Lee Hsien Loong: Challenges in developing the Asian capital markets: the Singapore experience

Address by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the Euromoney Asia-Pacific Issuers & Investors Forum, Singapore, 19 March 2002.

*   *   *

Introduction

First, may I welcome all of you to the Euromoney Asia Pacific Issuers & Investors Forum, held for the first time here in Singapore. We are honoured to have here with us, a diverse and distinguished group of regional government officials, investors and issuers.

Over the past few months, signs are emerging that the worst of the economic downturn may now be behind us. New orders, industrial output, consumer confidence and retail sales in the US have picked up. The swift policy response by the US Federal Reserve has helped restore liquidity and confidence to global financial markets, especially in the aftermath of Sept-11. Markets have also taken in stride the adjustment in the technology sector, the synchronized global slowdown, the Sept 11 terrorist attacks, Argentina, and Enron.

In line with the recovery in the US economy and the global electronics industry, the Singapore economy too is expected to pick up this year, after the most severe recession in decades. Private sector economists are revising their growth forecasts for the year upwards. The government's own forecast is currently for 1-3% growth, which is a fair assessment of the prospects.

Lessons from the Asian crisis

Five years have passed since the Asian financial crisis began, prompting a major re-think of policies held to be obvious and valid before the crisis. In particular, the crisis has highlighted three major issues in Asian economic and financial systems.

First, some analysts have questioned East Asia's growth model, with its emphasis on high savings, reliance on foreign investment, and export growth. East Asian economies, it is argued, should instead lower savings rates, in order to stimulate domestic demand, develop indigenous enterprise, and insulate themselves from volatile external conditions.

Second, the crisis highlighted the dangers of liberalising capital markets too rapidly and without adequate safeguards. Before the crisis, capital account liberalization was the vogue. Conventional wisdom emphasized benefits rather than costs of free capital flows. The crisis demolished this complacent confidence. Undoubtedly, structural flaws and policy errors, especially in the financial and corporate sectors, contributed to the crisis. However, the financial markets' reaction to these weaknesses was out of proportion to the severity of the crime. Markets proved highly susceptible to contagion and herd behaviour. Crashes and panics shook seemingly sound economies to their roots.

Third, the crisis demonstrated the dangers of over-reliance on bank-based financing. In many Asian countries prior to the crisis, capital markets were underdeveloped. Bond markets, in particular, were illiquid or nonexistent. So Asian firms relied on bank loans for working capital and to fund capital expenditure. When banks ran into trouble, firms were left without alternative sources of capital. More generally, the thin capital markets in Asia accentuated price movements when investor preferences shifted. This made Asian economies more vulnerable to financial shocks.

So how have countries responded in the wake of the Asian crisis? On the East Asian growth model, no Asian country is abandoning exports or foreign investment as engines of growth, not even those countries which harbour reservations about the risks of globalisation. For small Asian economies, and Singapore in particular, the idea of relying on tiny domestic markets to stimulate growth and enterprise is inherently implausible. Larger economies may make more of their domestic markets, and indeed the ASEAN countries as a group need to integrate their markets in the ASEAN Free Trade Area, to make themselves more attractive to foreign investments. But no single domestic market can substitute for the world market, in an age where economies of scale are global, whether in industries like electronics and pharmaceuticals, or services like banking and telecommunications.

Indigenous enterprise is an important factor in economic development. Strong local companies add depth and resilience to the economy, while a spirit of entrepreneurship enables the population to seize new opportunities and thrive in uncertain times. But indigenous enterprise cannot rely on the traditional family firms, doing small scale businesses on the margins of a modern economy. It requires firms which are strong in technology and know-how, with systematic managements and meritocratic practices, firms which can hold their own against foreign competition, and with the potential to grow into significant industry players. Even then, such firms will complement, not replace, foreign investments by MNCs.

Following this philosophy, Singapore's economic policies will therefore remain externally oriented. We will continue to push for free trade, welcome investments, and integrate into the global economy, even as we promote entrepreneurship and seek to build Singapore firms into regional players. The pressures of globalisation can be uncomfortable, and the changes they force upon us can be painful. But globalisation has helped us to build a stronger, more resilient economy, one better prepared to hold our own against formidable competitors, and deliver a high and rising standard of living for our population.

On capital account liberalisation, countries are now acutely aware that sound macroeconomic management is a key prerequisite, without which no regime of exchange controls can deliver stability. They also realise that they must sequence liberalization judiciously, and strengthen financial supervision and prudential safeguards as they liberalize.

In the aftermath of the crisis, no Asian country imposed capital controls, apart from Malaysia. But several tightened safeguards to reduce the risks of destabilising capital flows, and to shield domestic foreign exchange and money markets from speculative pressures emanating from abroad. They improved monitoring, and discouraged trading in currencies that was not related to the real economy. A few countries went further, and sought to curb transactions in home currencies in offshore markets.

At the same time, there has been an ongoing effort to develop bond markets in Asia. Issuance of domestic government bonds has increased sharply in most Asian countries. Certainly, a large part of the increase reflected the spike in fiscal deficits resulting from the debt restructuring operations in the financial sector during the Asian crisis. Nonetheless, corporate bonds have also grown.

There is a trade off between tightening up the capital account, and developing the bond markets. Measures to restrict offshore foreign currency trading have been effective, in so far as reducing or eliminating offshore markets is concerned. But these safeguards come at a cost – they also hinder the development of capital markets, especially the bond markets. Size and liquidity are essential attributes for a market to attract international interest. Already in size and liquidity, we clearly lag behind our counterparts in the West. If Asian markets are fragmented and unable to grow, they risk being ignored by global investors.

In the immediate aftermath of the Asian crisis, countries that have suffered at the hands of the markets are understandably disinclined to err on the side of fewer restrictions, especially as the benefits from bond market development are not likely to be large given structural problems in the economy. However, over time as the Asian countries make progress in restructuring their economies and strengthening their institutions, they will reassess the balance of risks, and perhaps modify some of these restrictions.

Liberalisation of S$ policy

In Singapore, we are subject to the same trade-offs. But our circumstances are somewhat different as we were less severely affected by the crisis. Our financial services sector is also relatively larger and more established, compared to other countries in the region. By 1997, we had decided that we were sufficiently well established to shift from our previous highly conservative and risk-averse regulatory approach towards the financial industry and instead supervise with a lighter touch and accept calculated risks in order to promote its development. As part of this overall liberalisation, we progressively relaxed restrictions on the Singapore dollar, and fostered the growth of our capital markets, throughout the Asian crisis.

Our monetary policy has been centred on the exchange rate since 1981. But as a large financial centre with open capital markets, we are exposed to large and sometimes, volatile capital flows. Thus we have long maintained an explicit policy of discouraging the internationalisation of the Singapore dollar, in order to support our monetary policy framework. We limited the use of the Singapore dollar by non-residents for purposes unrelated to the Singapore economy, for example currency speculation.

This non-internationalisation policy, supported by our strong macroeconomic fundamentals and substantial foreign reserves, has helped us to maintain a stable Singapore dollar, and to avoid large swings in our exchange rate which would have severely damaged our economy. The trade-off was less vibrant capital markets. Indeed in some cases, the tight domestic restrictions fostered the growth of offshore markets in these restricted activities, undermining our purpose.

Recognizing this, we have over the past four years progressively relaxed the S$ restrictions. Our approach has been a cautious one: weighing the trade-off between development and the risk to exchange rate management, and feeling our way forward step by step.

Our efforts have yielded encouraging results. The outstanding volume of Singapore Government Securities (SGS) has doubled since 1998 and average daily turnover volume increased about three-times. SGS outstanding volume in 2001 was S$54 billion and average daily turnover was S$1.9 billion. New corporate debt issuance has continued to grow strongly, with S$ and non-S$ corporate bond issuance totalling a record S$72 billion in 2001. This was an almost 8-fold growth over issuance volumes in 1998, spurred by exceptional merger and acquisition activities, but significant nevertheless. Outstanding corporate bonds have also more than doubled to S$80 billion.

Besides higher volumes of issuance, we are also seeing a greater diversity of corporate bonds in the market. The tenors issued range evenly across a spectrum of maturity up to 15 years. The average size of S$-bond issues has also increased. Last year, there were several bond deals of about S$1 billion from domestic corporate issuers successfully placed in Singapore. Structured debt products now account for about 35% of the total S$ debt issuance, reflecting a move towards more sophisticated debt instruments.

With deeper and more mature capital markets, and greater confidence and experience in managing larger S$ flows, we are now ready to make a further move. Since October last year, MAS has been seeking the views of key market participants on how we can facilitate the continued growth of the S$ capital markets. Following these dialogues, we have reviewed the non-internationalisation policy, taking into account their ideas and suggestions.

We have decided to further liberalise the policy, to lift many of the specific restrictions on the use of the S$. Henceforth, we will retain only two basic guidelines:

a. First, financial institutions may not extend S$ credit facilities exceeding S$5 million to non-resident financial entities, where they have reason to believe that the proceeds may be used for speculation against the S$ exchange rate. This continues to be necessary, as we have no reason to allow offshore speculators to access the liquidity in our onshore FX swaps and money markets.

b. Second, when a non-resident entity wishes to obtain a S$ loan, or tap our equity or bond markets to fund overseas activities, it must swap or convert the S$ proceeds into foreign currency as and when it uses the proceeds offshore. This guideline is unlikely to stand in the way of market development, as the S$ is not a currency commonly used for transactions abroad, and non-resident entities would in any case wish to swap or convert the S$ proceeds into a currency of their choice for overseas use.

With this liberalisation, the following will now be possible.

a. First, MAS will exempt all individuals and non-financial entities, which includes corporate treasury centres, from the S$ lending restrictions of the non-internationalisation policy. This recognises that such entities are not usually the prime drivers of destabilizing currency speculation.

b. Second, for non-resident financial entities that continue to be governed by the S$ policy, we will lift restrictions in the following financial activities:

   i. Asset swaps, cross-currency swaps and cross-currency repos can now be transacted freely. MAS had hitherto treated such transactions as forms of S$ lending. It will no longer do so.

   ii. Securities Borrowing and Lending (SBL) – Financial institutions in Singapore may now lend any amount S$-denominated securities in exchange for both S$ or foreign currency-denominated collateral. MAS will lift the requirement that any lending of S$ securities exceeding $5 million has to be fully collaterised by S$ collateral.

iii. S$ FX options – Financial institutions may also freely transact S$ FX options with non-resident entities. FIs no longer need to maintain documentary proof showing that S$ FX option transactions with non-resident entities are for hedging purposes.

iv. Investments in financial assets and real estate – Financial institutions are no longer required to ensure that S$ credit facilities extended for investment purposes be withdrawn when the investments are either wholly or partially liquidated. This will relieve FIs of the need to institute additional arrangements to track their non-resident client's investments in financial assets.

These measures, which take effect from tomorrow, should pave the way for even greater liquidity and range of activities in the FX, equity and debt capital markets. They should also attract offshore S$ activities back onshore.

We are still maintaining the two core requirements of the non-internationalisation policy – the restriction on lending for purposes of speculating on the S$, and the requirement to swap into foreign currency the proceeds of S$ loans, debt or equity issues if these proceeds are to be used offshore. Some market participants have suggested that we should go all the way and lift these requirements too, but we continue to believe it wise to maintain a basic stance of not encouraging internationalisation of the S$, through these two requirements. They are unlikely to hinder the activities of legitimate players. They will also provide us basic safeguards in case activity in currency markets turns out not to be self-stabilising, which from time to time seems to be the case.

Conclusion

The new financial landscape offers many opportunities for the astute market players and investors, but at the same time, presents many challenges for regulators and supervisors. In Singapore, we have made much progress, but the task ahead remains challenging. We will continue to engage the industry and seek ways to develop our capital markets further. The key is to liberalise without compromising the soundness of the financial system or conduct of our monetary policy.

I am optimistic over the prospects for the further development of Asian capital markets and look forward to your exploring investment opportunities in this region.

I wish you all an enjoyable and fruitful conference.