Lee Hsien Loong: Singapore's economic restructuring against the background of Asia's changing economic landscape

Keynote address by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the Morgan Stanley Asia-Pacific summit 2002, Singapore, 22 October 2002.

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Distinguished Guests

Ladies and Gentlemen

Introduction

For two decades during the East Asian miracle, Southeast Asia grew rapidly. Large volumes of foreign investments helped to transform the economies, creating jobs and expanding exports. This ended abruptly in 1997, when the Asian Crisis swept through the region. The crisis has passed. But since then, Northeast Asia's economic performance has outshone Southeast Asia's. In Southeast Asia, growth has been weaker and more disparate, both direct and portfolio investments have fallen, and ebullience has been replaced by pessimism. There are three main reasons.

First, China. A large part of Northeast Asia's strong performance reflects the continuing growth and transformation of the Chinese economy, which largely escaped the Asian Crisis. The past few years have witnessed rapid market liberalisation in China, as it prepared itself to join the WTO and bring 1.3 billion people into the global trading system. As the Chinese economy grew and showed tangible progress, MNCs have become euphoric over China's potential, both as a production base and an enormous market. Accordingly, foreign direct investments have poured into China. China still faces daunting problems, for example, in its banking system, state-owned enterprises, and intellectual property rights regime. But the dramatic and ongoing changes give investors hope and confidence that these problems will in time be overcome, making them feel that they cannot afford not to be in China.

A second reason for Southeast Asia's under-performance is **the regional political and security situation**. The Asian Crisis precipitated major social and political changes in many countries, deterring MNCs from committing to new investments in an uncertain climate. These overriding political concerns also distracted the governments from tackling urgent economic problems and implementing painful structural reforms to remedy weaknesses uncovered by the crisis. In contrast, South Korea's aggressive post-crisis restructuring of its corporate sector has spurred a more rapid recovery.

Most crucially, the Asian Crisis brought down the Suharto Government in Indonesia, and launched Indonesia on a new and uncharted path. For thirty years, a stable Indonesia, with a strong government focused on economic development, had provided a critical basis for confidence and peaceful cooperation in the whole of Southeast Asia. Suharto's fall changed this. The subsequent Indonesian government abandoned Suharto's longstanding policy of restraining political Islam, thus opening Pandora's box. Islamic groups, including the militant ones, now wield considerable influence in Indonesia's body politic. Indonesia's political and social landscape has altered drastically and permanently, affecting the whole region.

More recently, Southeast Asia has faced security problems from extremist Islamic terrorist groups linked to Al Qaeda. After September 11, such groups were discovered in Malaysia, the Philippines, Singapore and Indonesia. They are linked to one another in a network which seeks to create an Islamic state in Southeast Asia through violence and terror. The recent bomb attack in Bali was a tragic reminder that Southeast Asia is at the frontline of the worldwide war against terrorism.

A third, more cyclical, factor underlying Southeast Asia's under-performance, has been weakening external demand. Although Southeast Asia's economies have been diversifying their sources of demand, they are still heavily dependent on external demand, unlike China. But Southeast Asia's main export markets – US, Japan, and the EU – are all languishing. The timing and strength of a pick-up in the US economy is uncertain, especially given the possibility of a war in Iraq, and the concomitant impact on oil prices and the international security climate. The Japanese economy is still mired in difficulties, with no imminent prospect of decisive fundamental change. With fiscal and monetary policies constrained by the Maastricht Stability Pact and a stringent inflation target, the EU economy too remains weak.

Southeast Asia's response

These three factors – China's rise, regional political and security problems, and weak external demand – explain Southeast Asia's under-performance, but they do not condemn Southeast Asia to perpetual stagnation. How can Southeast Asia overcome these problems?

China

First, Southeast Asia should not see China only as a challenge, but also as an opportunity. A rising China is a formidable competitor for investments and in global markets, but Southeast Asia is better off with a prosperous and modern China, than with a poor and backward China.

International trade is not a mercantilist zero sum game. As China's exports have grown, so have its imports. Southeast Asian exports to China have been expanding rapidly. Between 1999 and 2001, Singapore's own exports to greater China (i.e. PRC, Hong Kong and Taiwan) grew by an average of 14% p.a., and now exceed our exports to the US. These exports range from integrated circuits, disk drives, scientific measuring instruments, oil and chemical products to food and beverages.

In services too, China's rising affluence offers great opportunities to Southeast Asia. China is one of the fastest-growing sources of tourists to Thailand, Malaysia and Singapore. A growing Chinese middle-class will want high-quality healthcare and education services. And wealthy Chinese – whose numbers are already not insignificant – will need more sophisticated financial services.

In manufacturing, China is rapidly expanding into activities previously carried out in Southeast Asia. But that does not mean that Southeast Asia will revert to agriculture and primary production. Attractive as China is to investors, it will not soak up all manufacturing investments, nor will it out-compete all other countries in every industry and every product. More likely, Southeast Asia and China will complement each other in an international division of labour, for example, with Southeast Asia providing the components and intermediate processing, and factories in China doing the final assembly for the Chinese market. The desire of MNCs to diversify their investments beyond one or two countries will also promote such an outcome.

For our part, Singapore is actively positioning itself to benefit from China's growth. When Chinese Vice President Hu Jintao visited Singapore recently, he proposed four areas for increased bilateral cooperation: high-tech industrial sectors, the economic development of China's western provinces, helping Chinese enterprises to exploit international opportunities, and the training of personnel and exchange of talent. Officials from both countries are pursuing these ideas. To help Chinese companies go international, Singapore has mooted the idea of setting up a base in Singapore to help Chinese companies market their products to the region and beyond. We are actively facilitating Singapore business ventures interested in China, providing market information, office space and consultancy services, and maintaining business networks. We have also launched an Asian Business Fellowship Programme, to develop a talent pool with operational experience, and network and market knowledge in China.

Politics & Security

Second, Southeast Asian governments must tackle the security problems resolutely and decisively. Terrorism is not unique to Southeast Asia. It is a global problem, originating in the Middle East, and spreading to every continent. Southeast Asia cannot be immunised against the terrorism virus. The large Muslim populations in the region are a natural host which extremist Islamic groups will exploit for concealment and political cover. Fortunately, the vast majority of Southeast Asian Muslims are peaceful and moderate in their beliefs. The problem therefore lies in dealing with the extremist elements in a way which does not alienate the majority of peaceful Muslims. This calls for deft political handling.

Southeast Asian governments are already taking action. In Malaysia, with a Muslim majority, the government has acted with despatch, arresting members of extremist groups and rooting out their organisations. The Malaysian government also controls the outflow of Malaysian students studying in madrasahs in Pakistan, where they may pick up extremist ideas.

In Singapore, with a sizeable Muslim minority, the government has arrested extremists belonging to the Jemaah Islamiyah group, and severely disrupted their operations. We have gone beyond security actions and taken pains to explain the problem to the population, so that Muslim Singaporeans do not feel that they are all under a cloud of suspicion, and the non-Muslims do not treat their Muslim fellow citizens any differently than before. Muslim community leaders have come together to publicly condemn the extremists as doing great harm to the Muslim community. Their clear and unequivocal collective stand has been enormously helpful in maintaining confidence and avoiding a rupture in racial and religious harmony.

In Indonesia, where 90% of the population is Muslim, the government has been extremely circumspect in acknowledging and dealing with the problem. The extremist groups have skilfully used religious and nationalist sentiments to garner political support and protect themselves against arrest. However, the Bali bombing has changed the situation. President Megawati has promulgated tough anti-terrorist decrees, including powers to detain suspected terrorists. The Indonesian government has arrested Abu Bakar Ba'asyir, who is the emir, or leader, of the Jemaah Islamiyah group, who had till now defied the Indonesian authorities to act against him. Government action in the aftermath of the Bali bombings has won the strong backing of key local institutions and the Indonesian population. Parliamentary leaders concurred with the passing of the anti-terrorism decrees, and the leaders of the two largest Muslim groups in Indonesia, the Nahdlatul Ulama and Muhammadiyah, have also voiced their support. The people of Indonesia know that if the militants succeed, not only will international confidence plummet and economic progress grind to a halt, but their country will be torn asunder.

Southeast Asian governments will act because they know that the objectives of the terrorists are totally beyond the pale. These are not innocent political dissidents exercising their democratic rights. They are ruthless fanatics, quite willing to destroy innocent lives in order to create civil strife and animosity between communities and countries, shake confidence in Southeast Asian economies and their legitimate governments, and weaken the basis of the states. They cannot succeed, but they can cause great harm in trying. Provided the governments respond vigorously to the extremist threat, they can contain the problem and gradually restore confidence to the region.

Access to Markets

Third, Southeast Asian economies need to boost external demand by strengthening their access to the major developed markets. In the short term, there is little we can do about the cyclical downturn. But for the longer term, favourable and assured access to key trading partners will allow Southeast Asian countries to maximise benefits from free trade and globalisation, and make themselves more attractive to investors.

One basic approach is to promote multilateral trade, and contribute to a successful outcome of the Doha Development Agenda of the World Trade Organisation (WTO). But we need to complement the multilateral approach with bilateral Free Trade Agreements (FTAs) with our key trading partners. This is why Singapore is actively pursuing an FTA strategy. We have concluded FTAs with New Zealand, Japan, and the European Free Trade Area (EFTA), and hope to conclude agreements with the US and Australia very soon.

Singapore's aim is not just to boost our own trade links with our FTA partners, but also to catalyse broader economic engagement between ASEAN and its trading partners. This is indeed happening. After New Zealand concluded its FTA with Singapore, Australia and New Zealand proposed starting a Closer Economic Partnership Agreement with ASEAN. Last year, ASEAN and China agreed to set up an ASEAN-China FTA within 10 years. Weeks later, Prime Minister Koizumi of Japan proposed a Japan-ASEAN Comprehensive Economic Partnership, to be modelled on the Japan-Singapore bilateral agreement. Similarly, we hope that the US-Singapore FTA will become a model for a US-ASEAN FTA in the longer term. These link-ups show that ASEAN is not turning inwards and away from the global economy, and will give ASEAN a valuable edge as an investment destination.

Singapore's economic restructuring: philosophy & initiatives

Given this bracing environment, Singapore is at a turning point in our economic development. The whole landscape has changed. We need to change our strategies to continue to thrive. This is why we convened the Economic Review Committee (ERC), to carry out a comprehensive review of our economic policies, and to identify ways to develop a vibrant and competitive private sector. We have concluded that the key tenets of our economic strategy are as follows:

First, we must **enhance the competitiveness of our economy**. This means keeping direct taxes as low as possible. There is a worldwide trend towards lowering taxes to attract and anchor companies. We also need to cut personal tax rates to spur entrepreneurship, risk-taking and wealth creation, and to attract and retain talent. Hence we undertook a major restructuring of our tax system, reducing corporate and personal tax rates from around 25% to 20% over three years. We will tax individuals who are not ordinarily resident in Singapore, based on the number of days they actually spend working in Singapore. To make up part of the revenue shortfall, we are raising our consumption tax from 3% to 5%.

Tax incentives have also been enhanced. Qualifying high-growth and high value-added financial activities will enjoy a concessionary tax rate of 5%, while a 10% rate will apply to tax-sensitive but mature activities. We have also enhanced incentives for specific activities, such as fund management, trustee and custodian services, insurance and capital market and treasury activities.

We also undertook a fundamental review of the Central Provident Fund (CPF) Scheme, which is our social security and pension fund scheme. We refocused the CPF on its core objective of providing for the basic needs of the majority of Singaporeans, in terms of retirement needs, healthcare expenses and home ownership. We are tightening the use of CPF for buying properties, so as to leave more for retirement needs. We are reducing the coverage for high-income Singaporeans, who should be able to plan and provide for their own retirement. We are lowering contribution rates for older workers, who are most vulnerable to losing their jobs. These measures will make our labour market more flexible, and contribute to our economy's overall resilience and competitiveness.

Second, we want to encourage entrepreneurship in order to develop more local and foreign start-ups and emerging enterprises to complement our strong base of MNCs and established local companies. In this rapidly changing, unpredictable environment, the best way to spot and exploit new opportunities is not by centralised direction, but through the drive and entrepreneurship of our people. According to the 2001 Global Entrepreneurship Monitor Report, Singapore ranked 27th out of 29 countries in terms of entrepreneurial activity. We need to do better.

We need to imbue our young with entrepreneurial instincts and attitudes, through their school education and life experiences. At the same time, the government should cut red tape, create more economic space for private enterprise, nurture high-potential local enterprises and develop a culture tolerant of risk-taking, experimentation and honest failure.

A self-renewing, self-sustaining entrepreneurial culture will not emerge overnight, but we are making some headway. Ten Singapore companies made it to this year's list of Forbes' Global 200 companies with revenues under US$1 billion. This ranks among the largest number of companies for any country.

A third area of focus is the development of our human capital, both local and foreign. Singaporeans rank highly in technical skills, and our students often top international mathematics and science competitions. But we need to improve our soft skills, such as people skills, management skills, communications skills, as well as cultural and artistic skills. We will also continue to welcome foreign talent to work, live and play here, to add to our talent pool.

Fourth, we need to identify, nurture and promote new areas of growth in both manufacturing and services, the two complementary engines of our economy. The continuing emergence of lower-cost locations spurs us to constantly review and refresh our manufacturing value proposition, be it in refining our division of labour, exploiting economies of scale through shared facilities, or undertaking more innovation and R&D work. For instance, about 70 companies are located on our petrochemical complex in Jurong Island, where they plug into customised infrastructure facilities, specialised services and the supply of feedstock. We cooperate with the Indonesian islands of Batam and Bintan, each specialising in different parts of the manufacturing value-chain that it is strong in.

In the services sector, we expect regional demand for health, education, tourism and financial services to grow rapidly as the middle-income group burgeons. Already, Singapore plays host to 50,000 foreign students in tertiary and commercial institutions, and 150,000 foreign patients per year from across the region. They are attracted to local universities and hospitals, as well as to the international arms of top schools and medical research institutes based in Singapore, like INSEAD, University of Chicago and Johns Hopkins.

Fifth, Singapore is improving our corporate governance practices and standards. A globally oriented economy needs a robust framework for corporate governance. Singapore's standards are high but we must continue to improve them, not only in the form of the rules but also in the spirit of their implementation. Our integrity premium is a precious competitive advantage which we guard zealously, and which will not be easy to replicate.

The Company Legislation and Regulatory Framework Committee, a private sector-led body, has been reviewing our company law and regulatory framework. The Committee has made recommendations to simplify the process of incorporating a company, facilitate capital raising and reduce compliance costs for companies in Singapore. Let me highlight some key recommendations.

To widen the options available for businesses and investments, the Committee recommended introducing Limited Partnerships and Limited Liability Partnerships. To improve access to finance and lower the cost of raising capital, the Committee advocated allowing additional exempted offerings, such as private placement and small offering exemptions. The Committee also suggested removing statutory requirements for audit and appointment of professional company secretaries, so as to trim compliance costs for companies, especially small private companies and start-ups. Safeguards will be simultaneously introduced to uphold corporate governance standards and protect stakeholders' interests.

I am happy to announce that the government has accepted all the recommendations of this Committee. They will ensure that our company law is market-driven, supportive of entrepreneurship and aligned with international best practices. The Ministry of Finance will release further details.

Finally, just as we are encouraging greater corporate disclosure, the government is also working towards raising levels of transparency through consultation and collaboration with the private sector. Consultation lengthens the policy-making process and entails commitment of effort and resources on the part of the industry and the public. But it also helps to pre-empt implementation problems, minimise unintended consequences, and foster better industry understanding and support. The Monetary Authority of Singapore (MAS) has introduced guidelines to make public consultation a standard procedure whenever significant changes in the financial services regulatory framework are planned. Over time, these changes will further improve the operating environment for the financial sector. The MAS will release further details.

Conclusion

Singapore has not shied away from tough measures to remake our economy and maximise our chances in a difficult environment. These measures will enhance our competitiveness, strengthen our companies and consolidate our social cohesion. They will make our economy more flexible, resilient and able to adjust quickly to changing circumstances, and so help it to remain ahead in the race of nations.

Although the media impression is that Southeast Asia has stagnated since the Asian Crisis, the reality is less gloomy. ASEAN economies have made progress in picking up the pieces and pursuing domestic reform and restructuring, albeit some more successfully than others. Between 1999-2001, ASEAN economies as a whole grew by about 4% per annum. Last year, an export-led slowdown on the back of a global electronics slump broke the recovery trend. But ASEAN economies weathered the downturn fairly well, with most still managing positive GDP growth. Most are running current account surpluses, in contrast to the large deficits that prevailed in 1997. From a macroeconomic standpoint, the countries have held up well and even shown a certain resilience. Reflecting this, ASEAN stockmarkets have generally performed better than their counterparts in the rest of the world thus far this year.

Part of Southeast Asia's negative image is attributable to political and security concerns, which are indeed real. A week or so after the Bali attack, these worries naturally loom large. Many observers, seized by the mood of the moment, are now forecasting the worst for the region. But we should adopt a longer-term, more nuanced perspective. Southeast Asia's economic fundamentals remain positive – a sizeable market with a collective population of 500 million people, high savings, abundant natural resources, under-developed consumer appetites and a strong work ethic. The political problems can be overcome, provided governments act swiftly and resolutely to counter terrorism and restore order and confidence. Those countries which do so will regain investor interest, while those investors shrewd enough to discern which countries and projects deserve support will be amply rewarded by the risk premiums. Provided Southeast Asian countries adapt themselves to their new environment, remedy their economic weaknesses, and grasp the new opportunities, this region can once again become a vibrant part of Asia.