DEVELOPMENTS IN THE FOURTH QUARTER OF 2012

INTERNATIONAL ECONOMIC ENVIRONMENT

Global economic activity grew modestly

The world economic landscape in the fourth quarter of 2012 was characterised mainly by the uneven performance between the advanced and emerging regions. Growth in the major advanced economies weakened, while improvements were recorded in the emerging economies. Economic activity in several advanced economies was constrained by fiscal sustainability concerns, while the slowdown in Japan was partly attributable to weak export performance. In Asia, the growth momentum picked up at a modest pace amid the strengthening of production and regional demand, especially towards the end of the quarter. Several major central banks undertook easing measures to provide further support to economic activity and to boost sentiments.

While conditions in the international financial markets remained volatile during the quarter, the degree of volatility eased significantly from the highs recorded in the second quarter of the year. Financial markets were affected by the developments in Europe and the impending fiscal cliff in the US. At the beginning of the quarter, risk appetites were initially dampened by uncertainties surrounding the US presidential elections. Investors' attention was then refocused on the looming US fiscal cliff issue. Delays over the release of the next tranche of financial aid to Greece, together with weak economic data releases in the euro area, led to further risk aversion and higher volatility in the financial markets in mid-November. As the quarter advanced, market sentiments generally improved following the agreement on a package of measures for Greece and further progress in resolving the European debt crisis. Specifically, the approval of the framework for a single supervisory mechanism centred on the European Central Bank (ECB) in early December was a crucial move towards establishing a banking union in the euro area. Towards year-end, however, renewed uncertainties surrounding the outcome of the US fiscal cliff negotiations resulted in a brief period of heightened volatility. This subsequently receded as positive sentiments towards the achievement of a resolution of the fiscal issue overcame earlier concerns.

The US economic growth moderated in the fourth quarter (1.5%; 3Q 12: 2.6%). On a seasonally adjusted annualised basis, the economy contracted by 0.1% (3Q 12: 3.1%). Economic activity was dampened by the temporary disruption of economic activity during Hurricane Sandy in late October and uncertainties surrounding the fiscal issue in December. After the very rapid growth in 3Q 12 (11.1%), private domestic investment moderated to a more sustainable rate of growth of 3.1% due primarily to lower inventory and investment on structures. Government spending was a significant drag on growth (-1.7%; 3Q 12: -0.5%), following larger cuts in defense spending. Private consumption expanded at a modest pace, supported by an improvement in personal income growth and higher job creation of 603,000 jobs (3Q 12: 456,000). Residential investment continued to strengthen, supported by the recovery in prices and sales in the housing market. The overall assessment is that the US economy was adversely affected by temporary factors during the quarter, and that the modest recovery remained intact. Meanwhile, inflation edged higher to 1.9% (3Q 12: 1.7%), as increases in food and shelter prices outweighed the relatively flat growth in gasoline prices.

The euro area remained in recession as it registered its third consecutive negative quarter-on-quarter growth (-0.6%; 3Q 12: -0.1%). On an annual basis, real GDP declined by -0.9% (3Q 12: -0.6%). The contraction in economic activity was attributable to decline in domestic demand amid high uncertainties surrounding the sovereign debt crisis and weak global environment that affected export performance. Economic activity in the crisis-affected economies weakened further, weighed down by fiscal austerity measures, higher unemployment, negative sentiments and sluggish bank lending. Germany recorded its first contraction since the fourth quarter of 2011 as the weak exports and gross fixed capital formation affected growth. Inflation moderated slightly to 2.3% (3Q 12: 2.5%) amid lower energy prices.

Growth in the UK contracted on a quarter-on-quarter basis (-0.3%; 3Q 12: 0.9%), as the temporary boost to economic activity from the hosting of the Olympic Games receded. On an annual basis, economic performance was sluggish at 0.1% (3Q 12: 0.1%). The weak growth was attributable to the decline in the production sector and flat growth in services. In the production sector, the contraction in mining and quarrying was due in part to maintenance work at the UK's largest North Sea oil field, which reduced oil and gas extraction during the quarter. Manufacturing activity declined on account of weak domestic and external demand. In addition, domestic demand continued to be affected by the ongoing fiscal austerity measures, anaemic labour market conditions and low confidence. Inflation increased at a faster pace of 2.7% (3Q 12: 2.4%), following a broad-based increase in most components.

In Japan, growth remained weak at 0.3% (3Q 12: 0.4%) as the strength of domestic demand waned amid continued weakness in external demand. On a seasonally adjusted annualised basis, the economy contracted at a slower pace (-0.4%, 3Q 12: -3.8%). Exports recorded a further decline of -5.7% (3Q 12: -4.9%), as trade activity was affected by lower global demand for machinery equipment. On the domestic front, household spending moderated as average wage growth continued to decline, dampening consumer spending. This was further exacerbated by a sharp decline in automobile sales following the expiration of subsidies for energy-efficient cars in September. The economy remained in deflation as headline consumer prices (excluding fresh food) declined by -0.1% (3Q 12: -0.2%) following the decline in prices of durable goods amid slower increases in energy prices.

Advanced Economies: Real GDP Growth

	2011		2012		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
US[1]	4.1	1.8	3.1	-0.1[a]	2.2
Japan[1]	0.3	-0.6	-3.8[r]	-0.4[p]	1.9[p]
Euro area	0.6	1.5	-0.6	-0.9[p]	-0.5[p]
UK	0.6	0.9	0.1	0.1[p]	0.0[p]

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

Source: National authorities

Monetary policy in the advanced economies remained accommodative during the quarter. In the US, the Federal Open Market Committee (FOMC) maintained the federal funds rate at 0–0.25%. The Committee highlighted that a highly accommodative stance of monetary policy will remain appropriate as long as the unemployment rate is above 6.5% and inflation is below 2.5%. The FOMC also announced that it will continue to purchase agency mortgage-backed securities in the amount of USD40 billion a month and the maturity extension programme will be replaced with an outright purchase of long-term Treasuries at an initial USD45 billion a month. In the euro area, the European Central Bank (ECB) decided to leave the interest rate unchanged at 0.75%. Through the Outright Monetary Transactions programme, the Governing Council remained committed to preserving the monetary union and in ensuring the proper transmission of the policy stance to the real economy. The actions of the ECB, however, will be subjected to the affected governments' commitment to fiscal targets. The Bank of England maintained its key policy rate at 0.5% and the size of its asset purchase programme at £375 billion. Similarly, the Bank of Japan (BoJ) kept its overnight policy rate at a range of 0–0.1%. Nevertheless, its asset purchase programme was expanded by approximately ¥21 trillion to ¥101 trillion. The BoJ also announced that it will provide unlimited amounts of long-term funds to financial institutions at low interest rates in an effort to stimulate bank lending. In January 2013, the BOJ introduced a price stability target of 2% and the 'open-ended asset purchasing method' under the Asset Purchase Programme to overcome deflation and spur growth.

Regional Countries: Real GDP Growth

	2011		2012		
	4Q	Year	3Q	4Q	Year
	Annual change (%)				
PR China	8.9	9.3	7.4	7.9[p]	7.8[p]
Philippines	4.0	3.9	7.2[r]	6.8	6.6
Indonesia	6.5	6.5	6.2	6.1	6.2
Chinese Taipei	1.2	4.1	1.0	3.4[a]	1.3[a]
Korea	3.3	3.6	1.5	1.5[p]	2.0[p]
Singapore	3.6	5.0	0.0	1.1[a]	1.2[a]

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

Source: National authorities

In Asia, growth improved at a modest pace across most economies in the fourth quarter. Resilient domestic demand continued to be the primary driver of growth in the region, particularly in ASEAN, where it served to partially offset the weak external demand. The strength of domestic demand was underpinned by favourable labour market conditions, sustained income growth and continued access to credit. The improvements in growth performance in several economies were also attributable partly to the recovery in regional demand. PR China's economy expanded by 7.9% (3Q 12: 7.4%), underpinned in part by a rise in infrastructure spending. In the Philippines and Indonesia, economic activity remained resilient (6.8% and 6.1% respectively, 3Q 12: 7.2% and 6.2% respectively), with continued growth in consumption, investment and exports. Chinese Taipei expanded at a faster pace of 3.4% (3Q 12: 1.0%) mainly on account of a rebound in investment and an improvement in exports. Growth in the Korean economy remained steady at 1.5% (3Q 12: 1.5%), as the improvement in private consumption was offset by a larger decline in investment. In Singapore, growth improved to 1.1% (3Q 12: 0%), supported by an expansion in the services sector while the manufacturing sector remained in contraction.

With the exception of PR China, Korea and Thailand, headline inflation moderated across most economies, following stable commodity prices. Prices rose in PR China and Korea mainly on account of higher food prices, particularly vegetables due to the unusually cold winter. In Thailand, the rise in inflation reflected partly a faster pace of increase in energy prices. In most economies, core inflation remained stable. Amid a benign inflation environment, several regional central banks pursued further monetary policy easing to mitigate the weakness in the external sector. In October, the Bank of Thailand and Bangko Sentral ng Pilipinas lowered their key policy rates by 25 basis points (bps) each to 2.75% and 3.50% respectively to provide support to domestic economic activity. Similarly, the Bank of Korea reduced its benchmark interest rate by 25 bps to 2.75%. Other central banks in Asia kept their key policy rates unchanged during the quarter. In January 2013, the Reserve Bank of India reduced its policy repo rate by 25 bps to 7.75% to support growth amid lower inflationary pressures. The cash reserve ratio was also reduced by 25 bps to 4.00% to increase liquidity in the banking system. Several authorities highlighted signs of stabilisation in the global economic environment but remained vigilant to downside risks to the domestic economy.

Prices of crude oil[1] averaged at USD110.11 per barrel in the fourth quarter (3Q 12: USD109.42). Upward pressures on oil prices due to supply disruptions were partially mitigated by concerns arising from US fiscal policy. Heightened tensions in some Middle Eastern countries and the shutdown of the North Sea oilfields for maintenance resulted in higher oil prices at the beginning of the quarter. Subsequently, the easing of tensions in the Middle East and the return of the North Sea supply resulted in prices declining to a three-month low. In the latter half of the quarter, prices fluctuated within a tight range as markets responded to a confluence of factors. Favourable economic data releases from PR China provided upward support to oil prices, while uncertainties surrounding the US fiscal policy provided some offsetting effect. As at end-December 2012, crude oil prices closed at USD111.11 per barrel.

Major currencies ended the quarter broadly unchanged against the US dollar. Nevertheless, the movements of these currencies showed divergent trends in the middle of the quarter amid developments in the euro area. In the first half of the quarter, speculations of a full bailout in Spain and subsequently the delayed disbursement of a financial aid tranche for Greece led to heightened risk aversion and weighed on the euro's performance. Nevertheless, the trend reversed in end-November following the agreement to release the next tranche of Greek bailout funds amounting to €44 billion. Towards the end of the quarter, the agreement to install ECB as the direct supervisor for major European banks also led to an improvement in market sentiments. In

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

contrast, the Japanese yen depreciated against the US dollar mainly on account of weaker economic activity. The yen weakened further following the newly-elected government's pledge to undertake more aggressive fiscal and monetary easing to provide support to growth. Asian currencies appreciated against the US dollar as risk appetites improved following favourable policy measures undertaken in the advanced economies. Of significance, the Fed's commitment to continued accommodative monetary easing, coupled with more progress towards the resolution of the European sovereign debt crisis, increased investors' appetite for higher yielding assets. The appreciation of the Philippine peso was also supported by the announcement that the country is on track to receive its first investment-grade rating. The Indonesian rupiah, however, depreciated amid concerns over the weakness in its external account position.

Going forward, there are emerging signs of improvements in the global economy. Latest economic indicators also suggest further stabilisation in the growth performance in Asia. Notwithstanding these improvements, considerable structural challenges remain in the advanced economies, which would constrain the prospect for a stronger economic recovery. In particular, several advanced economies will continue to address the issues relating to fiscal sustainability and persistently weak labour market conditions. In the emerging markets, the highly accommodative monetary policy sustained in the major advanced economies requires close surveillance given the potential impact of excessive global liquidity on asset price inflation.