1 The International Economy

Emerging Market Concerns Weigh On Global Growth In 2015

Global economic growth slackened in Q2 2015, with a rebound in the US unable to fully compensate for more subdued outturns in the Eurozone and Japan, as well as weakening momentum in emerging economies. Growth in Asia ex-Japan eased, led by slowing industrial activity in China—the erstwhile locomotive for emerging markets. Goods exports from the region have been disappointing, dragged down by the commodity downturn as well as sluggish global demand. Longer-term factors, including an ongoing reconfiguration of the region's cross-border production networks, could also have played a part in exacerbating the decline in trade flows.

Looking ahead, the G3 economies are expected to stay on a path of modest expansion, with the US recovery sufficiently entrenched for the Federal Reserve to contemplate a policy rate hike by the end of this year, while in the Eurozone and Japan, the pickup in economic activity is envisaged to be more gradual. However, the positive effects that steady growth in the G3 would have on exports from Asia ex-Japan are likely to be limited, given the consumption- rather than investment-driven expansions in all three economies. Further, the region will have to confront the gathering headwinds from China's slowdown, tighter external financing conditions, and domestic idiosyncratic factors including political uncertainty and flagging reforms. Overall, the outlook for global growth has softened, compared to the last Review, dipping slightly to 3.9% in 2015 from 4.1% last year, before recovering to 4.0% in 2016. (Table 1.1)

Global headline inflation remained subdued, mostly on account of a renewed decline in oil prices over the period Jun–Aug, even as food prices moderated. Sustained low inflation also reflected persistent slack in some advanced economies as well as decelerating activity in Emerging Asia. As such, several central banks have eased monetary policy, which should offer some support to growth in the quarters ahead.

Table 1.1
Global GDP Growth

(%)

	Q1 2015	**Q2 2015**	**2014**	**2015F**	**2016F**
	q-o-q SAAR		y-o-y		
Total*	**3.9**	**3.3**	**4.1**	**3.9**	**4.0**
G3*	**2.1**	**1.8**	**1.3**	**1.7**	**2.0**
US	0.6	3.9	2.4	2.5	2.6
Japan	4.5	−1.2	−0.1	0.6	1.3
Eurozone	2.1	1.4	0.9	1.5	1.7
NEA-3*	**2.9**	**−0.9**	**3.1**	**2.1**	**2.4**
Hong Kong	3.0	1.6	2.5	2.3	2.2
Korea	3.3	1.3	3.3	2.5	2.9
Taiwan	2.3	−6.6	3.8	1.4	2.4
	y-o-y				
ASEAN-4*	**4.8**	**4.5**	**4.7**	**4.5**	**4.6**
Indonesia	4.7	4.7	5.0	4.7	5.0
Malaysia	5.6	4.9	6.0	4.8	4.6
Philippines	5.0	5.6	6.1	5.7	5.9
Thailand	3.0	2.8	0.9	2.6	3.3
China	**7.0**	**7.0**	**7.3**	**6.8**	**6.5**
India**	**7.5**	**7.0**	**6.9**	**7.3**	**7.5**

Source: CEIC, Consensus Economics, Oct 2015 and EPG, MAS estimates
* Weighted by shares in Singapore's NODX.
** Refers to fiscal year ending March.

1.1 G3 Economies

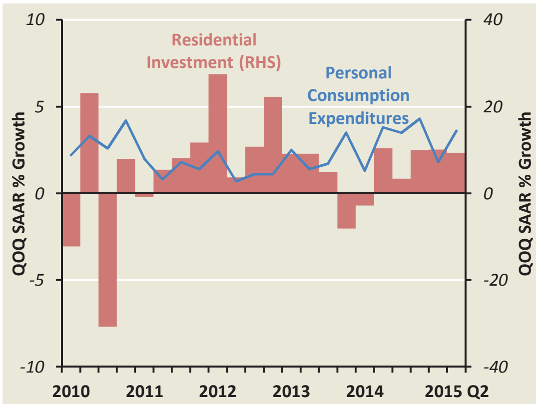
A Modest Upturn With Limited Positive Spillover Effects

The US economy picked up pace in Q2 2015, mainly on the back of stronger private consumption. Yet, against the backdrop of elevated financial market volatility and slower growth in emerging markets, the Federal Reserve decided not to raise the policy rate in September, while retaining the possibility of a hike in December. The Eurozone managed to maintain moderate growth momentum despite softer domestic demand in the core economies, but the Japanese economy contracted unexpectedly due to weak household consumption and exports. On the whole, growth in the G3 economies is expected to rise to 1.7% in 2015 and further to 2.0% in 2016. However, this is likely to provide less support to global growth via the trade channel than in previous upturns, as it is driven more by consumption of services, which have lower import content.

Consumer spending has underpinned US growth.

US GDP growth rebounded to 3.9% q-o-q SAAR in Q2 2015 from a tepid 0.6% in the previous quarter. The growth rate of 2.3% registered in the first half of this year was a discernible, though modest, improvement from the average of 2.1% achieved since the recovery commenced in 2010. Private consumption continued to underpin the recovery, with growth picking up to 3.6% in Q2 from 1.8% in Q1, as households benefited from lower oil prices, steady employment growth and modest wage increases. (Chart 1.1) Unlike in Q1, net exports no longer detracted from overall growth in Q2, with goods exports recording a sharp turnaround as the effects of the West Coast port strikes faded.

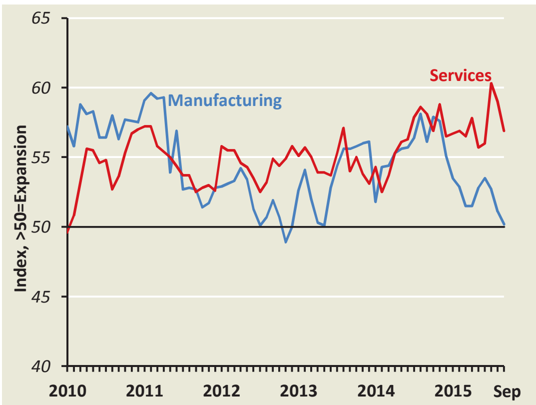
Chart 1.1
US Personal Consumption and Residential Investment



Source: Bureau of Economic Analysis

In Q2 2015, residential investment expanded at a robust pace of close to 10% q-o-q SAAR for the third consecutive quarter. (Chart 1.1) New home sales volumes reached a post-crisis high, while inventories of homes available for sale have been pared back. Overall, however, gross fixed capital formation (GFCF) continued to disappoint. It took six years for US investment to return to its pre-GFC level in Q1 2014, compared to 2–4 years in past recoveries. The US is not alone in experiencing a muted capex upturn—investment in the advanced economies as a whole grew by only 2.1% p.a. between 2011 and 2014, well short of the 2.5–3.5% seen in past recoveries. On a sectoral basis, moreover, US economic activity appears to be driven more by services, which tend to have lower import content compared to manufacturing. (Chart 1.2) Indeed, new export orders in the manufacturing sector contracted for the fourth straight month in September.

Chart 1.2
Manufacturing and Services PMI



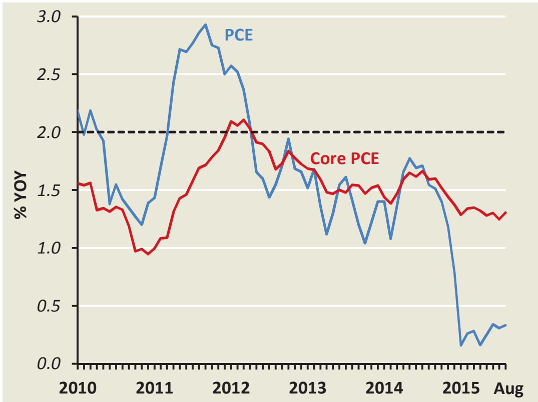
Source: Institute for Supply Management

The ongoing deceleration in production is likely to have been exacerbated by the strong US dollar. The cumulative dollar appreciation of 15% since Q3 2014 has contributed to weak net exports, which subtracted 0.6% point from GDP growth between Q3 2014 and Q2 2015.

Taken together, these developments imply that the moderate recovery in the US may not generate large positive spillovers for the rest of the world, including the trade-oriented economies of Asia. Conversely, weakening growth in emerging market economies (EMEs) may restrain US economic activity somewhat.[1]

Since the beginning of the year, core PCE inflation has not experienced an appreciable pickup even as the headline unemployment rate has fallen to 5.1%—in the vicinity of most estimates of full employment. (Chart 1.3) Other labour market developments, such as the decline in the labour force participation rate and muted wage growth, suggest that there is still some slack in the economy. Given the absence of a pickup in inflationary pressures, the Federal Reserve has deferred the decision to raise interest rates, possibly to the end of this year. With the pace of interest rate normalisation expected to be gradual and unlikely to derail growth, US GDP is projected to strengthen to 2.5% this year and 2.6% in 2016.

Chart 1.3
US PCE and Core PCE Inflation

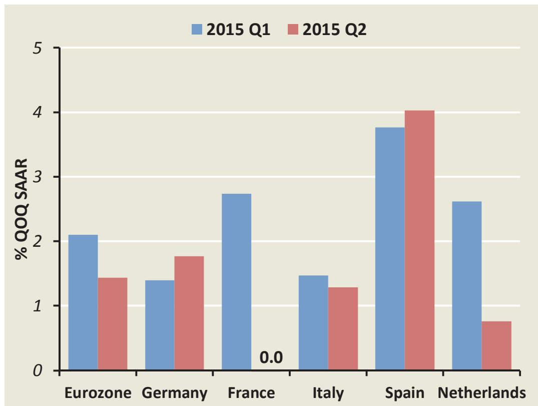


Source: Bureau of Economic Analysis

Growth in the Eurozone eased in Q2 …

Eurozone growth retreated to 1.4% q-o-q SAAR in Q2 2015, from a relatively vigorous 2.1% in the preceding quarter. (Chart 1.4) Weaker growth momentum in France, Italy and the Netherlands accounted for the moderation in the headline figure. In comparison, Germany and Spain expanded by 1.8% and 4.0% respectively, supported by buoyant exports and a recovering labour market. From an expenditure perspective, the composition of Eurozone growth bore some similarities with that in the US—consumer spending was resilient while private investment faltered, registering an outright contraction from the previous quarter. However, unlike in the US, the Eurozone benefited from firmer net exports on account of the weaker euro.

Chart 1.4
Eurozone GDP Growth



Source: Eurostat

… but is poised to pick up slightly in H2 2015.

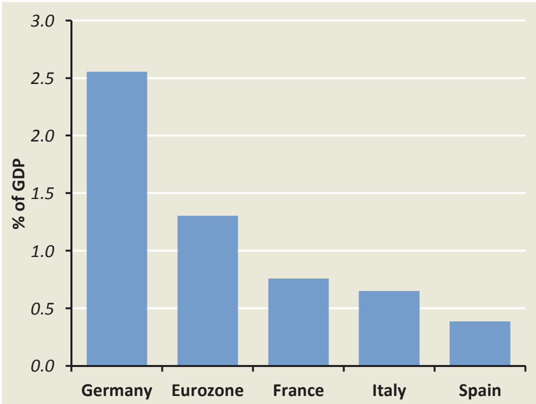
Together with the US, the Eurozone is expected to be one of the brighter spots in the global economy.

[1] Similar views were reflected in the minutes of the Federal Open Market Committee, Federal Reserve System, September.

The ECB's bold decision to launch quantitative easing (QE) earlier this year has led to an easing of financial conditions, which in turn contributed to a pickup in bank lending to both households and firms, to 1.0% y-o-y and 0.4% y-o-y in August, respectively. Consumption spending is likely to firm on the back of steady wage growth and employment gains, while real disposable incomes will continue to be supported by low inflation. Moreover, the uncertainties stemming from the Greek debt situation have been mitigated, with the country entering into a new bailout programme.

Nonetheless, new downside risks to growth have emerged, chiefly in the form of a deterioration in the external environment. The slowdown in EMEs, especially China, will pose a drag on the Eurozone's exports, particularly for Germany. (Chart 1.5) Automobile exports could be severely affected in the wake of the Volkswagen emissions scandal, in which Europe's largest carmaker admitted to misstating diesel vehicle emissions. More generally, cutbacks in consumption and investment spending by EMEs will impact the recovery in the Eurozone more than in the US, given the former's higher dependence on trade. These downside risks, in addition to persistent weakness on the inflation front, have left the door open for the ECB to intensify its QE programme. Meanwhile, discretionary fiscal policy remains constrained and is unlikely to provide significant support to growth. The assimilation of large numbers of refugees could impose substantial fiscal costs, thus delaying the attainment of fiscal targets in some deficit countries. Germany alone is expected to incur an additional €10 billion, or 0.3% of GDP, in public spending on account of the refugee crisis.[2] On balance, growth in the Eurozone is projected at 1.5% this year and 1.7% in 2016.

Chart 1.5
Eurozone Exports to China



Source: Haver Analytics

Improving domestic demand in Japan will support a gradual recovery.

The Japanese economy contracted by 1.2% q-o-q SAAR in Q2 2015, following strong growth of 4.5% in the first quarter. The decline in Q2 was mainly due to a fall-off in private consumption and net exports. The decrease in household spending of 2.7% q-o-q SAAR, caused partly by unseasonal weather, came after three quarters of moderate expansion. While residential investment has continued to improve since Q1 2015,

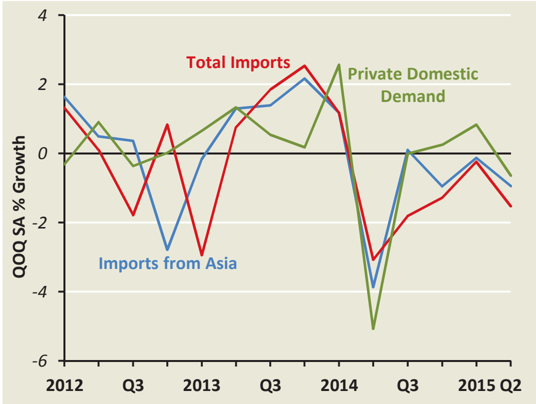
2 Deutsche Welle (2015), "Refugee Crisis to Cost Germany 10 billion euros", (URL http://www.dw.com/en/refugee-crisis-to-cost-germany-10-billion-euros/a-18696346), September 6.

non-residential investment pulled back in Q2 after a double-digit increase in the previous quarter. Meanwhile, Japan's imports shrank in tandem with the decline in private consumption and non-residential investment (Chart 1.6), while exports plunged by even more due to tepid Asian demand. As a result, net exports subtracted 1.1% points from overall GDP growth in Q2.

The weakness in shipments to Asia, which make up about 54% of Japan's total exports, can be traced to the slowdown in China (18% of total exports). The sharp pullback in China's capex amid excess capacity in a number of industries has significantly reduced the country's absorption of capital goods imports. In Q2 2015, Japan's real exports of machinery to China, including industrial and electrical machinery and transport equipment, contracted by 7.7% y-o-y. Similarly, machinery exports to the ASEAN-10[3] economies fell by 5.0% over the same period, reflecting depressed private investment activity in the region as a whole.

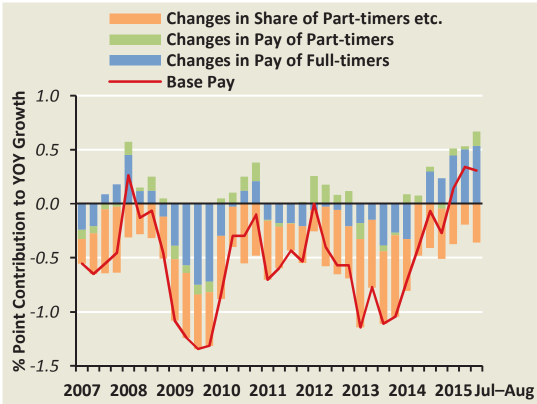
In view of these recent trends, exports are not envisaged to contribute strongly to Japan's growth in the coming quarters, notwithstanding the weak yen. However, a steady pickup in private consumption—undergirded by lower oil prices and rising wages—should still support a gradual recovery in the economy. The successful wage negotiations earlier this year have resulted in a moderate increase in base pay (excluding overtime pay and bonuses) of 0.3% y-o-y in Jul–Aug 2015. At the same time, downward pressure on wages stemming from increased participation by part-timers in the labour force has also been waning. (Chart 1.7) In addition, private non-residential investment is expected to pick up gradually alongside healthy corporate profits and diminishing industrial excess capacity, as indicated by the latest BOJ Tankan survey. All in, the Japanese economy is projected to grow by 0.6% in 2015 and 1.3% in 2016.

Chart 1.6
Japan Domestic Demand and Imports



Source: CEIC and EPG, MAS estimates

Chart 1.7
Decomposition of Changes in Japan Base Pay



Source: CEIC, Japanese Ministry of Health, Labour and Welfare, and EPG, MAS estimates

Note: The base pay measure is a weighted average of amounts paid to full-timers and part-timers; shifts in shares between the two categories may occur. The percentage point contributions are estimated by weighting the respective y-o-y changes by each category's share of overall base pay in the previous year. The changes arising from the compositional shift in type of employee fall into the residual, defined as "Changes in Share of Part-timers etc.".

[3] ASEAN-10 economies consist of ASEAN-4, Brunei Darussalam, Cambodia, Lao PDR, Myanmar, Singapore, and Vietnam.

1.2 Asia

The Growth Outlook Has Dimmed

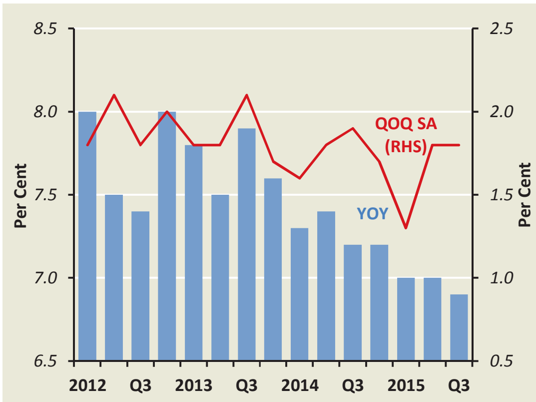
Asia ex-Japan saw a broad-based growth deceleration in Q2, as exports registered a dismal performance alongside more muted domestic demand growth. China's current transition towards a less investment-driven growth model, together with deleveraging efforts, has impacted negatively on regional trade flows of primary commodities, as well as intermediate and final goods. In the third quarter of 2015, the large corrections in the Chinese stock market and the uncertainty surrounding the country's revamp of its exchange rate fixing mechanism triggered a bout of currency volatility and a wave of investor pessimism.

In the quarters ahead, Asia ex-Japan will continue to contend with three major transitions—downward momentum in China's economy, tightening financial conditions accompanied by rising borrowing risks, and a generalised downshift in trade. Buffeted by these headwinds, the immediate growth outlook for the region has dimmed. Moreover, political uncertainty in some countries is hindering reforms and impeding longer-term potential growth. Consequently, growth in Asia ex-Japan is projected to come in at a lower 4.7% in 2015, before rising marginally to 4.8% in 2016.

China's growth is likely to slow next year, as the efficacy of policy easing measures wanes …

In Q2 2015, China's economy grew by 7.0% y-o-y, on par with the previous quarter's performance. (Chart 1.8) In sequential terms, growth rose to 1.8% q-o-q SA in Q2, from 1.3% in Q1. Headline growth in the second quarter held up on account of a 17.5% y-o-y year-to-date surge in financial services value added, attributable to increased brokerage activity, as the stock market boomed in Q2. Meanwhile, trade-related services posted slower growth from a year ago, as both exports and imports contracted. At the same time, growth slackened in secondary industries, with weaker expansions recorded by the manufacturing and construction sectors. Against a backdrop of substantial industrial slack and subdued real estate construction activity, fixed asset investment (FAI) rose by a slower 11.4% y-o-y year-to-date in Q2, down from 13.5% the quarter before.

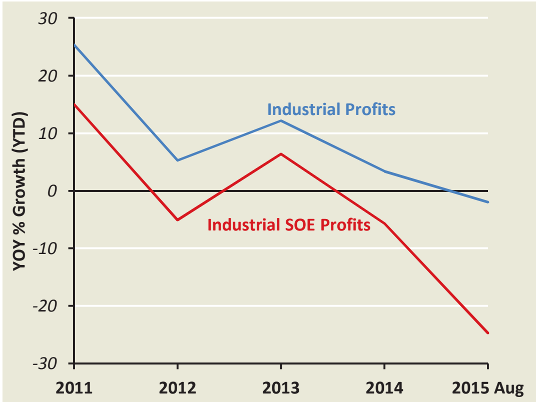
Chart 1.8
China GDP Growth



Source: CEIC and EPG, MAS estimates

China's GDP growth slipped to 6.9% y-o-y in Q3, amid a continued slowdown in industrial production and FAI growth. In sequential terms, the economy expanded by 1.8% q-o-q SA, the same as the previous quarter. Going into 2016, the country's GDP growth rate is likely to decelerate further, although successive policy measures rolled out since last year will cushion economic activity to some extent. Following a series of policy rate and reserve requirement cuts since November 2014, the government has intensified fiscal policy support through infrastructure investment, tax reductions and increased lending by policy banks. Nonetheless, the impact of these measures could be blunted somewhat by a number of factors. First, the persistence of excess capacity and supply gluts in China has inserted a wedge between improved final demand and higher production. In turn, corporate fixed investment will likely be hampered. Second, some local government officials were reportedly hesitant to execute stimulus-financed investment projects, concerned that they would run afoul of the central government's anti-corruption campaign which continues unabated.[4] Third, shrinking industrial profits and heightened risk aversion in the wake of the Chinese stock market correction could also dampen firms' and households' willingness to invest and consume. (Chart 1.9) Indeed, China's consumer confidence index has been sliding since May 2015.

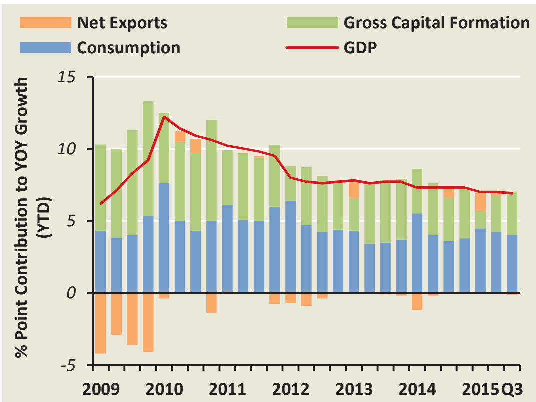
Chart 1.9
China Industrial Profits



Source: CEIC and EPG, MAS estimates

Despite the near-term slide in consumer sentiment, consumption has been a resilient component of China's GDP growth over the past decade, accounting for slightly over half (51%) of its growth from 2005–14, from a low of 36% in 2003. In the first half of this year, its contribution went up to 58%. (Chart 1.10) Meanwhile, the role of gross capital formation (GCF) has been more volatile. After falling to a low in 1997, its contribution to GDP growth has fluctuated substantially, in part due to the role of investment as a countercyclical tool. For example, in 2009, GCF accounted for 86% of growth, as Beijing embarked on an investment-led stimulus to counter a plunge in external demand. By H1 2015, its share of GDP expansion had tapered to around a third. With the exception of 2009, China's net exports have played a relatively modest role in recent years, adding only 0.1% point to growth last year, compared with nearly 2% points in 2006. In the medium term, China's policies to rebalance its economy away from an investment-led model to one that is more consumption-driven should result in more sustainable and stable growth.

Chart 1.10
Contribution to China GDP Growth



Source: CEIC

In the short term, however, a gradual deceleration in China's growth can be expected, from both the supply and demand perspectives. On the supply side, labour force growth will be limited by the projected fall in China's working-age population. Prospects for a marked pickup in China's total factor productivity growth could also be stymied if structural reforms are carried out more slowly than planned. In terms of the structure of demand, China's services industry has seen

4 Kang, L B (2015), "China seizes up to $157 billion of unspent local government budgets", *Reuters*, September 14.

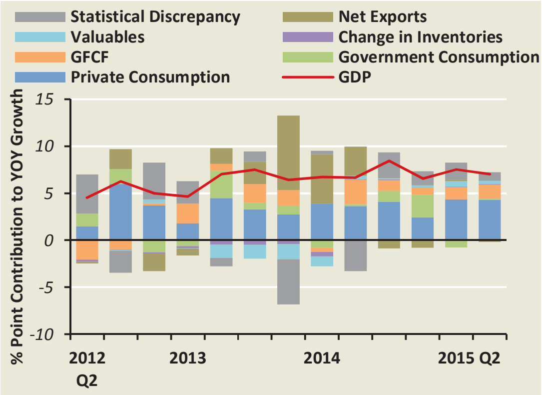
its share of GDP rise to around 48% in 2014, compared with the combined 43% contribution from manufacturing and construction. However, the services sector's already robust expansion will not be sufficient to offset the effects of subdued export demand and weak industrial output on overall growth. Taking these developments into consideration, China's growth is projected to dip to 6.8% this year and fall further to 6.5% in 2016.

… while India's economy is on an upswing.

The Indian economy expanded strongly by 7.0% y-o-y in Q2 2015, albeit slower than the 7.5% seen in the previous quarter. (Chart 1.11) Private consumption, the main driver of the expansion in Q2, contributed 4.3% points to headline growth, as the effects of earlier monetary easing and lower oil prices filtered through to the economy. GFCF also ratcheted up in tandem with the government's infrastructure push, recording a 4.9% y-o-y increase. Reversing a contraction of 7.9% in Q1, when the administration consolidated spending to meet the fiscal year-end target, government expenditure added to growth in Q2 with a 1.2% expansion.

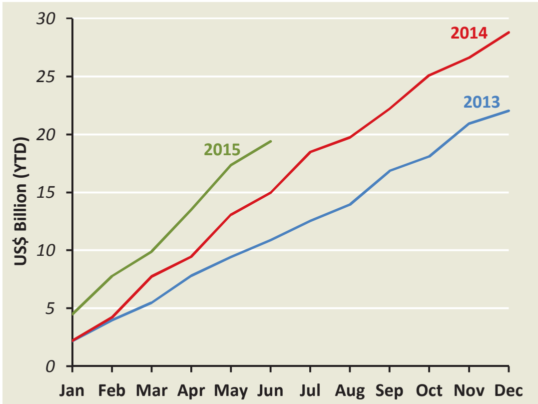
Looking ahead, India's GDP growth is expected to remain on an upward trajectory. Depressed global commodity prices have translated into benign domestic inflation, allowing the Reserve Bank of India (RBI) to lower rates by a cumulative 125 bps since the start of the year. The effects of four rounds of rate cuts should continue to filter through the economy and spur private investment, but a fuller pass-through to lending rates would be impeded by banks' weak balance sheets, which remain saddled with non-performing loans. Current reforms in the banking sector, such as capital infusions by the government, should enhance monetary policy transmission over time. Meanwhile, foreign investors have increased their investment in India, signalling rising confidence in the economy. Foreign direct investment inflows amounted to US$19.4 billion year-to-date in June—a 29.5% improvement over the same period last year. (Chart 1.12) In particular, the computer software, automobile and construction sectors saw a discernible uptick in investment flows. All in, India's GDP growth is expected to increase to 7.5% in FY2016, from 7.3% in FY2015, making it the fastest growing economy in the region.

Chart 1.11
Contribution to India GDP Growth



Source: CEIC and EPG, MAS estimates

Chart 1.12
India Foreign Direct Investment Inflows



Source: CEIC and EPG, MAS estimates

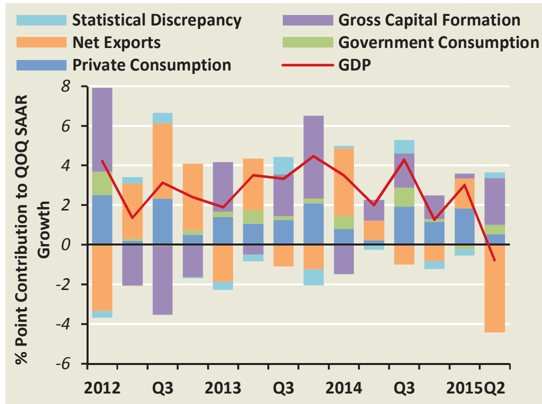
The slowdown in China will continue to dampen growth in the NEA-3.

Average GDP growth in the NEA-3 economies fell to −0.9% q-o-q SAAR in Q2 2015, following an expansion of 2.9% in Q1. The dip was led by a sharp fall in net exports, as these countries took a severe hit from the downshift in global trade flows. (Chart 1.13) A decline in heavy industrial shipments, owing to the investment pullback in China, was especially pronounced in Korea and Taiwan. Despite relatively robust domestic demand, Taiwan's GDP contracted by 6.6% q-o-q SAAR, after growing by 2.3% in Q1. At the same time, growth in Korea slowed to 1.3% q-o-q SAAR in Q2 from 3.3% in the preceding quarter, as the country's ailing exports was compounded by a MERS-induced downturn in the retail and hospitality-related sectors. Subsequently, the economy rebounded in Q3, expanding by 5.0% q-o-q SAAR. Household spending recovered following the dissipation of MERS, while investment picked up strongly, aided by the accommodative monetary policy environment. Meanwhile, Hong Kong's GDP growth eased to 1.6% q-o-q SAAR in Q2 from 3.0% in Q1, owing to anaemic transhipment activity and lower tourist arrivals.

Going into 2016, the launch of new consumer IT products, alongside improving G3 conditions, is expected to provide a modest boost to the region's electronics shipments. However, this will be more than offset by reduced demand from China's slowdown. Critically, China represents the largest export market for both Korea and Taiwan, forming about a quarter of all shipments. As a popular mainland tourist destination and transhipment hub, Hong Kong is even more reliant on China as its largest trading partner, accounting for around half of total trade. Given this dependence, the latest PMI readings for both Hong Kong and Taiwan came in significantly below 50 in September, even as the manufacturing PMI for Korea indicated a milder pace of contraction. (Chart 1.14)

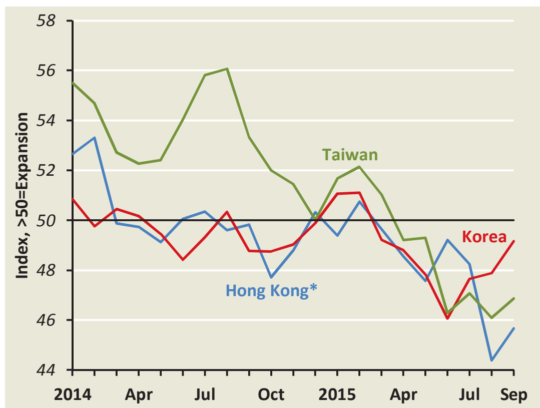
The more subdued outlook for China's economy, coupled with muted global trade flows, have dampened economic prospects in the NEA-3 economies, leading to a notable downgrade in growth projections for the next two years. Consensus forecasts for NEA-3 growth have been lowered markedly over the course of the year, from 3.2% to 2.1% for 2015, and from 3.2% to 2.4% for 2016.

Chart 1.13
Contribution to NEA-3 GDP Growth



Source: CEIC and EPG, MAS estimates

Chart 1.14
NEA-3 Manufacturing PMIs



Source: Markit
* Whole Economy

Growth in ASEAN-4 will be hindered by external and domestic headwinds.

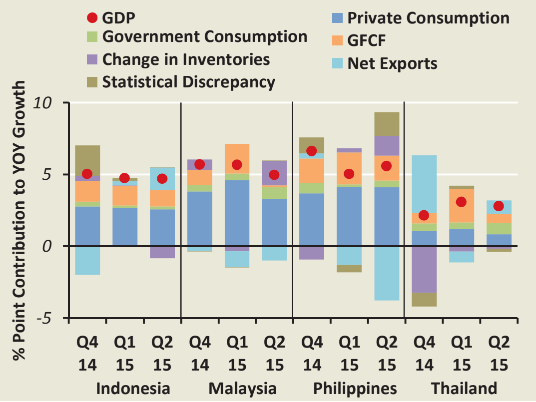
GDP growth in the ASEAN-4 economies as a whole decelerated from 4.8% y-o-y in Q1 2015 to 4.5% in Q2. This was attributable to a further deterioration in the region's export performance, as well as easing domestic demand growth. (Chart 1.15) Aggregate merchandise exports from ASEAN-4 contracted in Q2, dragged down by the commodity downturn, as well as subdued intra-regional demand. The persistent weakness in exports, which started around Q4 2014, in turn depressed private investment activity, particularly in Malaysia and Thailand. Nevertheless, resilient household spending in Indonesia and the Philippines, coupled with increased public sector spending across the region, provided some support to growth in Q2.

Economic activity in the ASEAN-4 is projected to remain soft in the quarters ahead. Despite a gradual improvement in the G3 economies, weakness in Asian final demand will continue to impinge on trade flows. The Philippines is expected to turn in the strongest performance in the region, given its relatively large exposure to the G3, as well as sustained strength in household spending and ongoing construction of basic infrastructure. In Indonesia and Malaysia, commodity-dependent sectors, such as mining and manufacturing, will continue to be weighed down by low prices and restrained demand—especially from China—with knock-on effects on private spending. At the same time, investor sentiment has been negatively affected by political uncertainty and flagging reform momentum. Nonetheless, Indonesia's renewed efforts to expedite infrastructure investment should help to bolster economic activity. In Thailand, private consumption and investment will be dampened by the political impasse. Nevertheless, growth for this year is still expected to improve somewhat, compared to 2014, on the back of increased spending on infrastructure projects and tourism-related activities. On the whole, growth in the ASEAN-4 is projected to moderate from 4.7% in 2014 to 4.5% in 2015, before rising to 4.6% next year.

Asia ex-Japan's trade prospects are clouded by several developments.

Over the medium term, the outlook for Asia ex-Japan's exports has downshifted due to several factors. First, oil and other primary commodity prices have eased since the middle of last year, marking

Chart 1.15
Contribution to ASEAN-4 Growth



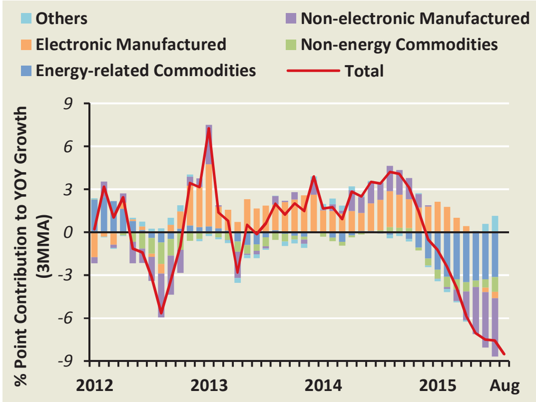
Source: CEIC and EPG, MAS estimates

the end of what some have called a "super cycle". These developments have been a key factor behind the fall-off in Asia-7's exports[5], with a significant part of the decline since early 2015 due to commodities. (Chart 1.16) There has been a corresponding fall in the nominal value of merchandise imports into the G3. (Chart 1.17)

Second, as discussed earlier, the step-down in G3 investment growth is likely to have further depressed Asia ex-Japan's exports. Investment tends to be more trade-intensive than other types of expenditure and, as such, less robust investment activity could partly explain a decoupling of the relationship between G3 demand and the region's exports. Indeed, in real (price-adjusted) terms, exports from the region decelerated in H2 2014 and then contracted in H1 this year, even as economic conditions in the G3 improved. (Chart 1.18)

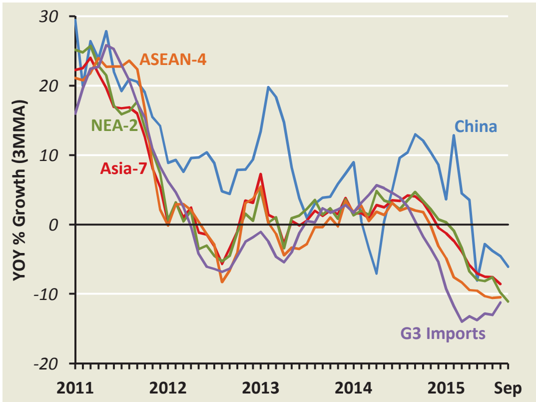
Third, the growing importance of emerging Asia's demand for final goods has accentuated the impact of cyclical weaknesses on the region's trade flows. In particular, China has grown considerably as a market for consumption goods in its own right. Over the past 10 years, its imports of consumption goods have risen by more than five-fold, amounting to US$218 billion last year, or one-third of US imports. However, the contribution of consumption to GDP growth in China has taken a step down from an average of 5.4% p.a. in 2009–11, to about 4% p.a. since 2012. In many other Asian economies, growth in household spending is poised to soften in line with weakening real incomes, amid subdued economic activity. Furthermore, nominal earnings in commodity-dependent countries will remain depressed, while the slide in regional currencies since the middle of last year will translate into higher imported inflation. In recent quarters, growth of consumer goods imports has started to decelerate in some Asian economies, a trend that is expected to continue into 2016.

Chart 1.16
Asia-7 Exports by Product (Nominal)



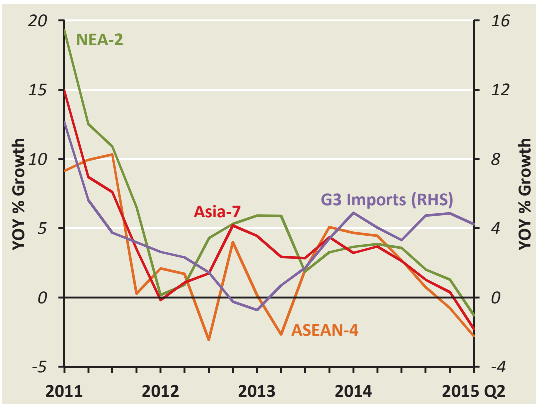
Source: CEIC and EPG, MAS estimates

Chart 1.17
Asia-7 Exports & G3 Imports (Nominal)



Source: CEIC and EPG, MAS estimates

Chart 1.18
Asia-7 Exports & G3 Imports (Real)



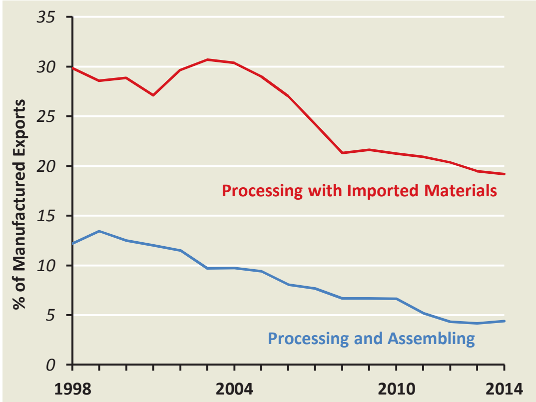
Source: CEIC and EPG, MAS estimates

Note: For Malaysia, the series on exports of goods and services is used due to lack of data.

5 Asia-7 refers to ASEAN-4, NEA-2 (Korea and Taiwan) and China, while exports and imports pertain only to merchandise trade.

Fourth, there are tentative signs of shifts in the region's cross-border production networks. As China continues to move up the technological ladder, Chinese manufacturers may have intensified the vertical integration of their domestic production processes and, accordingly, depend less on imported components from the region. The share of imports that went into China's processing and assembly plants (for subsequent export) has fallen steadily over time, from around 40% in 2003 to 24% in 2013 and 2014. (Chart 1.19)

Chart 1.19
China Processing Imports



Source: CEIC and EPG, MAS estimates

Note: "Processing and Assembling" captures inward processing in which imported inputs and finished outputs remain the property of foreign suppliers. All other instances of inward processing are included under "Processing with Imported Materials".

1.3 Global Inflation

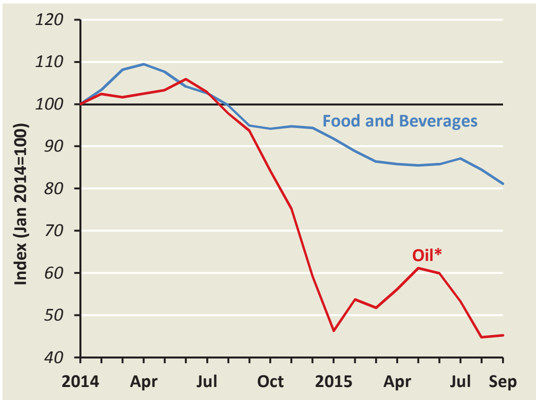
Global Inflationary Pressures Remain Subdued

Global inflation outturns have continued to moderate, reinforced by the decline in oil and commodity prices and a protracted period of below-potential global growth. The moderation in price increases, particularly in Asia, should be seen in the context of fairly strong inflation rates in recent years, as well as generally stable core inflation. With continued weakness in aggregate demand, global inflation is expected to come in lower at 1.0% in 2015, compared to 1.9% in 2014. However, a pickup is expected next year, with inflation rising back to 1.9%.

Inflation remains below trend in the G3 economies.

In the G3 economies, inflation rates have stayed at very low levels, mainly on account of a renewed decline in oil prices over the period Jun–Aug. (Chart 1.20) Headline inflation in the US rose marginally to 0.1% y-o-y in Q3 2015, from 0% in Q2, reflecting the continued pass-through of the steep decline in energy prices since end-2014. (Chart 1.21) Nonetheless, core inflation has been relatively firmer at 1.8% y-o-y in Q3 2015, as the labour market returns to full employment.

Chart 1.20
Global Oil and Food Price Indices

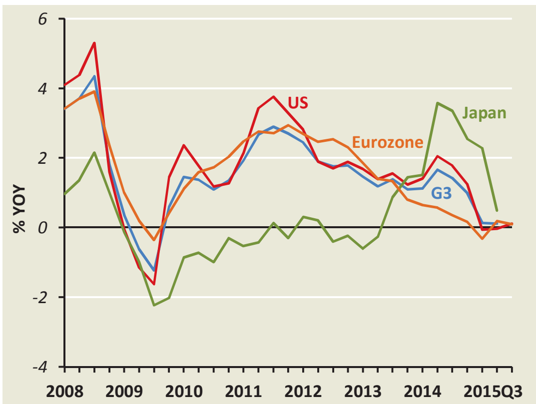


Source: IMF

* Average of UK Brent, Dubai and West Texas Intermediate oil price benchmarks.

In the Eurozone, headline inflation has been similarly depressed, with the Q3 reading coming in at 0.1% y-o-y. Unlike in the US, where headline inflation is expected to rebound next year, inflationary pressures in the Eurozone are likely to remain subdued even after the impact of energy prices has dissipated, given the smaller headway made in closing the negative output gap. Meanwhile, in Japan, headline CPI inflation declined to 0.5% y-o-y in Q2 from 2.3% in the preceding quarter, largely because of diminished base effects from the April 2014 consumption tax hike. Inflation is likely to pick up slightly next year, in line with a gradual economic recovery. Overall, G3 inflation is projected to come in at 0.3% in 2015, before rising to 1.4% in 2016.

Chart 1.21
G3 Inflation



Source: CEIC and EPG, MAS estimates

Asia ex-Japan inflation will be lower in 2015.

Inflation in Asia ex-Japan will be influenced by countervailing forces in the quarters ahead. The negative contribution from low global energy prices to the CPI is likely to fade next year as oil prices stabilise. At the same time, the broad-based depreciation in Asian currencies, particularly the ringgit and the rupiah, will translate into higher imported inflation. Nevertheless, persistent economic slack in the regional giant, China, and economies such as Korea and Thailand, will exert downward pressure on prices in the region. Accordingly, inflation in Asia ex-Japan is expected to come in milder at 2.3% in 2015 before rising to 2.9% in 2016.

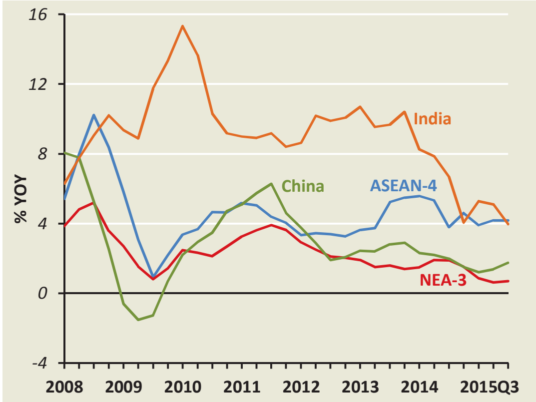
In China, headline inflation rose to 1.7% in Q3 2015 from 1.4% the previous quarter, primarily owing to a 17.9% y-o-y spike in pork prices, while non-food CPI inflation remained tame. (Chart 1.22) At the same time, PPI deflation intensified to 5.7% y-o-y and encompassed not only commodities and industrial materials, but also electrical equipment, consumer durables and daily sundries. Against this backdrop, China's CPI inflation is forecast to slip to 1.6% in 2015, before rising to 2.1% in 2016.

India's CPI inflation eased sharply to 3.9% y-o-y in Q3 from 5.1% in Q2, mostly on account of contained food prices. Looking ahead, while a deficient monsoon could lead to an increase in food costs, effective food supply management by the government could mitigate the upside risk. On balance, CPI inflation in India is expected to come in at 5.4% in FY2016, below the RBI's target of 6% by January 2016.

Within the NEA-3, inflation has remained muted, registering 0.7% y-o-y in Q3 2015, compared to 0.6% in the preceding quarter. Subdued energy prices were again the main factor behind the soft Q3 outturns in Korea and Taiwan, with Korea's inflation rate coming in at 0.7% and Taiwan's consumer prices falling by 0.3%. Meanwhile, Hong Kong's composite inflation decreased to 2.3% in Q3 from 3.0% in the previous quarter, primarily due to electricity rebates. On the whole, inflation in the NEA-3 is expected to be mild in 2015 at 0.8%, before rising to 1.7% in 2016.

In the ASEAN-4 economies, CPI inflation held steady at 4.2% in Q3. Inflation in Indonesia stayed elevated at 7.1% in Q3, largely due to an uptick in food prices and transportation costs. In Malaysia, price pressures strengthened further, possibly reflecting second-round effects from the implementation of the GST in April and the impact of the sharp ringgit depreciation. Meanwhile, falling energy prices continued to exert downward pressure on headline inflation in the Philippines and Thailand, with the prolonged weakness in domestic demand further dampening the outcome in Thailand. For ASEAN-4 as a whole, inflation is forecast to come in at 3.7% this year, and rise slightly to 4.0% in 2016, in line with a modest pickup in economic activity, and the diminishing impact of low oil prices.

Chart 1.22
Asia ex-Japan Inflation



Source: CEIC and EPG, MAS estimates