Lee Hsien Loong: Prospering in a rising Asia

Speech by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the opening dinner of the Conference Board Symposium on Asian Economies and Financial Markets, Singapore, 27 May 2004.

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Distinguished Guests,
Ladies and Gentlemen,
Let me first welcome all of you to the Conference Board Symposium on Asian Economies and Financial Markets, held for the first time here in Singapore.

Asia's comeback since the financial crisis

Asian economies have come a long way since the financial crisis in 1997. For six years they have had a tumultuous ride, marked by unexpected shocks and painful adjustments. The September 11th attacks were followed by the Bali and Marriot bombings in Indonesia, which shook confidence in the region and brought the harsh realities of Islamist extremist terrorism closer to home. Last year, the Iraq war and the SARS outbreak weakened business sentiments and consumer spending, setting back economic recovery yet again.

Prospects for the region have since brightened considerably, on the strength of a synchronised upturn in the G3 economies. The electronics industry, a lynchpin of export-driven Asian economies, is finally picking up robustly after a prolonged slump. Investor confidence has returned, bond spreads have narrowed, and stock markets have outperformed the developed countries, until very recently.

The Asian crisis forced governments in the region to tackle weaknesses in their financial and corporate sectors and implement much needed structural reforms. Weak banks have been recapitalised, bad loans reduced, and prudential regulations strengthened. Government finances have been put on a firmer footing, while balances of payments have moved into surplus. The result is a stronger and leaner Asia, more prepared for storms and more ready to seize opportunities.

A major development in recent years is the emergence of China as an economic powerhouse. China's growth and transformation have been phenomenal. Its buoyant exports, supported by low-cost manufacturing capabilities, and its huge domestic market, have created strong competition as well as immense opportunities for the rest of the world. China's growth has driven the rapid increase in intra-regional trade, and fuelled economic expansion in the region, if not worldwide. China's economy is showing signs of overheating, but its government is mindful of the danger and determined to act decisively to rein in credit and investment. This gives them a good chance of achieving a soft landing. Beyond this cyclical issue, China is set to continue growing strongly for the next decade or two.

The other Asian giant, India, is becoming a dynamic and prosperous economy. Liberalisation policies and market reforms are freeing up the long moribund Indian economy. State-owned enterprises are being privatised. Ports, airports, telecommunications and financial services have been opened up to competition and foreign participation. As the dead hand of bureaucracy is withdrawn, growth is taking off, especially in the services sector. With well-trained, English speaking, and cost-competitive professionals, India has created a niche for itself as the world's back-office as well as a global software centre.

The BJP coalition's unexpected defeat in the general elections reflects the unhappiness of rural voters who have not benefited from the liberalisation. This may cause the new Congress government to be more circumspect about pressing ahead with reforms, although optimistic commentators argue that the voters are pressing for faster reforms rather than slower. Whether or not that is so, the policy of liberalisation commands bipartisan support, and is likely to continue. After all, the new Prime Minister, Dr Manmohan Singh, was the architect of the initial economic reforms in the early 1990s. He has appointed as Finance Minister Mr Chidambaram, who is also a reformist and a former Commerce Minister and Finance Minister. I am therefore hopeful that the thrust of liberalisation will continue, and India will play increasingly a prominent role like China's in the regional and global economies.

Closer to home, the prospects for Southeast Asian economies are also looking better. The region initially struggled as political and security concerns deterred foreign investments and distracted governments from tackling serious economic problems. But Southeast Asia has stabilised considerably in recent years. Governments are responding more vigorously to the threat of terrorism and restoring order and confidence. The political upheavals that swept across the region have also subsided, allowing governments to focus their attention on fostering growth and development.

The Thai economy has done particularly well. For the past few years it has been the fastest growing economy in Southeast Asia. Through a series of bold initiatives, the Thai government has revived the rural economy, stimulated domestic demand, and repaid its IMF loans. This has bolstered confidence and got business moving again.

Indonesia's economy has improved significantly despite a complex political situation. Reforms were slow initially, as corruption and an unreliable legal system impeded progress. Nevertheless, Indonesia has made significant headway in financial sector reforms. IBRA accelerated the pace of its bank asset sales, while non-performing loans ratios fell from nearly 50% in 1998 to just 8% last year. Indonesia graduated from the IMF programme in December 2003, and has continued to maintain sound macroeconomic policies. While foreign direct investments remain slow, the oversubscribed US$1 billion sovereign bond sale in March this year is a vote of confidence from international investors. The challenge over the longer term is to attract enough investments to sustain growth and reduce unemployment.

Overall, Asia is showing a new dynamism, and has put the financial crisis behind it. For all the difficulties that remain, this is probably the most promising region in the world.

Asia's strategic landscape

Asia's economic growth rests on the stability of the strategic environment in the region. Constructive and stable relations among the major powers set limits on rivalries and conflicts in the region, and enable trade and investments to flourish.

The key post Cold War global geopolitical reality is America's unique pre-eminence. The US will not always get its way; for example it is facing serious difficulties in Iraq. However, there is no credible challenger for America's global position. In East Asia a strong US presence has been the cornerstone of peace since the end of the Second World War. The US will remain a vital and irreplaceable part of the East Asian strategic picture for the foreseeable future.

Of course in Asia as in other regions, many countries, including friends and allies of the US, are uncomfortable with the scope of US pre-eminence and some of its policies. But all still want the best possible relationship they can have with the US. They know that they cannot challenge US pre eminence and that no issue in the region can be resolved without America's cooperation.

China is a prime example. China's fundamental preoccupations are internal. It wants a stable regional environment in order to deal with them. Beijing will not compromise on its vital interests, one of which is the status of Taiwan. But it knows that it is also in China's interest to have good relations with the US. For its part, the US knows that it needs the cooperation of China in order to deal with terrorism and other post Cold War challenges.

US China relations are the most important bilateral relationship in Asia and soon, perhaps in the world. Some degree of competition between the US and China is inevitable, but conflict is not. The complexity and multidimensional nature of US China relations requires both sides to balance and reconcile different perspectives to achieve equilibrium. Good US China relations will calm all of Asia.

The major Asian powers are also striving to stabilise relations with one another, at least in part to better deal with post Cold War geopolitical realities. The most fundamental interest of all Asian countries is in development: in growth, trade and investments, not war.

Three issues could disrupt Asia's strategic stability. They are the India Pakistan conflict over Kashmir, the North Korean issue and Taiwan. All three have a potential nuclear dimension. Let me deal briefly with each one.

The India Pakistan conflict is complex, mired in history and religion. It is difficult to envisage a definitive solution. But the conflict can and has been managed. In recent months, we have seen encouraging signs of a thaw. We should not underestimate the importance of these small but positive steps, given that only a few years ago India and Pakistan were on the brink of a nuclear war. Both countries know that a conflict over Kashmir would have disastrous consequences that far outweigh any possible gains. It would grievously disrupt India's economic reforms and perhaps permanently relegate India behind China. For Pakistan, it could mean the end of the state as it presently exists. It is therefore a good sign that the new Indian Government has signalled that it wishes to continue dialogue and engagement with Pakistan.

Like Kashmir, it is difficult to see a definitive solution to the North Korean problem. But this too can be managed. The six party talks have reduced the risk of accidental war. The key actors are rational and, despite their differences, share a common interest in a peaceful resolution of the issue. Kim Jong Il is a master of brinkmanship. But he too is rational and must know that war will lead to the outcome that he fears most, the disappearance of North Korea as a sovereign state. Therefore, while he may go to the very edge, unlike Saddam Hussein, Kim will not deliberately step over it. The North Korean issue is a strong incentive for the US and China to cooperate for their common interest.

The risks of miscalculation are perhaps highest over Taiwan. The issue is extremely delicate because it engages the domestic politics of China, US and Taiwan. There is growing tension between economic forces that are integrating Taiwan with the Mainland and Taiwan's desire for a separate identity. No PRC leadership can ever tolerate a bid for independence by Taiwan. If Taiwan pushes too far, the Chinese must react or be exposed as a 'paper tiger'.

The US stand, and perceptions of the US stand in China and Taiwan, are key to the problem. President Bush has said publicly that he does not support Taiwan's independence. But the US may still be drawn into a Cross Straits conflict. If this happens, there will be serious consequences for the entire region. But it is encouraging that Chen Shui-bian's inauguration speech took a more conciliatory tone, suggesting that he is aware of the grave dangers, although he still left open the possibility of independence.

In Southeast Asia, terrorism will be a major preoccupation for many years to come. Another terrorist attack will shake confidence in Southeast Asia, damaging growth prospects. The Southeast Asian waterways are vital lifelines for Japan, China and South Korea. A maritime terrorist attack that disrupts them will have wide economic and political repercussions. Unfortunately, there is widespread discomfort among Muslims everywhere with American policies in the Middle East and towards the Israel Palestine conflict. Mainstream Muslims are afraid to speak up against extremists for fear of appearing pro American. This is a serious problem that has not yet been adequately addressed.

One important question is the role of Islam in Southeast Asian countries. Traditional Southeast Asian Islam is syncretic and tolerant, but it is increasingly influenced by more austere Middle Eastern variants of Islam, especially Wahhabbism. Which way this battle for the soul of Islam goes is a key uncertainty that will determine the future of the region.

In Malaysia, Prime Minister Abdullah Badawi won a clear victory over PAS, the opposition Islamist Party. He did not challenge PAS' contention that Malaysia should be an Islamic State, but instead fought PAS on what kind of Islamic State Malaysia should be. His victory bolsters his vision of progressive Islam and should encourage mainstream Muslims everywhere. But PAS will not give up and is girding itself for a long-term struggle.

In Indonesia, it is significant that all three major Presidential candidates are secular nationalists. But all three have also found it necessary to seek Vice Presidential candidates with strong Muslim credentials, and support from Muslim parties. Although Indonesia has a long history of tolerant, syncretic Islam, more so than other Southeast Asian countries, political Islam is now at the centre of Indonesian politics and a crucial swing factor.

In Thailand, Prime Minister Thaksin's pro business and pro growth economic policies have not found resonance in the Muslim south. The recent upsurge of Islamic separatist violence is worrying, though there is so far no evidence of international terrorist connections.

Southeast Asian governments, even those with large Muslim populations, are secular, moderate and intent on economic growth. If progressive and moderate forces are to win the global battle for the hearts and minds of the Muslims, Southeast Asia is perhaps the most favourable battleground.

Riding on Asia's growth

This backdrop gives hope that the strategic and security environment in Asia will remain stable. I am also optimistic that Asian countries will continue to maintain stable political environments, pursue pro-business economic policies, and participate in the global economy. One significant economic issue countries must tackle is to strengthen and develop their financial sectors.

Asian countries need a two-pronged approach to do this. First, they should foster greater regional cooperation in financial markets to leverage on their collective strength. Second, individual countries need to press on with unfinished financial reforms and take judicious steps to liberalise the financial sector.

Greater regional cooperation

On regional cooperation, countries have clearly recognised the benefits of greater trade integration, driven by the forces of globalisation. To facilitate the integration process, ASEAN has accelerated the timetable for the formation of an ASEAN Free Trade Area. Last October, the leaders decided to commit to creating an ASEAN Economic Community, giving for the first time a supranational cast to ASEAN's aspirations. The ASEAN+3 process that links ASEAN with China, Japan and South Korea, ought eventually to evolve into an East Asian Economic Community that may include Australia and New Zealand. ASEAN is also negotiating free trade agreements with key trading partners. In addition to a Comprehensive Economic Partnership with Japan, ASEAN has targeted FTAs with China and India by the end of this decade. Meanwhile, individual ASEAN countries are already concluding FTAs with China, India and Japan.

More recently, regional countries have also embarked on various initiatives to deepen capital market cooperation and integration in the region. For example, the EMEAP Group, comprising 11 central banks and monetary authorities in the East Asia and Pacific region, has launched the Asian Bond Fund I. The group is now working towards launching the local currency-denominated Asian Bond Fund 2. The ASEAN+3 member countries have also made significant progress to develop regional bond markets under the Asian Bond Market Initiative and to establish a regional financing arrangement through the Chiang Mai Initiative. These initiatives are significant not only for their tangible economic benefits, but also as symbolic demonstrations of the collective interest in regional financial cooperation.

Alliances among Asian exchanges

Another area with potential for regional financial collaboration is in the securities and futures exchanges market.

In US and especially in Europe, a wave of consolidation among leading exchanges has resulted in mega-exchanges that have the economies of scale to make investments in advanced infrastructure, offer competitive fees, and most importantly provide investors and issuers with the liquidity that they seek. Exchanges in Asia have thus far been largely insulated from the trends of consolidation. Asian stock markets are generally smaller in size and less liquid than those in more developed countries. To remain relevant to international investors in this changing landscape, regional exchanges should deepen their collaboration with one another.

The decision of the recent ASEAN Finance Ministers' meeting to explore alliances and linkages among ASEAN securities markets will catalyse and encourage this collaboration. Regional exchanges are already taking the first steps. The Singapore Exchange, SGX, for instance, established a co-trading linkage with the Australian Stock Exchange in 2001. It is in discussions with Tokyo Stock Exchange on a possible alliance, and has recently started talks with Bursa Malaysia, formerly the Kuala Lumpur Stock Exchange, on possible collaborations.

Pressing on with reforms at the national level

While pursuing regional initiatives, individual countries need to press on with reforms at the national level. Although many Asian countries have significantly strengthened their financial systems, they still need to follow through with reforms in the financial and corporate sectors.

Singapore's financial system was lucky to emerge from the Asian crisis relatively unscathed. During the crisis, we undertook an extensive liberalisation program aimed at deepening and broadening capital markets, consolidating and upgrading the local banks, and enhancing Singapore's position as an international financial centre. At the same time, we put in place a new supervisory framework to oversee financial institutions, shifting from one-size-fits-all regulation to more risk-based supervision.

Our efforts have achieved encouraging results. Our debt market has grown three-fold since 1998 to reach S$90 billion in 2002, driven by growing demand in the region for debt financing. Our wealth management industry more than doubled in the same period, with total Assets Under Management growing from S$150 billion in 1998 to S$344 billion in 2002. In treasury activities, we have maintained our position as the fourth largest FX centre in the world, with an average daily trading volume of US$119 billion in 2003. The local banks have consolidated from seven into three banks that are larger and stronger, and are building up their regional footprints. In the recent Financial System Stability Assessment of Singapore, the IMF affirmed the robustness of Singapore's financial system and the soundness of our legal, supervisory and institutional framework.

We are heartened by these outcomes. But we still need to press on with further reforms and policy adjustments, because the international financial landscape continues to evolve. In this regard, let me highlight two things that MAS is doing.

Revisions to capital adequacy requirements of locally incorporated banks

First, MAS will be revising the capital adequacy requirements of locally incorporated banks.

Singapore banks have since 1992 been required to meet a minimum Capital Adequacy Ratio, or CAR, requirement of 12%. MAS has progressively adjusted this requirement.[1] However, the current MAS requirement of 12% Total CAR of which 8% must be Tier 1 capital still exceeds those in other major financial centres.

As part of MAS' efforts to keep our regulatory framework up-to-date with international best practices, we started to review the CAR requirements in March last year. I am sure the industry will be pleased to know that MAS has completed the review. MAS will announce the details at a press conference tomorrow evening. I will touch briefly on the three components of the revisions.

(i) Minimum CAR

The first change is in the minimum CAR requirements of local banks. MAS will lower this minimum CAR to 10%, of which at least 7% should comprise Tier 1 capital. This is competitive, taking into account our small and open economy, and the systemic importance of the three local banks. Some other countries, including Switzerland, similarly have a higher requirement than other developed jurisdictions.

This reduction in minimum CAR does not necessarily translate into a full 2% lowering of the total CAR requirements because in parallel with this, MAS will amend the rules for computing CAR, which is the second component of the package of CAR revisions.

(ii) Changes in CAR computation rules

One noteworthy revision to the computation rules will be a requirement for banks to set aside more capital for significant investments, commensurate with the risks associated with such investments. We had stated in August last year that this would be done, when we extended by two years the grace period for Singapore banks to divest non-financial businesses.[2]

Another significant revision is to allow banks to include 45% of the revaluation surpluses from banks' holdings of property assets as well as portfolio equity investments as Upper Tier 2 capital. This will raise the capital available to banks, but it is unlikely to offset the higher capital that they will have to set aside for significant investments.

In line with the policy of setting more transparent requirements, MAS will publish these CAR requirements and computation rules. Local banks will report their CAR based on the revised rules starting from their second quarter financial results.

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[1] MAS lowered the Tier 1 component from 12% to 10% in November 1998, and again from 10% to 8% in September 2000.

[2] "Extension of grace period for banks divestment of non-financial businesses", MAS Press Release, 22 August 2003.

(iii) Bank specific supervisory CAR requirements.

The third component is supervisory CAR. Like other supervisors, MAS may impose additional bank-specific supervisory CAR to address risks not adequately covered by the minimum requirement. MAS has refined the framework for setting these supervisory CAR add-ons.

It takes advantage of MAS' existing risk-based supervisory approach and is based on MAS' risk assessment of individual banks. In line with international practice, these supervisory CAR add-ons will be kept confidential.

Impact of the revisions

The adjustments in our CAR framework will allow local banks to manage their capital more flexibly. Banks which have lower risk profiles and which are better managed will enjoy lower total regulatory CAR requirements than before. At the same time, the adjustments will maintain prudential standards observed by supervisors in other major financial centres, which tend to be more stringent than the minimum standards stipulated under the current Capital Accord.

Overall, these changes will result in modest but meaningful reductions to the CAR requirements, but they may or may not translate into immediate capital reductions for the banks. Leading banks tend to maintain capital at levels well above regulatory minimums, and that will undoubtedly prove to be the case in Singapore as well. In managing their capital positions, banks will also take into account their future expansion plans, as well as the risks they potentially face in their business environment.

Non-internationalisation of Singapore dolla (S$) policy

The second policy adjustment concerns the non-internationalisation of Singapore dollar.

Monetary policy in Singapore is centred on the management of the exchange rate. As an international financial centre with open capital markets, we are exposed to large and sometimes, volatile capital flows. To facilitate the effective conduct of our monetary policy and to avoid large swings in our S$ exchange rate, we have a policy of discouraging the internationalisation of the S$. However, we recognised that the trade-off was a less vibrant capital market, particularly the debt market. So we have progressively relaxed the specific restrictions over the past six years, while maintaining the intent of the policy. The results have been positive.

The non-internationalisation policy is now down to two basic safeguards to discourage speculation in the S$ - banks may not lend S$ to non-resident financial institutions in order to speculate on the S$, and non-resident borrowers who raise S$ through bank borrowings or on our capital markets must swap or convert these S$ to foreign currencies before remitting them abroad. This stance remains appropriate, and continues to underpin the effective conduct of our monetary policy. Nevertheless, there is scope for further fine-tuning.

We have decided that non-resident, non-financial issuers of S$ bonds and equities will no longer be required to swap or convert their S$ proceeds into foreign currencies before remitting abroad. Non-resident, financial issuers of bonds and equities will still have to do so. This will give the issuers greater flexibility in managing their S$ funds.

In addition, MAS will exempt from the restrictions under the policy, any extension of temporary overdrafts of S$ vostro accounts to prevent settlement failures. This will facilitate straight-through processing and more efficient handling of S$ payments.

With the progressive relaxation of the S$ restrictions, the current policy essentially limits only lending of S$ to non-resident financial institutions for the purpose of speculating in the S$, and does not specifically seek to prevent the internationalisation of the S$. The present label: “Non-Internationalisation of the S$” may suggest that Singapore restricts foreign participation in S$ markets, which we do not do. We have therefore also decided to rename the policy "Lending of S$ to non-resident financial institutions".

Conclusion

Asia has had a remarkable recovery and can now look forward to a period of renewed growth and prosperity. Financial markets will play a major role in this process. Despite some strategic and security risks in the region, the political situation is generally stable and positive. There are challenges ahead, but with greater regional collaboration and integration, and continued reforms and developments to financial sectors in individual countries, Asians, and investors in the region, can look forward to a vibrant and dynamic future.