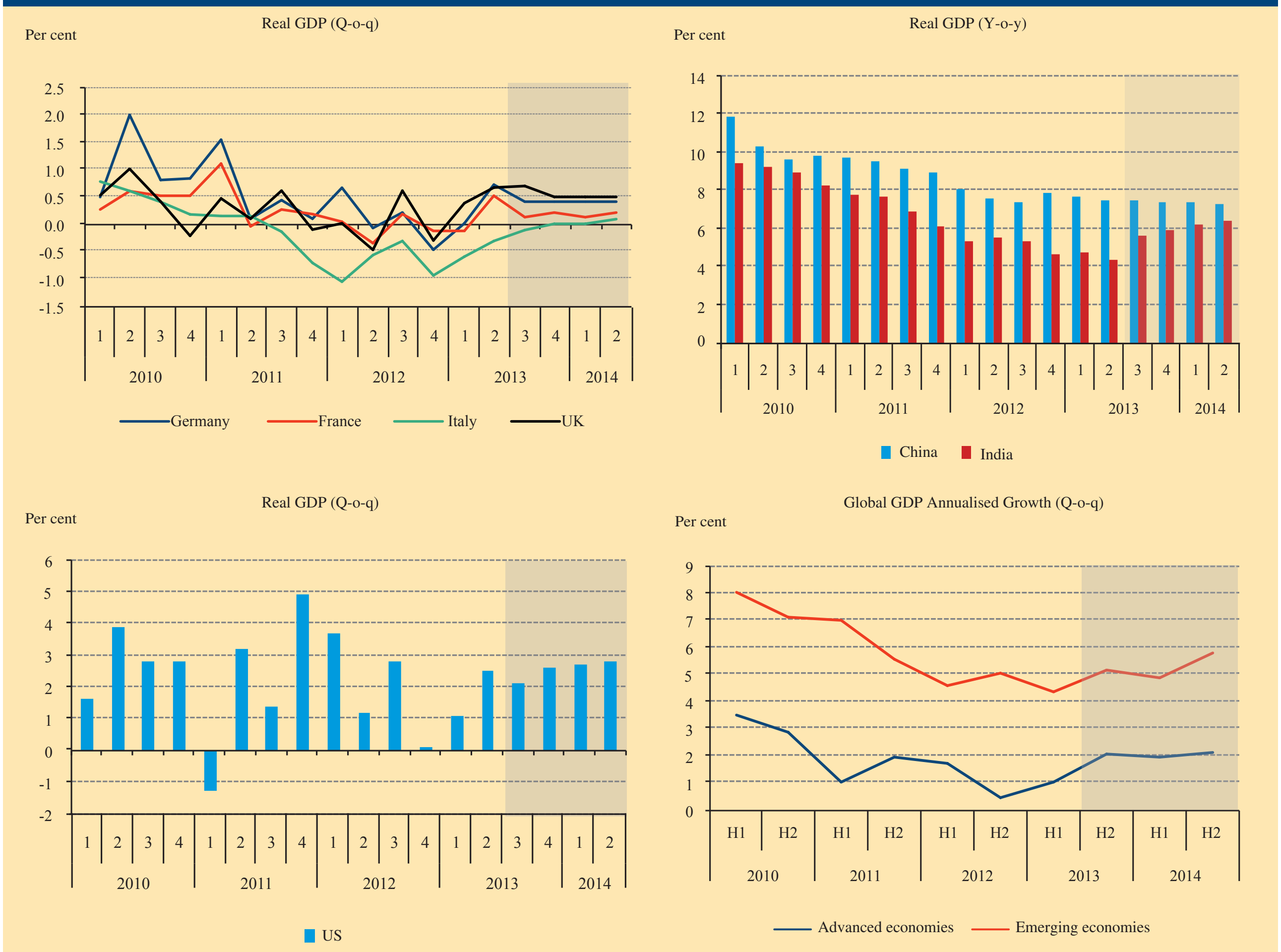
2. THE GLOBAL ECONOMY

The world economy has improved slightly since the April 2013 Inflation Report, as a result of the somewhat better performance of advanced economies. The Eurozone notably emerged out of recession after six consecutive quarters of contraction. In several major emerging economies, including China and India, growth has slowed and looks unlikely to return to previous highs in the medium term. Looking ahead, there is still considerable uncertainty surrounding the global growth outlook and a number of downside risks remain. Against the backdrop of fragile and uneven global economic recovery, global inflation has remained subdued though, faced with capital outflows and depreciating currencies, some emerging economies have seen an increase in inflation. Global inflationary pressures are expected to remain contained in the medium term as commodity prices continue to ease and as demand factors in high income countries remain weak [1].

2.1 Demand and Output

Latest data showed that global economic activity picked up with better prospects expected in the near term. However, the growth momentum remained uneven. Among major advanced economies, which experienced a small rebound in 2013Q2, the US is expected to drive the recovery. While emerging markets are experiencing a sharper slowdown than expected, growth will remain above those of the advanced economies but below the elevated levels seen in recent years. Some of these economies have also experienced significant outflows of capital following the announcement by the Federal Reserve

Chart 2.1: Growth in Selected Economies



Sources: OECD, IMF and Thomson Reuters

[1] *IMF's October 2013 World Economic Outlook.*

(FED) that it might start tapering its asset-purchase programme. The subsequent decision to maintain the pace of monetary stimulus in the US provided some relief to these economies.

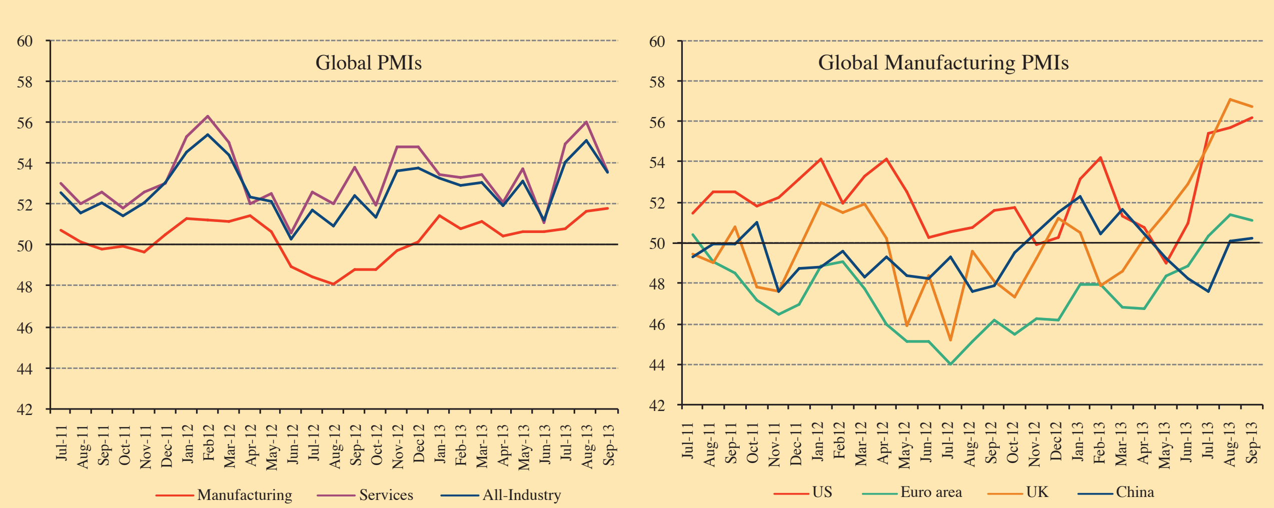
In the October 2013 release of the World Economic Outlook, the IMF downgraded its initial global growth forecast by 0.3 per cent to 2.9 per cent for 2013. This was mainly attributable to downward revisions in growth of emerging and developing market economies, from the 5.0 per cent expected previously to 4.5 per cent. Growth in advanced economies remained unchanged at 1.2 per cent. In 2014, the world economy is projected to grow by 3.6 per cent, with growth forecast at 2.0 per cent in advanced economies and 5.1 per cent in emerging and developing economies (Chart 2.1).

The JPMorgan Global All-Industry Purchasing Managers' Index (PMI), a leading indicator of global output, fell in September 2013 but still pointed to a strong pace of growth in global output. The decline in the All-Industry PMI was driven by a drop in global services PMI whereas the global manufacturing PMI continued to increase, reaching 51.8 in September. New orders and finished goods inventory continued to support global manufacturing output. By country, the manufacturing PMI for China indicated better prospects for manufacturing activity as the index crossed the 50-level mark that indicates expansion (Chart 2.2)[2].

In the US, private domestic demand supported by very accommodative monetary conditions was the main engine of growth. The economy grew by 2.5 per cent in 2013Q2 following a revised growth rate of 1.1 per cent in the previous quarter[3]. The housing sector continued to improve, with continuous gains in residential construction and home prices. The labour market was also recovering, but at a slow pace, with slight declines in the unemployment rate. The FED's announced intention to reduce quantitative easing tightened financing conditions in the US and possibly delayed actual tapering. There were, however, reasonably good data from the US to indicate that tapering might effectively take place in the near future. Continued uncertainties about the debt ceiling in the US and reductions in Government debt were important risk factors for the US economy. The IMF has forecast US GDP growth to be lower at 1.6 per cent in 2013 but to increase to 2.6 per cent in 2014.

After six consecutive quarters of contraction, GDP in the euro area expanded by 0.3 per cent in 2013Q2, marking the end of the longest recessionary phase recorded to date[4]. Faster-than-expected growth in Germany and France, led the rebound. A number of peripheral countries also appeared to perform better in the second quarter. Consumer and business confidence improved in some countries. The unemployment rate, which has been near record highs for some time, is not expected to worsen. Overall prospects have improved for the Eurozone but severe fiscal austerity measures in some countries, as well as fragile financial conditions will continue to weigh on growth. According to the IMF, the euro area is expected to contract by 0.4 per cent in 2013 and grow by 1.0 per cent in 2014.

Chart 2.2: JPMorgan Global Purchasing Managers' Index



Source: JPMorgan.

[2] *JPMorgan Purchasing Managers' Index releases, Markit Economics.*

[3] *US Bureau of Economic Analysis.*

[4] *Eurostat.*

UK economic growth accelerated to 0.7 per cent in 2013Q2, from 0.3 per cent in 2013Q1[5]. Recent data indicated that the UK manufacturing sector continued to expand at a marked pace in September while the services sector performed strongly. The labour market continued to stabilise and consumer confidence improved. A fundamental shift in the UK housing market has taken place over the past nine months, with credit conditions easing and house prices starting to rise. However, risks remain that the US growth will be more moderate than expected and renewed troubles in the euro area may hinder the current bounce in the economy. The IMF forecast that the UK economy will grow by 1.4 per cent and 1.9 per cent in 2013 and 2014, respectively.

Emerging markets have lost considerable momentum following a period of double-digit growth, in which they drove the world economy in the aftermath of the financial crisis. GDP growth in China has moderated for two consecutive quarters, to 7.5 per cent in 2013Q2 due to sluggish external demand and weak private investment[6]. However, monthly activity indicators have shown some positive signs. The September's HSBC China Manufacturing PMI recovered to 50.2, from an 11-month low of 47.7 in July. In India, GDP growth slowed markedly to 4.4 per cent in 2013Q2, hurt by a decline in mining and manufacturing[7]. While ample monsoon rainfall may support agricultural production in 2013H2, business conditions in the Indian manufacturing sector deteriorated. Judging from market reaction to the planned cutback in US monetary stimulus, there are continued risks of an abrupt cut-off in capital flows to emerging market economies as well as severe balance of payments disruptions. The economic outlook is generally weaker for emerging market economies. The IMF forecast China and India to grow by 7.6 per cent and 3.8 per cent, respectively, in 2013. For 2014, the IMF estimates growth at 7.3 per cent and 5.1 per cent, respectively, for these two countries.

Latest data from the Netherlands Bureau of Economic Research indicated that global trade volumes were up by 3.6 per cent in the year to July 2013, with a 8.2 per cent expansion in imports of emerging economies being the main driver of higher trade volumes[8]. In October 2013, the IMF downgraded the forecast for world trade volume growth by 0.2 percentage point to 2.9 per cent in 2013, reflecting subdued momentum in global economic activity. The IMF estimated that trade would grow by 4.9 per cent in 2014.

2.2 Recent Developments in Prices

2.2.1 Consumer Price Inflation

The factors that contributed to the low inflationary environment on the global front stemmed mainly from sliding commodity prices, including low energy prices, and the weak demand in China and Europe. In advanced economies, inflation rose slightly but remained below target while in some emerging economies, faced with capital outflows and depreciating currencies, inflation has increased. With the slight pickup in activity in the advanced economies not expected to lead to a major reduction in output gaps, it is projected that inflationary pressures will remain subdued. The IMF forecast consumer prices in advanced economies to stand at 1.4 per cent in 2013 and at 1.8 per cent in 2014. While the

Table 2.1: Consumer Price Inflation in Selected Countries

Per cent

	2009	2010	2011	2012	February 2013	August 2013
China	-0.7	3.3	5.4	2.6	3.2	2.6
Euro area	0.3	1.6	2.7	2.5	1.8	1.3
India	12.4	10.4	8.4	10.4	12.1	9.5
Indonesia	4.8	5.1	5.4	4.3	5.3	8.8
South Africa	7.1	4.3	5.0	5.7	5.9	6.4
Thailand	-0.9	3.3	3.8	3.0	3.2	1.6
Turkey	6.3	8.6	6.5	8.9	7.0	8.2
United Kingdom	2.1	3.3	4.5	2.8	2.8	2.7
United States	-0.3	1.6	3.1	2.1	2.0	1.5
Mauritius	2.5	2.9	6.5	3.9	3.6	3.5

Sources: IMF and The Economist.

[5] *Office for National Statistics.*

[6] *National Bureau of Statistics of China.*

[7] *Central Statistics Office of India.*

[8] *Netherlands Bureau for Economic Policy and Analysis.*

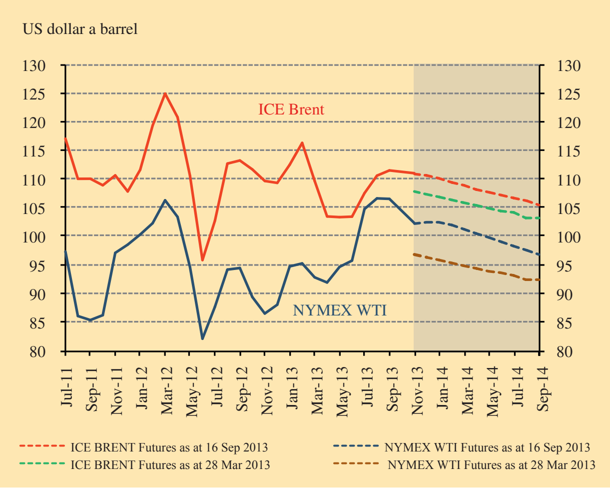
drop in commodity prices and lower growth should contain price pressures in emerging and developing economies, continued capacity constraints and the pass-through from weakening exchange rates are expected to keep inflation relatively high. According to the IMF, inflation could reach 6.2 per cent for 2013 before coming down to 5.7 per cent for 2014.

2.2.2 Commodity Prices

Commodity prices continued to face downward pressure from generally improved supply prospects and subdued demand conditions, which were exacerbated by the slower growth in emerging and developing economies.

Crude oil prices, which increased for some time during 2013Q3 on account of geopolitical tensions, are expected to remain range-bound. However, they may face some downward pressure if OPEC were to maintain output at current levels in a context where shale oil extraction has enabled many countries, including the US, to reduce oil imports dramatically. The October 2013 US Energy Information Administration (EIA) report expects the Brent crude oil price to continue to weaken, averaging US$107 per barrel during 2013Q4 and US$102 per barrel in 2014. West Texas Intermediate (WTI) crude oil prices are expected to average US$101 per barrel during 2013Q4 and US$96 per barrel during 2014[9]. Between March and September 2013, the oil price futures curves for ICE Brent and NYMEX WTI have shifted up, albeit less for ICE Brent, mainly on account of higher geopolitical risk premium and signs of improvement in the global economy. These

Chart 2.3: Monthly Average NYMEX WTI and ICE Brent and Futures Prices

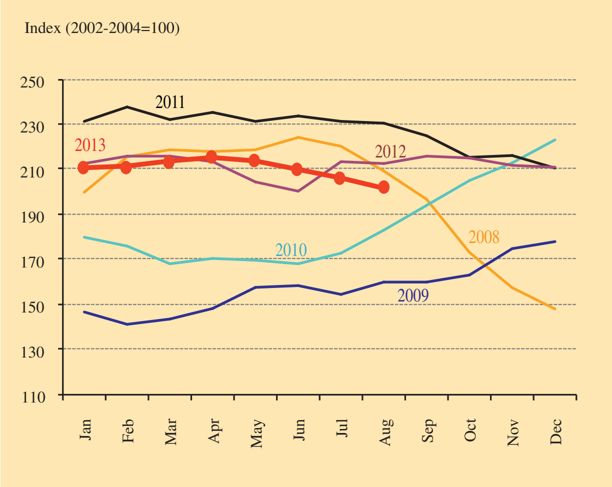


Sources: Thomson Reuters and ICE.

geopolitical tensions are expected to fade in the coming months. Current market expectation of future oil prices continue to confim the downward path of oil prices (Chart 2.3).

Global food prices remained moderate during the period under review. The Food and Agriculture Organisation (FAO) food price index that measures price changes for a basket of cereals, oilseeds, dairy, meat and sugar, fell from 210.9 points in February 2013 to 201.4 points in August 2013. This was its lowest level since June 2012 (Chart 2.4). Cereal prices have led the aggregate index down, with maize prices in particular recording significant falls on the back of good harvests in many producing areas across the globe. Looking ahead, global food prices are expected to fall on the assumption of normal weather conditions and improved harvests[10].

Chart 2.4: FAO Food Price Index



Source: FAO.

Among other commodities, metal prices retreated, reflecting the moderation in global demand, particularly from China, and high stocks for most metals. Copper prices fell by 10.8 per cent while nickel and zinc prices declined by 19.1 per cent and 10.8 per cent, respectively. Gold prices fell by 17 per cent during the period under review as investors shifted to stocks and real estate due to a rebound in investors' confidence. According to the World Bank Commodity Markets Outlook July 2013, metal prices are expected to fall due to abundant supplies and weakening demand conditions, but prospects still depend to a large degree on Chinese demand, as the country accounts for almost 45 per cent of global metal consumption[11].

[9] *Energy Information Administration.*

[10] *Food and Agriculture Organisation of the United Nations.*

[11] *World Bank Commodity Markets Outlook, July 2013.*

2.3 Exchange Rates[12]

During the period under review, currency markets were mainly influenced by major central banks' decisions, positive developments in the US and Europe and lower risk aversion among investors. Initially, the US dollar remained supported against most currencies as investors factored in that the FED would limit its quantitative easing program. Subsequently, however, weaker jobs' data that scaled back expectations that the FED would taper its monetary stimulus contributed to weakening the US currency. Between April and August 2013, the trade-weighted US dollar index depreciated by 1.4 per cent.

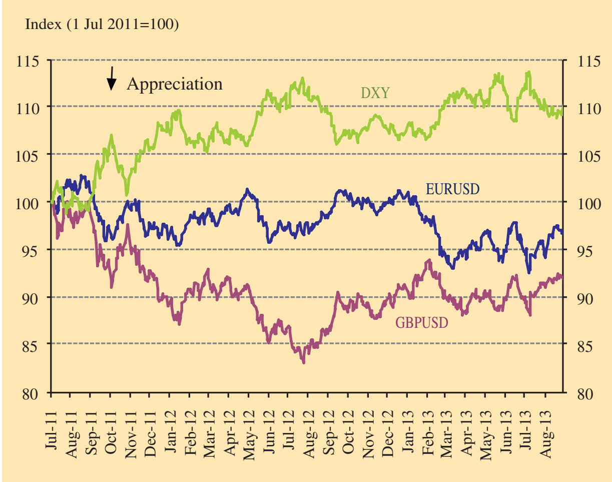
Movements of the euro were largely related to changing market expectations about the economic and financial outlook for the euro area, relative to other major economies, as well as developments in the policies of major central banks. After a slight appreciation in early June, the euro tumbled to as low as US$1.2754 on 9 July 2013, after rising borrowing costs in some peripheral euro area countries. It recovered thereafter as investors sold emerging-market currencies and shifted to less risky assets, including the euro. Better-than-expected economic reports, indicating that the economy was picking up, also supported the euro.

Among other major currencies, the Pound sterling remained mostly supported by improved domestic economic data, bolstering expectations of an early monetary tightening, whilst also capitalising on the US currency's broad-based weakness. During the period under review, the British currency appreciated to trade above US$1.56 by mid-August 2013.

The Japanese yen weakened, mainly as a result of massive monetary easing by the Bank of Japan. It crossed the 100 mark against the US dollar in May 2013.

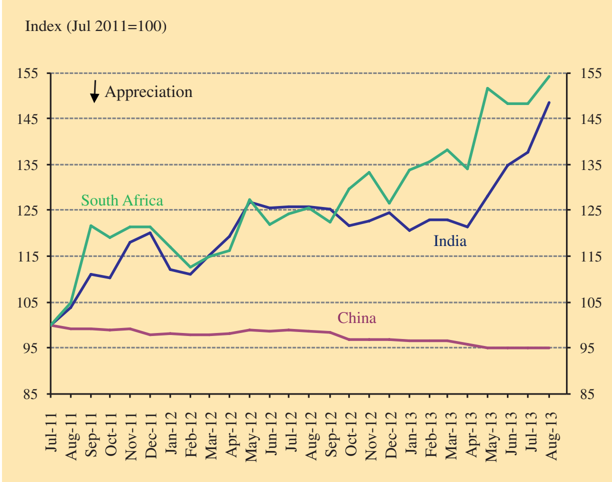
Many emerging economies saw a depreciation of their currencies as their economies weakened and capital flowed out. Except for the Chinese yuan, the BRICS currencies were all affected by important capital outflows. Countries with large current account deficits, like Indonesia and Turkey, were also affected. The Indian rupee lost more than 20 per cent of its value and fell to an all-time low of 68.80 to the US dollar by end of August 2013, while the Turkish lira, the Indonesian rupiah and the Brazilian real depreciated in the range of 10-18 per cent against the US dollar. The South African rand suffered significantly, hitting four-year lows, as poor economic data and labour market tensions additionally weighed on sentiment.

Chart 2.5: Evolution of the US dollar



Source: Thomson Reuters.

Chart 2.6: Trends of the Indices of Currencies in Emerging Markets against the US dollar



Source: Thomson Reuters.

[12] *Thomson Reuters.*

2.4 Global Monetary Policy[13]

Whilst monetary policy remained expansionary in advanced economies, central banks have been increasingly intent on providing forward guidance as to when they might eventually reduce monetary stimulus. They see forward guidance as an important step toward greater transparency about the factors that will guide policy rates and are increasingly using such guidance to communicate monetary policy and anchor market expectations.

In the US, the Federal Open Market Committee (FOMC) maintained its asset purchase program of USD85 billion per month despite an early announcement in May 2013 that it was considering to trim it down. In its forward guidance to the market, the FED pledged to keep interest rates low at least until the unemployment rate falls significantly below 6.5 per cent, and inflation rates remain close to the long-term goal of 2 per cent.

In May 2013, the ECB cut interest rates by 25 basis points to 0.5 per cent. Its forward guidance strategy makes explicit reference to rates being held at present levels, or lower, for an extended period. This was premised upon the euro area's subdued medium-term inflation outlook and broad-based weakness in the real economy, and could pave the way for another cut in the deposit facility rate.

The Bank of England (BoE) maintained both its key policy rate and its asset purchase program of GBP375 billion unchanged. Outlining its forward guidance concerning the future conduct of monetary policy at its meeting of August 2013, the BoE stated its intention neither to raise the Bank Rate nor reduce the stock of asset purchases at least until the unemployment rate has fallen to a threshold of 7 per cent.

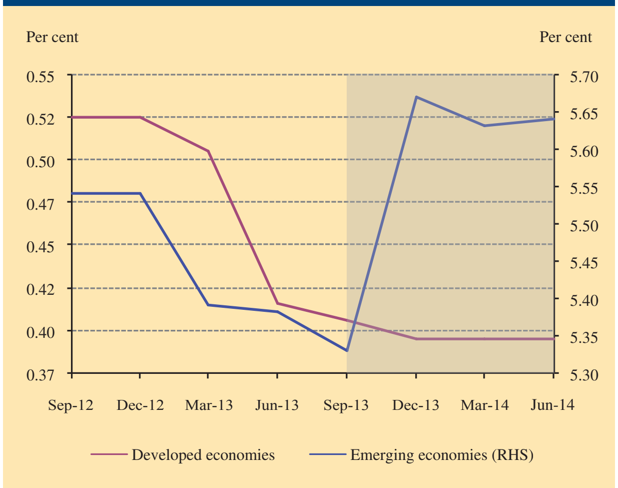
The Bank of Japan (BoJ) embarked on a more aggressive phase of quantitative easing in April to achieve an inflation target of 2 per cent. It undertook to provide a massive boost to the monetary base, which became the main operating target of money market operations instead of the uncollateralised overnight call rate.

A number of emerging market central banks tightened policy while intervening in currency markets, owing to sharp reversals of capital inflows. The People's Bank of China began to tighten the availability of liquidity in June and also removed the floor on lending rates. The Reserve Bank of India tightened interbank liquidity and raised the cost of shorting the rupee in July to restore stability in the foreign exchange market. It also increased the repo rate by 25 basis points to 7.50 per cent in September 2013 mainly on account of price pressures. The Central Bank of Indonesia raised its benchmark policy rate by a cumulative 150 basis points from June to September to 7.25 per cent in an effort to anchor inflation expectations amid the hike in subsidised fuel prices. Brazil's central bank increased rates by a cumulative 150 points in May, July and August to 9 per cent.

A smaller number of central banks reduced their monetary policy rates since the last Inflation Report. Among them, the central banks of Korea and Thailand reduced rates by 25 basis points in May 2013, on account of lower growth and contained inflation rates.

It is widely expected that central banks in emerging economies will increase key interest rates more rapidly than in advanced economies to counter exchange rate depreciation and rising inflation. Central banks in advanced economies are projected to keep key interest rates low for an extended period of time to boost growth though some of them may partially reduce monetary stimulus (Chart 2.7).

Chart 2.7: Expected Interest Rates in Developed and Emerging Economies



Source: JPMorgan.

[13] *Central Banks' websites and JPMorgan Global Data Watch.*