DEVELOPMENTS IN THE FIRST QUARTER OF 2012

INTERNATIONAL ECONOMIC ENVIRONMENT

Modest global growth amid improvement in financial market conditions

Global economic growth expanded at a slower pace in the first quarter of 2012. While growth in the US improved, several European economies slipped into recession. In Asia, economic activity continued to expand, albeit at a moderate pace, due to the slower export growth during the quarter. Domestic demand continued to provide support to economic activity.

International financial market conditions improved in the first quarter but remained volatile. In the earlier half of the quarter, markets were particularly affected by intensified concerns of investors over the potential of a Greek default. Nonetheless, market optimism subsequently improved following several policy actions taken by the EU leaders. These included the agreement for a second €130 billion bailout programme for Greece and the finalisation of its debt restructuring plan, and the increase in the combined lending capacity of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) to €700 billion from €500 billion. The second round of long-term refinancing operations by the European Central Bank in February also provided additional liquidity support to banks and alleviated financial market tensions. Nevertheless, the effect of these measures were temporary, as by end-March, financial market volatility re-emerged, driven by renewed fiscal sustainability concerns in Portugal and Spain. Furthermore, higher uncertainty in the financial markets was compounded by rising geopolitical risks in the Middle East and North Africa (MENA) region, which translated into a significant rise in oil prices during the quarter.

In the first quarter, the **US** economy grew at a faster pace of 2.1% in annual terms (4Q 11: 1.6%). On a seasonally adjusted annualised basis, the economy expanded by 2.2% (4Q 11: 3%), supported by private domestic spending. Consumption rose in response to an improvement in employment conditions and net financial wealth, increase in credit, a lower savings rate and favourable weather conditions. However, the pace of consumption growth remained constrained by the high household debt, a weak housing market and elevated gasoline prices. Private fixed investment expanded at a lower rate of 1.4% (4Q 11: 6.3%). The contraction in non-residential investment and a deceleration of capital spending in equipment and software offset the increase in residential construction activity. Government spending decreased as fiscally-constrained state and local governments cut spending and employment. Inflation grew at a slower rate of 2.8% (4Q 11: 3.3%) on account of a high base last year.

The **euro area** economy stagnated on both a quarterly (4Q 11: -0.3%) and annual basis (4Q 11: 0.7%). Growth performance continued to diverge between the economies in the region amid the unresolved sovereign debt crisis. While Germany experienced strong growth in the quarter, economic activity in the affected economies including Italy and Spain, continued to deteriorate. This is attributed mainly to weaker domestic demand and fragile banking sector conditions. Consumer spending also continued to decline as credit growth and private sector sentiments remained weak. Higher unemployment and additional austerity measures imposed on fiscal spending in the affected economies further weighed down on domestic economic activity. Inflation moderated slightly to 2.7% (4Q 11: 2.9%), but remained heightened amid higher energy prices.

The **UK** economy fell into a recession as real GDP contracted by 0.2% (4Q 11: -0.3%) on a quarter-on-quarter basis. On an annual basis, the economy stagnated in the first quarter (4Q 11: 0.5%). The deterioration in economic activity was mainly attributable to a continued decline in the manufacturing and construction sectors. Domestic demand continued to be weighed down by fiscal austerity measures, weak private sector sentiments and high consumer prices. The pace of inflation moderated

significantly to 3.5% (4Q 11: 4.6%), reflecting the normalisation from the impact of the value-added tax rate increase in January 2011. The rate of inflation however, remained above the central bank's 2% target.

The **Japanese** economy rebounded strongly in the first quarter, expanding by 2.7% (4Q 11: -0.5%). On a seasonally adjusted annualised basis, the economy grew by 4.1% (4Q 11: -1.1%). Export growth increased by 0.8% (4Q 11: -2.4%) following increased exports of transport equipment and higher shipments to the US in February and March amid the weaker yen. On the domestic front, household spending recorded positive growth, driven by government subsidies for the purchases of fuel efficient cars. Disposable income and wage growth also increased from a year earlier, supporting a moderate recovery in consumption. Sentiments were boosted by the setting up of the Reconstruction Agency in February, signalling some progress in the post-disaster reconstruction efforts. Core consumer prices (excluding fresh food) returned to the positive territory at 0.1% (4Q 11: -0.1%) amid higher energy prices.

Advanced Economies: Real GDP Growth

	2011			2012
	1Q	4Q	Year	1Q
	Annual change (%)			
US[1]	0.4	3.0	1.7	2.2[a]
Japan[1]	-9.8	-1.1	-0.7	4.1[p]
Euro area	2.4	0.7	1.5	0.0[a]
UK	1.6	0.5	0.7	0.0[p]

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

Source: National authorities

Monetary policy remained accommodative in the advanced economies, with further measures being undertaken given the continued weak growth prospects. In the US, the **Federal Open Market Committee** (FOMC) maintained the target range for the federal funds rate at 0-0.25% and revised its expectations of exceptionally low interest rates to remain through at least until late-2014, as compared to its previous expectations of low rates through mid-2013. The FOMC also announced the adoption of an inflation target of 2%. Amid heightened financial market uncertainty and higher risks to growth in the euro area, the **European Central Bank** (ECB) maintained its policy rate at 1% while embarking on its second round of three-year refinancing operations in February, aimed at providing liquidity to the banking sector and to support lending activity in the region. The **Bank of England** expanded its quantitative easing measures by increasing the size of its asset purchase programme in February by £50 billion to £325 billion, while keeping its policy rate at 0.5% in view of the modest state of economic recovery. Similarly, the **Bank of Japan** (BoJ) announced several measures to support its weak domestic economy. This included formalising an inflation goal of 1%, expanding its asset purchase programme by ¥10 trillion in February to ¥65 trillion, and increasing the loan scheme targeting growth industries by ¥2 trillion to ¥5.5 trillion. In April, the BoJ also extended the remaining maturity of Japanese government bonds to be purchased under the Programme from "one to two years" to "one to three years". The BoJ increased its asset purchase programme by an additional ¥5 trillion through the purchase of Japanese government bonds to address deflation and support the economy's return to sustainable growth.

Regional Countries: Real GDP Growth

	2011			2012
	1Q	4Q	Year	1Q
	Annual change (%)			
PR China	9.7	8.9	9.2	8.1
Indonesia	6.5	6.5	6.5	6.3
Korea	4.2	3.3	3.6	2.8[a]
Singapore	9.1	3.6	4.9	1.6
Chinese Taipei	6.6	1.9	4.0	0.4[a]
Hong Kong SAR	7.6	3.0	5.0	0.4
Thailand	3.2	-8.9[r]	0.1	0.3

[a] Advance estimate
[r] Revised

Source: National authorities

In **Asia**, domestic demand was generally sustained, supported by favourable labour market conditions, continued access to financing and steadily rising incomes. The overall economic activity, however, was affected by the slower external demand. **PR China's** economy expanded at a slower pace of 8.1% (4Q 11: 8.9%), as activity across the agricultural,

manufacturing and services sectors moderated. **Indonesia**'s economic growth moderated slightly, but remained robust at 6.3% (4Q 11: 6.5%), underpinned by resilient domestic demand. The **Korean** economy grew by 2.8% (4Q 11: 3.3%), supported mainly by public consumption and a rebound in investment activity. Growth in **Singapore** moderated to 1.6% (4Q 11: 3.6%) following a contraction in manufacturing activity which was also contributed by the high base in the previous year. In **Chinese Taipei**, growth slowed to 0.4% (4Q 11: 1.9%) mainly on account of a contraction in investment and exports. **Hong Kong's** growth moderated to 0.4% (4Q 11: 3.0%) following weak export performance. In **Thailand**, growth improved to 0.3% (4Q 11: -8.9%) as domestic demand rebounded while export growth contracted at a slower pace.

Headline inflation in the region moderated following slower increases in food prices, but remained elevated during the quarter. Amidst ongoing uncertainties in the global economy and lower inflationary pressures, several central banks in the region began to shift their policy focus towards supporting economic growth. **Bangko Sentral ng Pilipinas** lowered its key policy rate by a total of 50 basis points (bps) in two consecutive meetings to 4%. Similarly, **Bank Indonesia** cut its benchmark interest rate by 25bps to 5.75% in February. In an effort to mitigate the impact of the severe flooding on the economy, the **Bank of Thailand** further reduced its key policy rate by 25bps to 3% in January. The **Reserve Bank of India** cut its key lending rate by 50bps to 8% in April – the first rate cut in three years – in an effort to stimulate growth amid slowing inflation. This followed the Bank's decision to reduce its cash reserve ratio requirement by a total of 125bps to 4.75% in January and March to ease liquidity in the banking system. The **People's Bank of China** reduced the reserve requirement ratio by a total of 100bps to 20% in February and May to improve bank lending and support growth. The **Monetary Authority of Singapore** (MAS) maintained its policy of a modest and gradual appreciation of the S$NEER policy band. The slope, however, was increased slightly and MAS restored a narrower policy band to manage inflation expectations, ensure medium-term price stability and keep growth on a sustainable path.

Prices of **crude oil**[1] continued to trend upwards in the first quarter, averaging USD118 per barrel (4Q 11: USD109 per barrel). A confluence of factors, including geopolitical tensions in the MENA region, lower risk aversion and the onset of winter weather pushed oil prices to an 11-month high in mid-March. Nonetheless, in April, crude oil prices reversed the rising trend, although it remained above USD100 per barrel amid increasing signs of optimism following talks between Iran and key global powers. The release of unfavourable US economic data also suggested continued weak demand conditions. On 18 May, crude oil prices closed at USD107.14.

In the **foreign exchange markets**, most major and Asian currencies appreciated against the US dollar during the quarter, as global risk aversion receded following the progress made in addressing the sovereign debt crisis and the continued modest recovery in the US economy. The Japanese yen strengthened against the US dollar at the beginning of the quarter due to safe haven flows. Nevertheless, the trend was subsequently reversed as a result of the improvement in market sentiments and the BoJ's easing measures. The announcement by the FOMC in January to maintain its highly accommodative monetary policy stance until 2014 also provided some motivation for investors to return to the region in search for higher-yielding assets, providing further support for the appreciation in Asian currencies. Nevertheless, regional currencies weakened in March due mainly to concerns over the strength of growth prospects in PR China that could dampen the demand for the exports of regional economies.

Going forward, the European sovereign debt crisis remains a risk to the global economy. The continued high oil prices, driven mainly by geopolitical tensions, further adds to uncertainty in the global environment. Nevertheless, the ongoing gradual recovery in the US is expected to provide an upside potential to global growth prospects. For Asia, while economic activity may be affected by external developments, growth will continue to be underpinned by sound domestic macroeconomic fundamentals and policy flexibility.

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