2. THE GLOBAL ECONOMY

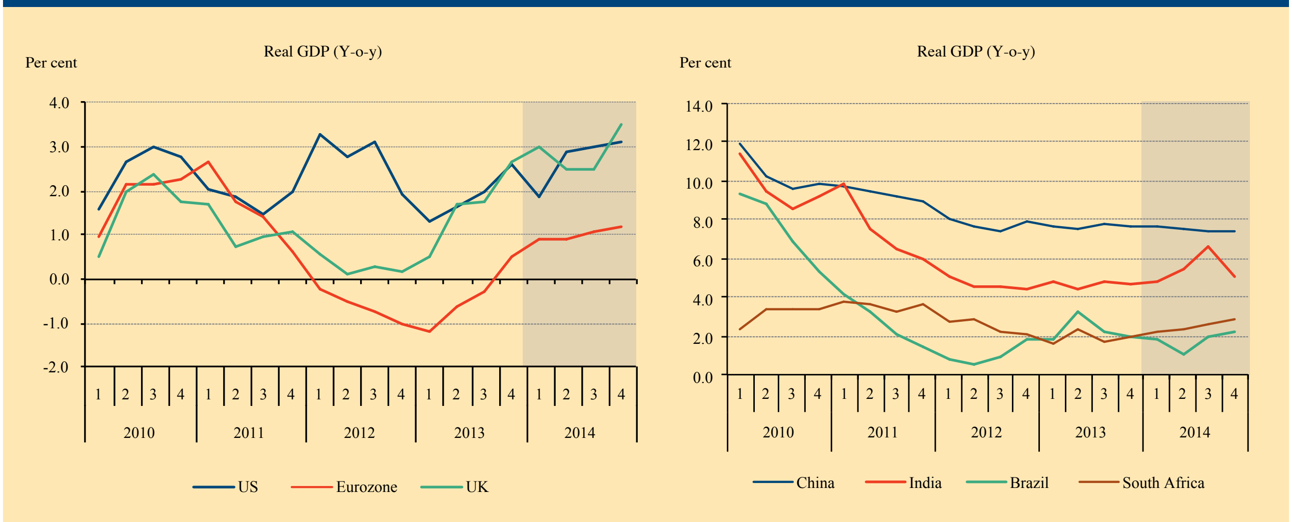
The global economy continued to recover since the October 2013 Inflation Report. While the US economy was adversely affected by fiscal uncertainties and severe weather conditions in the final quarter of 2013, it continued to grow at a reasonably robust rate. Meanwhile, the improvement in economic activity allowed the Federal Reserve to start tapering its expansive monetary policy. Conditions in the Eurozone have improved slightly and the situation is looking increasingly positive although regional differences remain. Growth across major emerging markets has slowed and some emerging economies have been exposed to capital outflows and currency depreciation. Inflation in the major economies remained low, although it had increased in some emerging economies. Looking ahead, global growth is poised to improve further in 2014, but risks to the outlook remain, mainly due to the uncertainties arising from moves to unwind unconventional monetary policies and the possibility of renewed deflation in the Eurozone[2].

2.1 Demand and Output

Recent developments confirmed the trend of an on-going recovery in advanced economies and sluggish economic activity in large emerging economies (Chart 2.1). Overall, global output is firming and, in its April 2014 World Economic Outlook (WEO), the International Monetary Fund (IMF) forecast the world economy to expand by 3.6 per cent in 2014 and 3.9 per cent in 2015, from 3.0 per cent in 2013. Shocks from adverse weather conditions in the US and Japan when coupled with geopolitical developments in Eastern Europe are expected to be temporary and to have a minimal impact on the output growth forecast for the year.

Latest global Purchasing Managers' Index (PMI) data are consistent with the view that the global economy is improving. However, they highlighted the growing disparity between advanced and emerging economies. Whilst the developed markets PMI is mostly stabilising at relatively high levels, the emerging markets PMI has continued to fall, mainly due to a sharper slowdown in China (Chart 2.2)[3]. In its latest WEO, the IMF maintained the growth outlook for advanced economies for 2014, but downgraded the growth forecast for emerging and developing market economies by 0.2 percentage points to 4.9 per cent.

Chart 2.1: Growth in Selected Economies



Source: OECD, JPMorgan and Thomson Reuters

2 *IMF's April 2014 World Economic Outlook*

3 *JPMorgan Purchasing Managers' Index releases, Markit Economics*

Advanced economies are replacing emerging economies as the main drivers of global growth. The US economy has markedly recovered on the back of better economic fundamentals as a result of less severe budget cutting, a recovering housing market and an easy monetary policy stance[4]. Consumer and business sentiment remained at solid levels while the labour market continued to improve, with the unemployment rate at 6.7 per cent in February 2014. Conditions in the manufacturing and services sectors improved in March, as reflected by the ISM PMIs. Despite severe US weather conditions in 2014Q1, growth for the year is expected to increase to 2.8 per cent, from 1.9 per cent in 2013.

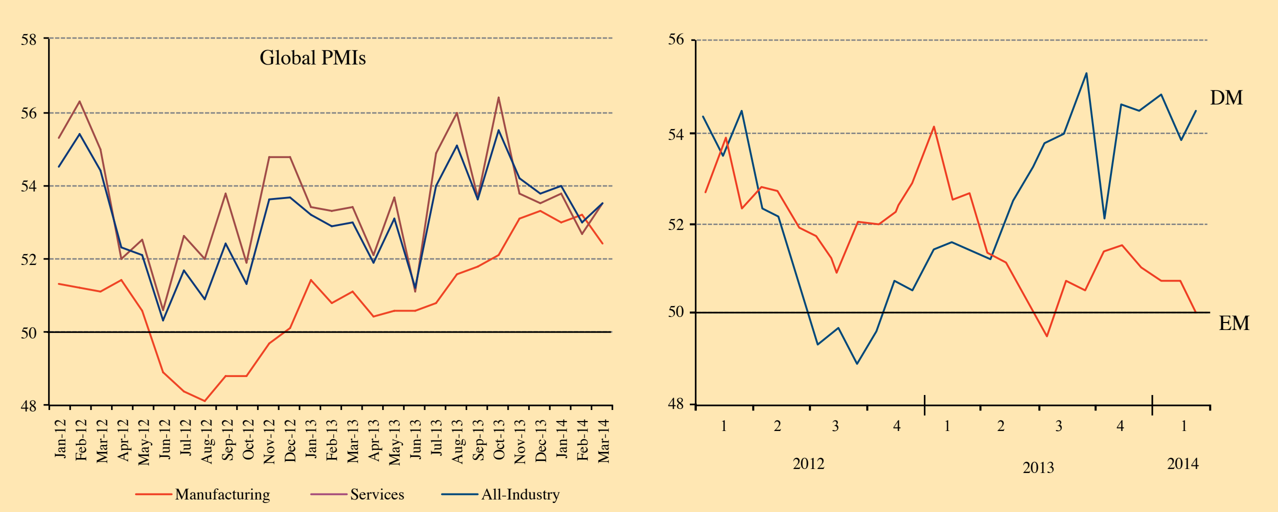
Whilst latest indicators for the Eurozone point to better economic performance, the growth momentum remains weak[5]. The recovery is still unbalanced from a regional perspective, with the major French economy showing some signs of weakness whereas Germany continues to power ahead. The upbeat German performance had positive spill-over effects on other core economies, including Spain and Italy. Peripheral economies also registered an improvement in economic activity. The PMI surveys for March were consistent with higher Eurozone growth for 2014Q1, but major issues, like high unemployment rate, low inflation and financial reforms, are still to be resolved. The IMF expects growth in the Eurozone to rise to 1.2 per cent in 2014.

The UK recorded one of the fastest expansion rates among advanced economies in 2013Q4[6]. The labour market continued to stabilise, with improved consumer confidence. Business surveys as well as manufacturing and services PMI suggest that economic activity remained buoyant at the beginning of 2014. Low inflation, a booming housing market and rising employment levels as well as continued monetary accommodation are expected to support growth, which the IMF forecast at 2.9 per cent in 2014.

The IMF trimmed its forecasts for some of the largest emerging market economies, including Russia, Turkey, Brazil and South Africa, which were affected by geopolitical factors, financial markets volatility in the wake of the US Fed tapering, and structural problems. The Chinese economy continued to grow, but at a slower pace than in previous years as it faced lower global demand and undertook significant reforms to improve its credit market. The latest HSBC Manufacturing PMI for China confirmed the weakness of the manufacturing sector amid clear signs that the risks to growth are tilting to the downside. India's economy remained weak due to high inflation and tighter monetary policy. Manufacturing activity picked up in 2014Q1 but the recovery is still likely to be delayed due to lingering structural constraints.

Global trade conditions improved in 2013Q4. Latest data from the Netherlands Bureau of Economic Research indicated that global trade volumes went up by 4.6 per cent in the year to December 2013, with a 7.7 per cent expansion in imports of emerging economies being the main driver of higher trade volumes (Chart 2.3)[7]. Looking ahead, the recovery in the US economy and in the Eurozone in 2014

Chart 2.2: JPMorgan Global Purchasing Managers' Index



Source: JPMorgan.

[4] *US Bureau of Economic Analysis* [5] *Eurostat* [6] *OECD*

[7] *Netherlands Bureau for Economic Policy and Analysis*

should contribute to higher growth in world trade. The IMF expects world trade to grow by 4.3 per cent and 5.3 per cent in 2014 and 2015, respectively, after exceptionally low growth in 2012 and 2013.

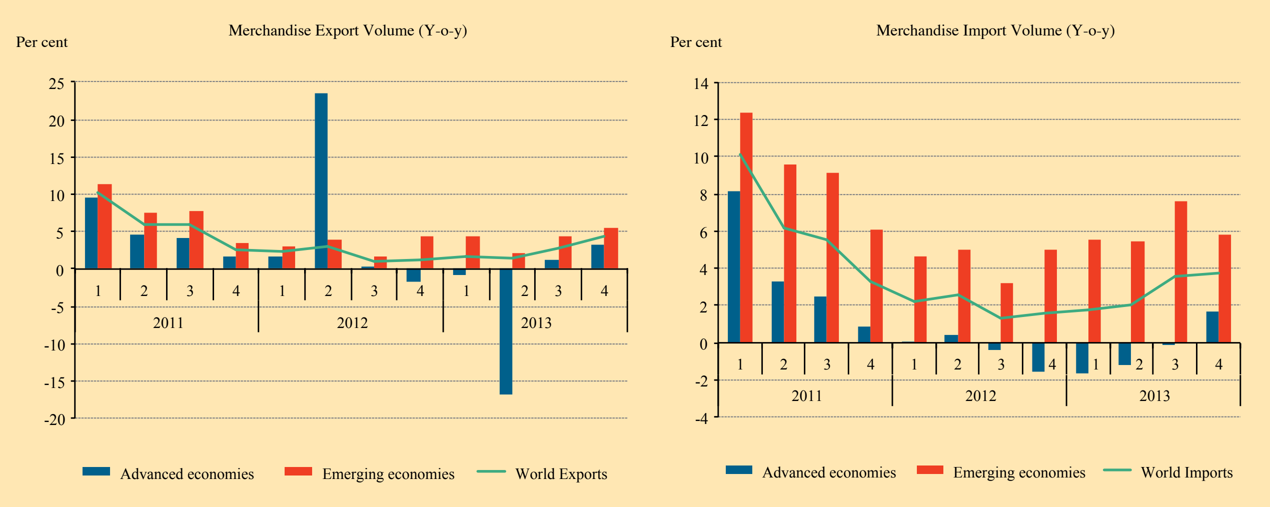
2.2 Recent Developments in Prices

2.2.1 Consumer Price Inflation

Global inflation has moderated recently reflecting modest global growth, sluggish demand and generally stable food and oil prices. Consumer price inflation continued to fall in advanced economies, raising the fear of deflation particularly in the Eurozone. In emerging market and developing economies, although inflation has eased, there are upside risks due to weakening exchange rates.

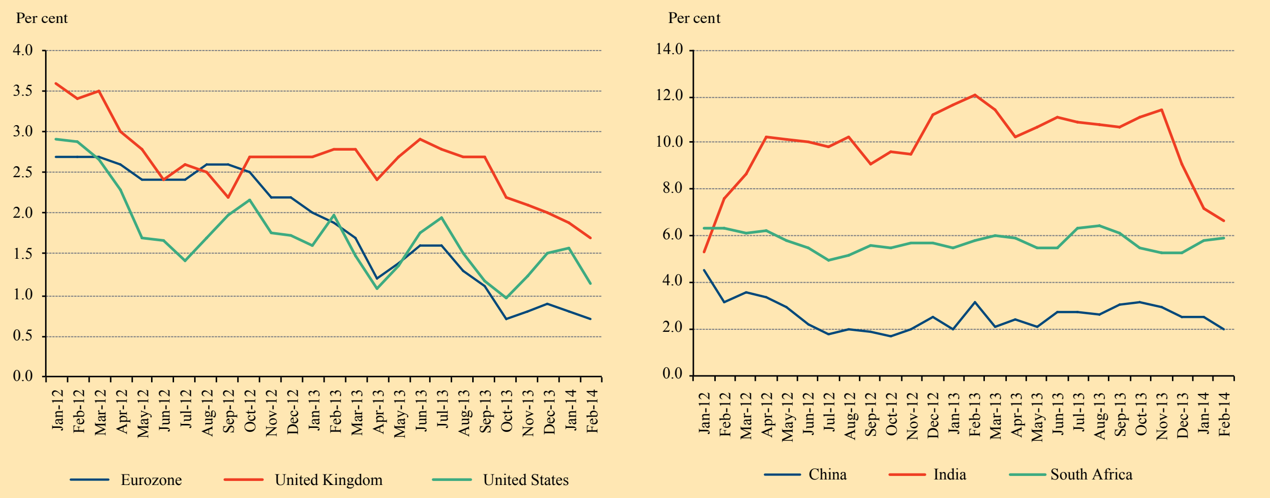
In the US, inflation reached 1.1 per cent in February 2014 given persistent weakness in energy prices. Inflation in the Eurozone eased substantially to 0.5 per cent in March 2014, well beneath the European Central Bank's (ECB) definition of price stability, of inflation below but close to 2 per cent. The ECB expects underlying price pressures to remain subdued over the medium term. In the UK, the inflation rate came down following slower increases in the prices of food as well as recreational

Chart 2.3: Global Trade Growth



Source: Netherlands Bureau of Economic Research

Chart 2.4: Consumer Price Inflation in Selected Economies



Source: OECD and The Economist.

goods and services. Among the major emerging and developing economies, inflation in China edged down in February 2014. It fell considerably in India, mainly on account of a significant fall in food prices (Chart 2.4).

The IMF projected that inflationary pressures would remain subdued in 2014, with output remaining below potential in advanced economies and close to or somewhat below potential in emerging market and developing economies. In 2015, prices are expected to rise moderately as economic growth strengthens.

2.2.2 Commodity Prices

Commodity prices remained broadly stable in 2013Q4. However, in 2014Q1 signs of strengthening global activity and adverse weather conditions impacted negatively on some commodity prices. The outlook for commodity prices for the remainder of 2014 would depend on demand and supply conditions.

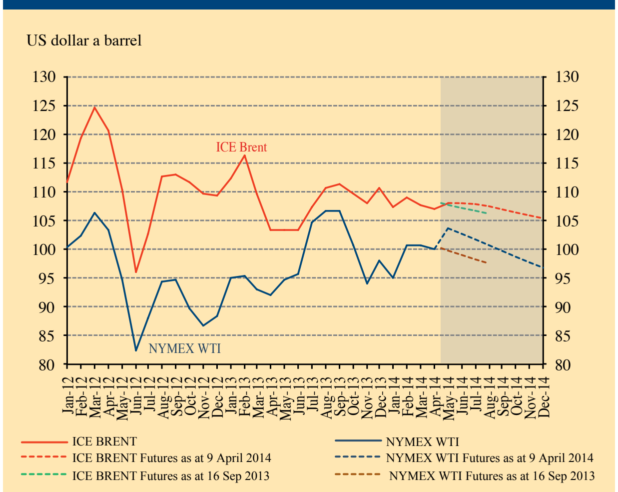
While ICE Brent crude oil prices have remained mostly stable since the last Inflation Report, NYMEX WTI prices fell significantly, mainly on account of higher supply from North America. They recovered thereafter amid geopolitical tensions and increased demand in the US due to the cold weather. ICE Brent averaged US$107.7 a barrel in March 2014 while WTI crude prices averaged US$100.5 a barrel. Looking ahead, oil prices, based on market expectation of future oil prices as at 9 April 2014, are projected to decline during 2014 (Chart 2.5). The March 2014 US Energy Information Administration (EIA) report expects the Brent crude oil price to weaken as non-OPEC supply growth exceeds growth in world consumption. The Brent crude oil price is projected to average US$105 per barrel and US$101 per barrel in 2014 and 2015, respectively[8].

After stabilising for the most part of 2013, food prices started to rise in early 2014, largely supported by the political uncertainty in Eastern Europe and adverse weather conditions affecting crop productions in various regions of the world. The Food and Agriculture Organisation's (FAO) food price index averaged 212.8 points in March 2014 compared with 205.8 in December 2013 (Chart 2.6)[9]. However, the production outlook is favourable for most major crops.

2.3 Exchange Rates[10]

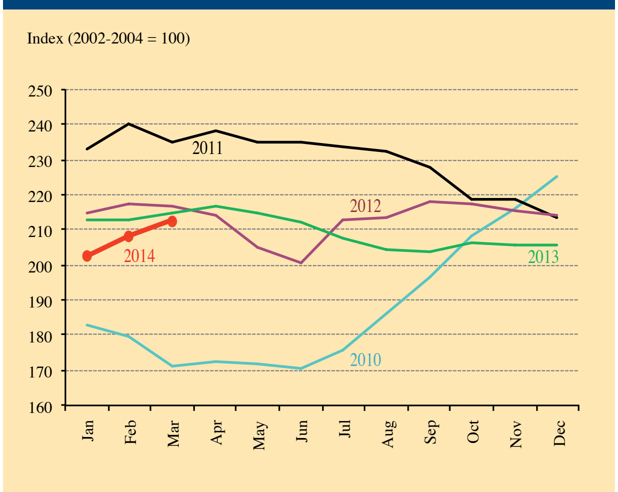
Currency markets were mainly influenced by the improving growth dynamics in advanced economies and the projected pace of normalisation in their monetary policies. The US dollar initially strengthened on signs that the US economy remained on a healthy growth track, but thereafter lost ground as its safe haven appeal diminished. The euro, which had been affected by the threat of deflation in the Eurozone, subsequently reversed trend on the back of capital flows into Europe and ECB interest rate policy. Over the medium term, a bullish view of the US dollar against major peer currencies is

Chart 2.5: Monthly Average NYMEX WTI and ICE Brent and Futures Prices



Sources: Thomson Reuters and ICE.

Chart 2.6: FAO Food Price Index



Source: FAO.

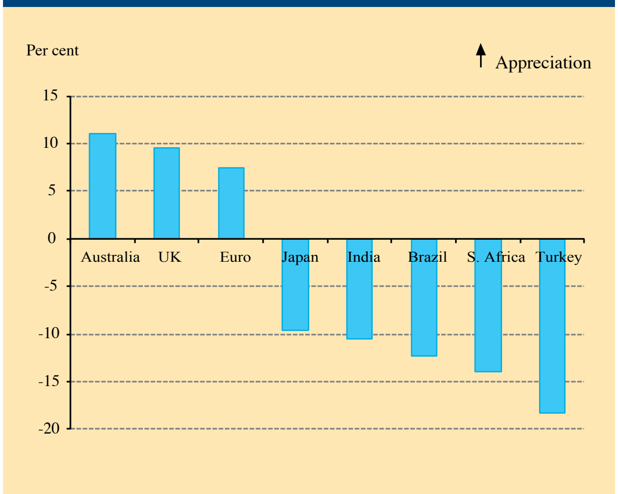
[8] *Energy Information Administration* [9] *Food and Agriculture Organisation of the United Nations* [10] *Thomson Reuters*

maintained with the expected gradual normalisation of monetary policy in the US. As the Fed moves away from unconventional policy instruments, the euro is projected to face a weakening bias.

Among the currencies of other advanced economies, the Pound sterling rallied against the US dollar as a result of relatively better economic performance and expectations of higher interest rates. The Japanese yen remained the best performing developed market currency in 2014, though it might resume a weakening trend due to the Bank of Japan turning to more aggressive policy measures.

A number of emerging market economies with large current account deficits saw their currencies stumbling against the US dollar as the US Fed started to wind down its massive stimulus although their currencies have recently recovered. The Indian rupee stabilised, reflecting a much improved external balance, following government measures to temporarily reduce the current account deficit. While the Brazilian real fared better, it is expected to remain sensitive to asset allocation shifts in favour of developed markets and retain a fragile tone in the near term. The Turkish lira recovered about 7 per cent against the US dollar following aggressive tightening by the central bank at the end of January 2014, but it has since weakened slightly again on political instability. With regard to the South African rand, increased investor unease resulting from frequent bouts of labour unrest, combined with the country's twin deficits and modest stock of foreign reserves, continued to expose the currency to capital flows and exchange rate volatility (Chart 2.7). The Chinese Yuan has sharply changed direction, weakening against the US dollar at the end of February as the central bank re-introduced two-way risk, increasing speculation over a potential shift in the exchange rate mechanism in place.

Chart 2.7: Performance of Selected Currencies against the US dollar (March 2013 – March 2014)



Source: Thomson Reuters.

2.4 Global Monetary Policy[11]

The stance of monetary policy in advanced economies remained highly accommodative although the US Fed has begun to taper its large-scale asset purchase programme. At its March 2014 meeting, the Fed modified its so-called forward guidance for a potential interest rate hike, acknowledging that the 6.5 per cent unemployment rate threshold had become outdated. The Fed removed this threshold and moved towards a reference to progress toward its objectives of maximum employment and 2 per cent inflation. There are expectations in the market that the Fed could now raise interest rates sooner than previously thought.

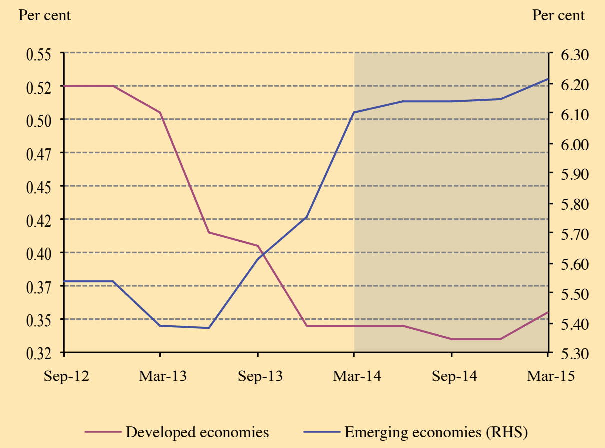
The ECB reduced interest rates to 0.25 per cent in November 2013 upon a prolonged period of low inflation below the 2 per cent target. It also reaffirmed its forward guidance for monetary policy to remain accommodative for as long as necessary. While the Bank of England (BoE) left its Bank rate at 0.5 per cent, Britain's surprisingly strong turnaround forced the central bank to come up with a new version of its forward guidance policy that focusses on a wider assessment of spare capacity in the economy. The BoE also indicated that the first rate hike could come in the second quarter of 2015.

The Bank of Japan (BoJ) maintained its accommodative monetary policy stance and extended special loan programs to support economic growth, signalling its resolve to prevent the reflationary policies from fading. The central bank reiterated its upbeat view on the economy and suggested that any additional stimulus would not be for the immediate future.

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

The central banks of Brazil, India, Turkey and South Africa had to significantly raise their policy rates at the start of 2014 to quell inflationary pressures arising from a depreciation of their currencies. Generally, emerging market central banks remain under pressure to raise rates further to ensure that the real yields on their domestic assets remain internationally competitive as they balance the dampening impact on economic activity from higher rates against rising inflation from a decline in their exchange rates (Chart 2.8).

Chart 2.8: Expected Policy Rates in Developed and Emerging Economies



Source: JPMorgan.