DEVELOPMENTS IN THE SECOND QUARTER OF 2012

INTERNATIONAL ECONOMIC ENVIRONMENT

Global growth moderated amid heightened volatility in financial market conditions

The global economic environment remained challenging in the second quarter, due mainly to vulnerabilities in several key economies. Growth in the major advanced economies slowed, weighed down by domestic fiscal adjustments, tight credit conditions and sluggish labour markets. Growth momentum in Asia had also moderated, particularly in the more open economies, reflecting the slowing external demand. Domestic demand in the region however was sustained, attributable to favourable macroeconomic fundamentals and policy support.

Conditions in the international financial markets deteriorated as market confidence was affected by the European sovereign debt crisis and the weakening growth prospects in several of the major economies. Earlier in the quarter, policy uncertainty in Greece and rising concern on the Spanish banking system led to a significant rise in risk aversion. This was reflected by a flight of deposits from some European countries, a decline in global equity markets and increased demand for safe haven and liquidity-related flows. As a result, government bond yields of US, Germany and Switzerland declined to record low-levels. In Asia, many economies experienced heightened volatility in capital flows which in turn affected asset prices. Market sentiment improved in June following the pronouncements of several immediate and long-term proposals, agreed during the European Union Summit on 29 June 2012. The proposals aimed to break the negative feedback loop between conditions in the banking system and the sovereign fiscal position and restore confidence in the currency union. These proposed measures include direct recapitalisation of the Spanish banks, the formation of a banking union and a €120 billion growth pact to support growth in the Euro area. However, financial markets remained highly volatile given uncertainties surrounding the implementation details and rising contagion risks. Credit rating agencies further downgraded the credit ratings of sovereigns and banks in several economies, including the US and core European economies. Fifteen US and European banks with large capital market operations were downgraded, reflecting the challenging funding conditions, tighter regulatory requirements and high risk exposures arising from Europe. In addition, Moody's lowered its outlook for triple A-rated Germany, the Netherlands and Luxembourg from stable to negative, citing the increasing risk of a Greek exit from the euro area and rising contingent liabilities as a result of policymakers' policy responses. In late July, financial market concerns on the European sovereign debt crisis reintensified. Spanish 10-year government bond yield rose to a record high of over 7.5% following concerns over regional fiscal problems amid weakening growth prospects. This was compounded by fears of a possible funding shortages in Greece as the release of the bailout funds was delayed, pending review by the IMF, European Commission and European Central Bank.

The **US** economy expanded by a modest growth of 2.2% on an annual basis (1Q 12: 2.5%) in the second quarter. On an annualised basis, the economy grew by 1.5% (1Q 12: 2.0%) due mainly to slower domestic demand activities. Private consumption was sluggish being adversely affected by the decline in net financial wealth and weaker labour market conditions. Employment registered a slower gain of 219,000 jobs in the second quarter (1Q 12: 677,000). In addition, consumer confidence trended downwards, reflecting the cautious outlook of households on the economy. Private fixed investment grew at a slower pace as investment in structure and residential investment offset the increase in equipment and software capital spending. Growth was also constrained by a contraction in government spending. On the inflation front, headline CPI moderated to 1.9% (1Q 12: 2.8%), due to lower fuel prices.

Growth in the **euro area** weakened as domestic demand continued to deteriorate amid high uncertainties surrounding the sovereign debt crisis. Manufacturing activity experienced a deeper contraction in both the

core and peripheral economies as private sector sentiments weakened. In addition, exports growth moderated following weaker global demand. Economic activity in the crisis-affected economies weakened further, weighed down by fiscal austerity measures, higher unemployment and impaired banking sectors which constrained the flow of credit to businesses and households. Inflation moderated slightly to 2.5% (1Q 12: 2.7%) due mainly to lower energy prices.

The **UK** economy remained in a recession as it contracted at a faster pace of 0.7% (1Q 12: -0.3%) on a quarter-on-quarter basis. On an annual basis, real GDP fell by 0.8% (1Q 12: -0.2%). The deterioration in economic activity was partly attributable to the Diamond Jubilee holiday and poor weather conditions. However, underlying economic conditions remained weak amid elevated financial market uncertainties and sluggish private sector sentiments. Domestic demand continued to be negatively affected by fiscal austerity measures, a weak labour market and tight credit conditions. The pace of inflation moderated to 2.7% (1Q 12: 3.5%) due to a decline in the prices of food, energy and clothing.

Advanced Economies: Real GDP Growth

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
US[1]	2.5[r]	1.3[r]	2.0[r]	1.5[a]	2.4[a]
Japan[1]	-1.9	-4.8	5.5[r]	1.4[p]	3.5[p]
UK	0.5	1.0	-0.2	-0.8[p]	-0.5[p]

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

Source: National authorities

The **Japanese** economy continued to recover from last year's natural disasters, expanding by 3.5% (1Q 12: 2.9%). On a seasonally adjusted basis, it recorded a growth of 1.4% (1Q 2012: 5.5%). Exports improved (8.8%, 1Q 12: 1%), underpinned by base effect amid higher shipments of automobile. On the domestic front, household spending continued to expand, supported by government subsidies for the purchase of fuel-efficient cars. In addition, disposable income and wage growth remained positive. The change in core consumer prices (excluding fresh food) declined to -0.1% (1Q 12: 0.1%) amid slower increases in energy prices.

Monetary policy remained accommodative in the advanced economies. Further measures were undertaken, given continued weak growth prospects. In the US, the Federal Open Market Committee (FOMC) announced a continuation of its maturity extension programme through the end of 2012 as compared to its previous plan of end-June 2012. The measure was aimed at reducing longer-term interest rates in order to ease financial market conditions and support the economic recovery. The European Central Bank (ECB) widened the range of securities that it would accept as collateral from euro area banks. This would increase the availability of collateral and help to ease credit conditions in the region. In July, the ECB reduced its policy rate by 25 bps to 0.75% and cut the overnight deposit rate to 0% in order to provide further support to bank lending activity. The Bank of England (BoE) expanded its quantitative easing measures by increasing the size of its asset purchase programme in July by £50 billion to £375 billion, while keeping its policy rate at 0.5%. In addition, the BoE and the British government jointly unveiled a £100 billion lending plan for households and businesses. The Bank of Japan (BoJ) increased its asset purchase programme by ¥5 trillion to ¥70 trillion as a measure to address deflation and to support the economic recovery.

Regional Countries: Real GDP Growth

	2011		2012		
	2Q	1H	1Q	2Q	1H
	Annual change (%)				
PR China	9.5	9.6	8.1	7.6	7.8
Singapore	1.2	5.0	1.5[r]	2.0[r]	1.8[r]
Korea	3.5	3.8	2.8	2.4[a]	2.6[a]
Chinese Taipei	4.5	5.5	0.4	-0.2[a]	0.1[a]
Indonesia	6.5	6.5	6.3	6.4	6.3
Hong Kong SAR	5.4	6.5	0.7[r]	1.1[p]	0.9[p]

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

Source: National authorities

In **Asia**, economic activity expanded at a moderate pace in the second quarter. Growth performance, however, showed divergent trends, mainly reflecting the degree of openness of the economies. Domestic demand continued to provide support to overall economic activity in the region, partially offsetting the weakness

in external demand. **PR China**'s economy moderated to 7.6% (1Q 2012: 8.1%) due mainly to slower manufacturing activity. Growth in Singapore remained modest at 2.0% (1Q 12:1.5%), as the rebound in the manufacturing sector was offset by a moderation in the construction sector. The **Korean** economy weakened (2.4%; 1Q 12: 2.8%) while growth in **Chinese Taipei** contracted (-0.2%; 1Q 12: 0.4%), as both economies experienced a moderation in private consumption and a decline in investment activity. The **Indonesian** economy grew by 6.4% (1Q 12: 6.3%), supported by sustained private consumption and stronger investment. **Hong Kong**'s economy grew by 1.1% (1Q 12: 0.7%), as stronger consumption and investment offset a weaker external trade performance.

Headline inflation continued to moderate in most regional economies, mainly on account of lower food and energy prices. The slower pace of increase in inflation was also partly attributable to the favourable base effects from last year's high price index levels. Nevertheless, it remained high in a few economies, particularly India, Hong Kong, and Singapore due to elevated costs of food and housing. Amidst continued uncertainties in the global economy and lower inflationary pressures, several monetary authorities in the region eased monetary policies. In April, the Reserve Bank of India lowered its key lending rate by 50 basis points (bps) to 8.00% in an effort to support growth amid slower inflation. The Monetary Authority of Singapore (MAS) maintained its policy of a modest and gradual appreciation of the S$NEER policy band. However, the slope was raised slightly and MAS also restored a narrower policy band, citing the need to manage inflation expectations, ensure medium-term price stability, and keep growth on a sustainable path. The People's Bank of China (PBOC) reduced its benchmark one-year lending rate for the first time since 2008 by a total of 56 bps to 6.00% in June and July. This followed the PBOC's decision to lower the banks' reserve requirement ratio by 50 bps to 20.00% in May to improve liquidity conditions. In July, the Bank of Korea lowered its key policy rate by 25 bps to 3.00%. The Bangko Sentral ng Pilipinas (BSP) cut its key policy rate by 25 bps, reducing overnight borrowing and lending rates to 3.75% and 5.75% respectively, as a benign inflation outlook provided room for it to further lower its interest rates.

Prices of **crude oil**[1] moderated in the second quarter, averaging USD109 per barrel (1Q 12: USD118 per barrel), and generally remained below USD100 in June. This reflected mainly weaker oil demand prospects as uncertainties weighed on the global growth outlook. Easing geopolitical tensions and continued high production by the Organisation of Petroleum Exporting Countries (OPEC) members also contributed to the reversal in oil prices from the peak of USD126 in March. As at 16 July, crude oil prices closed at USD103, recording an 8% decrease since the start of the year. Since the trough in late June, however, oil prices have increased slightly, attributable to renewed geopolitical tensions in the Middle East and the decline in US oil inventory.

In the **foreign exchange markets**, the euro, pound sterling and Asian currencies depreciated against the US dollar, as investors' sentiments continued to be affected by the ongoing European sovereign debt crisis. In the first two months of the quarter, currency movements in these economies were weighed down by growing concerns over the banking crisis and fiscal sustainability in Spain, intensified speculation of a Greek exit and weakening growth prospects in the advanced economies. In June, market concerns were partially alleviated by the result from the Greek election and the positive outcome from the EU summit, leading to a marginal appreciation for those currencies. Other major currencies such as the Japanese yen and Swiss franc appreciated against the US dollar, benefitting from their role as safe haven currencies, amid heightened investor risk aversion in the global financial markets.

Going forward, the global economy faces increasing downside risks, emanating from the developments in several major economies. Policy uncertainty surrounding the European sovereign debt crisis and fiscal issues in the US are expected to weigh on market sentiments and growth prospects. Asia's growth will be affected by the weakening external environment amid modest growth in PR China.

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