the region. However, rising external risks, which to some extent compounded domestic vulnerabilities, prompted some monetary authorities in the region to adopt a tighter monetary policy stance to ease inflation and stabilise domestic currencies.

Global financial markets experienced increased volatility amid uncertainties over the direction of fiscal and monetary policies in the advanced economies. At the beginning of the quarter, major equity markets in the advanced economies improved due to better economic data releases in Europe. However, financial markets in Asia remained volatile as weak Chinese economic data fuelled fears of a sharper-than-expected slowdown in PR China. In August, global financial market conditions deteriorated. Equity prices fell on uncertainty over the timing of the scale-back in the quantitative easing (QE) programme by the US Federal Reserve (the Fed) and concerns over the economic fundamentals of several Asian economies. There was also great anxiety amid the rising possibility of a US military strike against Syria. Market sentiment subsequently improved as developments in September lowered investors' risk aversion. These include the US Fed's decision to maintain asset purchases at the September Federal Open Market Committee (FOMC), the better growth outlook of most advanced economies and PR China, and the easing of geopolitical risks. However, towards the end of the quarter, market conditions deteriorated again due to uncertainties over an impending shutdown of the US government. Despite these challenging developments, most major equity markets ended the quarter higher.

Growth in the US economy was sustained in the third quarter of 2013 (1.6%, 2Q 2013: 1.6%). On a seasonally adjusted annualised basis, growth was higher at 2.8% (2Q 2013: 2.5%). The improvement was supported by higher private investment and a faster pace of private inventory accumulation. However, government spending declined further (-2.8%, 2Q 2013: -2.0%). Overall growth momentum faced headwinds from monetary and fiscal policy uncertainties. The housing and labour market recovery continued to progress, albeit at a more moderate pace. Residential construction and sales posted smaller growth following the increase in mortgage rates. Job creation moderated to 490,000 in 3Q 2013 (2Q 2013: 547,000) amid lower hiring in the services sector. On the inflation front, headline CPI rose to 1.6% (2Q 2013: 1.4%) due to an increase in energy prices.

In the euro area, mixed economic data in the third quarter suggest that the pace of recovery remained weak and uneven. Structural and fiscal concerns continued to constrain growth. These included the high indebtedness of the public and private sectors, high unemployment rate and sustained declines in bank lending. Inflation was subdued at 1.3% (2Q 2013: 1.4%) due to weak energy prices.

Economic activity in the UK economy grew by 1.5% (2Q 2013: 1.4%). On a seasonally adjusted basis, quarterly growth recorded an expansion of 0.8% (2Q 2013: 0.7%), driven by a broad-based expansion across all sectors. Inflation was steady at 2.7% (2Q 2013: 2.7%).

In Japan, economic activity benefitted from an improvement in external demand. Exports grew by 3.0% (2Q 2013: 0.0%) due mainly to increased shipments to Asia, the US and Western Europe. Investments rose amid better business sentiment. Consumption improved, supported by higher demand for durable goods. Headline inflation (excluding fresh food) turned positive (0.7%; 2Q 2013: 0.0%) following higher prices in energy as well as transportation and communication.

Advanced Economies: Real GDP Growth

	2012		2013		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
US[1]	2.8	0.1	1.1	2.5	2.8[a]
UK	0.0	-0.2	0.2	1.3	1.5[p]
Japan[1]	-3.7[r]	0.6[r]	4.3[r]	3.8	1.9[p]

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

Source: National authorities

Regional Countries: Real GDP Growth

	2012		2013		
	3Q	4Q	1Q	2Q	3Q
	Annual change (%)				
PR China	7.4	7.9	7.7	7.5	7.8
Indonesia	6.2	6.1	6.0	5.8	5.6
Singapore	0.0	1.5	0.3[r]	4.2[r]	5.1[a]
Chinese Taipei	0.7	4.0	1.6[r]	2.5	1.6[a]
Korea	1.6	1.5	1.5	2.3[p]	3.3[a]

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

Source: National authorities

Monetary policy in the advanced economies remained highly accommodative during the quarter. In the US, the Federal Open Market Committee (FOMC) maintained the federal funds rate at 0-0.25% and continued its asset purchase program of USD85 billion per month. During the September meeting, the FOMC stated it would "await more evidence of a sustained recovery" before reducing the current pace of asset purchases. To better reflect the current growth trajectory, the Fed's official growth projections were revised lower to 2.0-2.3% and 2.9-3.1% in 2013 and 2014, respectively (Previous: 2.3-2.6%, 3.0-3.5%, respectively). In the euro area, the European Central Bank (ECB) lowered interest rates to 0.25% in Novermber. The decision was premised upon latest indications of a prolonged period of low inflation below the 2% target amid weaker-than-expected economic activity. The ECB also reaffirmed the forward guidance for monetary policy to remain accommodative for as long as necessary. The Bank of England (BoE) maintained its key policy rate at 0.5% and its asset purchase programme of £375 billion. BoE also adopted forward guidance for the first time in August, stating that the central bank will not raise the Bank Rate above its current level of 0.5% until the unemployment rate has at least fallen below 7%. The central bank indicated that it stands ready to undertake further asset purchases if additional stimulus is warranted. It added that the forward guidance will cease to apply if there are material risks to price or financial stability. In Japan, the Bank of Japan maintained its accommodative stance through the expansion of its monetary base by ¥60-70 trillion per year.

Economic activity in Asia continued to expand, albeit with some variation across countries. In most economies, domestic demand remained a key driver of growth, underpinned by higher income and fiscal stimulus measures. Exports growth also improved in tandem with the gradual recovery in external demand. In PR China, Korea and Singapore, economic activity expanded at a faster pace (7.8%, 3.3% and 5.1%, respectively; 2Q 2013: 7.5%, 2.3% and 4.2%, respectively). Growth in PR China and Korea was driven by domestic demand amid government stimulus measures while exports continued to expand. In Singapore, growth was mainly supported by improvements in the manufacturing sector, particularly the transport engineering and electronics clusters. In Chinese Taipei and Indonesia, however, growth moderated (1.6% and 5.6%, respectively; 2Q 2013: 2.5% and 5.8%, respectively), attributable mainly to lower net exports.

Headline inflation rose in several economies (PR China, India and Korea) amid higher costs of food, due in part to adverse weather conditions. In Indonesia, food prices increased during the fasting month of Ramadhan, while transport costs accelerated following the hike in subsidised fuel prices in June. Higher inflation in Hong Kong SAR was attributable to a sharp increase in public housing rent growth during the middle of the quarter. In Singapore, inflation rose mainly on account of an increase in private road transport cost after recording a contraction in the previous quarter. Inflation, however, moderated in Chinese Taipei and Thailand on account of lower costs of food, while in the Philippines, the moderation was due mainly to a slower expansion in prices of electricity, gas and other fuels.

As inflationary pressures generally remained modest across the region, most regional central banks maintained their accommodative monetary policy stance to support growth amid a challenging global environment. The only exceptions were Bank Indonesia (BI) and the Reserve Bank of India (RBI) which raised policy rates due to country-specific factors. BI raised its key policy rate by a total of 125 basis points to 7.25% during the quarter. In August, the central bank announced that it will issue Bank Indonesia Deposit Certificates (SDBI) and improve Loan-Deposit-Ratio (LDR)-Reserve Requirements provisions to strengthen lending and prudent fund raising, as well as increase the Secondary Reserve Requirement for banks to bolster liquidity management. In November, BI increased its benchmark rate by a further 25 basis points to 7.50%. The central bank highlighted that the hikes in the policy interest rates form part of the measures taken to reinforce its policy mix, which focuses on controlling inflation, stabilising the rupiah and ensuring that the current account deficit is managed to a sustainable level. During the quarter through October, the RBI hiked the repo rate by 50 basis points to 7.75% in an effort to anchor inflation expectations. To improve liquidity conditions in the economy, the central bank reduced the marginal standing facility (MSF) rate by a total of 150 basis points to 8.75% in September and October and provided additional liquidity through term repos.

Amid signs of slowing economic activity, Thailand and Indonesia announced fiscal measures to provide support to their economies. In August, the Thai cabinet approved a stimulus package with the aim of increasing growth by one percentage point. The plan focuses on boosting private consumption and investment, speeding up the government's budget disbursements and stimulating exports. Similarly, the Indonesian government also unveiled a fiscal package in August to promote foreign investment, reduce imports and support its currency. In an effort to strengthen its current account position, import taxes on luxury goods will be increased, along with measures to reduce oil imports and remove export quotas on mineral and metal ores. The government will also provide tax incentives for labour-intensive industries.

During the quarter, Brent crude oil prices rose, due mainly to geopolitical events in the Middle East. Oil prices began the quarter at USD103 per barrel amid lower demand from the weak global growth outlook. However, beginning in July, the conflict in Egypt led to market concerns over oil delivery through the Suez Canal. As a result, prices rose and stayed at around USD108 per barrel throughout July and August. By late August, the risk of an international military intervention in Syria caused oil prices to climb to a six-month high of USD117 per barrel. However, towards the end of the quarter, oil prices moderated to USD108 per barrel as the likelihood of military action in Syria receded. For the quarter as a whole, crude oil prices averaged USD110 per barrel (2Q 2013: USD103 per barrel).

In the foreign exchange market, most major currencies ended the quarter higher against the US dollar. The euro and the pound sterling started the quarter on a depreciating trend due to heightened concerns over the political instability in Portugal and S&P's downgrade of Italy's sovereign credit rating. Since mid-July, the currencies generally appreciated, supported by better-than-expected economic data in the UK, Germany and the euro area. Meanwhile, the yen appreciated against the US dollar in the first half of the quarter following better-than-expected inflation data and expectations that the Bank of Japan will refrain from embarking on more stimulus measures. Towards the second half of the quarter, however, the yen weakened against the US dollar, reflecting negative investor sentiment arising from the increased possibility of a consumption tax hike. In Asia, the currencies of most newly-industrialised economies (NIEs) also ended the quarter higher against the US dollar, underpinned by sustained capital inflows due to relatively better economic fundamentals. However, most ASEAN currencies were affected by a reversal of capital flows, reflecting market uncertainty surrounding the possibility of a scale-back of US QE. While the Fed's decision to delay the scale-back of US QE in September supported most ASEAN currencies, the pace of appreciation was limited by some increase in risk aversion from the ongoing uncertainty over the timing and pace of a scale-back in US QE.

Going forward, emerging signs of a recovery in the US and euro area will provide some support to overall global growth. However, uncertainties surrounding the fiscal and monetary policy adjustments in the advanced economies present downside risks to the global economy. While global policy spillovers may impact Asia, growth will continue to be supported by domestic demand, and underpinned by sound macroeconomic fundamentals and policy flexibility.