DEVELOPMENTS IN THE FOURTH QUARTER OF 2006

INTERNATIONAL ECONOMIC ENVIRONMENT

Sustained growth in major economies

Global economic activity broadened in the fourth quarter with higher growth in the United States, continued recovery in Japan, rising growth momentum in Europe and sustained strong expansion in the Asian region.

The **US** economy expanded more rapidly in the fourth quarter of 2006, growing by 3.5%, driven largely by stronger consumption. Healthy job creation, rising wages and easing gasoline prices supported consumer spending. Following the lower crude oil prices, the trade deficit improved. Meanwhile the weaker dollar and firm foreign demand spurred export performance. There were also signs of stabilisation in the housing market, with new and existing home sales declining at a slower pace and the pending home sales index recording the biggest monthly gain since 2004. Investment activity related to the residential property and transportation equipment sectors, however, remained weak.

In **Japan,** the economy expanded strongly by 4.8% in the fourth quarter of 2006, supported mainly by a rebound in private consumption. Furthermore, corporate capital spending expanded significantly and exports continued to increase, albeit at a moderate pace. In the **Euro area,** 4Q growth was lifted by improved performance in Germany, Italy and France. Euro area economic activity strengthened with the expansion in exports and higher growth in private consumption, amid an improving labour market. Germany's broad-based recovery also emerged as a stronger driver of euro area growth. Labour market improvements were evident with unemployment rates on a downward trend in Germany, France and Italy. Overall sentiments were improving with upward trends registered by the Zew, Ifo and economic sentiment indicators. Meanwhile in the **UK,** GDP expanded by 3% in the fourth quarter, supported mainly by continued expansion in the services sector.

Industrial countries: Real GDP Growth

	2005		2006			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
US[1]	1.8	3.2	2.0	3.5[a]	3.4	Growth rebounded to grow at about potential output, supported by strong consumer spending and improved trade deficit despite continued weakness in the auto and housing sectors.
UK	2.0	1.9	2.9	3.0	2.7	Supported mainly by the services sector especially business services and finance.
Euro zone	1.8	1.4	2.8[r]	3.3	2.7	Growth appeared to be broad-based with continued expansion in exports and domestic demand.
Japan[1]	1.7[r]	1.9	0.3[r]	4.8[p]	2.2	Rebound in private consumption and robust private non-residential investment Growth in exports provided more support to underpin continued recovery for the economy.

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

Source: National authorities

Major central banks maintained their tightening bias in **monetary policy**. The **FOMC** continued to maintain interest rates at 5.25% for the fifth consecutive meeting on 31 January 2007 in view of potential risk to inflation arising from the high level of resource utilisation in the economy. The **Bank of Japan** increased the uncollateralized overnight call rate by 25 bps to 0.5% on 21 February 2007, citing that trends in consumer prices are likely to increase in the long run. Both the **European Central Bank** and the **Bank of England** maintained their interest rates in February at 3.5% and 5.25% respectively.

Global **crude oil prices** experienced the most significant correction in over 15 years, declining by nearly 20% from the peak in mid-July (USD78.40 per barrel) to average USD60.18 p/b in the 4Q. The decline in prices was supported by easing geopolitical concerns, rising crude inventories, the mild hurricane season in the US and a warmer-than-expected winter in the US Northeastern region.

In the **Asian region,** economic growth in the fourth quarter remained robust. Growth was led by China, and supported by continued strength in exports and domestic demand. Despite the moderation in US growth, regional exports as a whole remained resilient with many regional countries reporting double-digit growth.

Inflationary trends were mixed in the fourth quarter. Inflation in PR China and some of the NIE countries trended up slightly due to rising food costs. Easing crude oil prices however, led to lower inflation in the ASEAN-4 countries. Of significance, Indonesia recorded a sharp dip in inflation, as effects from the removal of fuel subsidies in the fourth quarter of 2005 began to recede. This has prompted the Indonesian authorities to cut interest rates throughout the quarter. Meanwhile, India raised interest rates to curb inflationary pressures emerging from strong domestic demand.

In the **foreign exchange market,** the US dollar ended the year mixed against major currencies. The dollar depreciated against the **euro** and **sterling** on expectations of higher interest rates in both the eurozone and the UK. On 24 November, the euro broke above USD1.30 against dollar for the first time in 1 ½ years. The weakness in the dollar was also driven in part by concern over foreign central banks diversifying their foreign reserves, narrowing interest rate differentials between the US and other parts of the world and to some extent, the softer US economic data. The dollar appreciated against the **yen,** breaking above the 120 level on 11 January 2007 following reduced expectations of an interest rate hike after data suggested that Japanese consumption and consumer prices had softened towards the end of the year. Meanwhile, all the regional currencies strengthened during the fourth quarter compared to the end of the third quarter. The **Thai baht** recorded the strongest appreciation, following the strong capital inflows. The rapid strengthening of the Thai baht and surging capital inflows prompted the Thai authorities to enact capital controls on 18 December 2006. Parts of the measures were however subsequently relaxed.

Regional Countries: Real GDP Growth

	2005		2006			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
PR China	9.9	10.4	10.6	10.4	10.7	Driven by strong exports and investments.
Singapore	8.3	6.6	7.0	6.6	7.9	Supported by manufacturing, wholesale & retail as well as financial services sectors.
Indonesia	4.9	5.6	5.9	6.1	5.5	Supported by the telecommunication and transportation sector, investment and exports.
Philippines	5.3	5.0	5.3	4.8	5.4	Supported by exports while agriculture sector registered slower growth.
Korea	5.3	4.0	4.6	4.0	5.0	Supported by the manufacturing and services sectors.
C Taipei	6.4	4.1	5.0	4.0	4.6	Driven by private consumption and investment.

Source: National authorities