Ravi Menon: Economic and financial developments in Singapore

Opening remarks by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore (MAS), at the MAS' Annual Report 2010/11 Press Conference, Singapore, 21 July 2011.

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Good morning. Welcome to MAS' Annual Report press conference.

I want to focus on four key themes with a forward looking orientation: first, prospects for ***GDP growth***, second, the outlook for ***inflation***, third, MAS' ***financial accounts***, and fourth, maintaining high standards of ***financial regulation***.

Let me begin with the economy.

Singapore's GDP growth forecast range remains at 5–7% for now, but uncertainties have clearly increased.

As you know, economic growth took a sharp step-down in Q2 following the strong performance in Q1. First, disruption to regional supply chains in the aftermath of the Japan earthquake was much more severe than expected. Second, the rise in oil prices due to the unrest in the Middle East and North Africa has put a dampener on global demand. Singapore's trade-related sectors bore the brunt of impact. Both manufacturing output and re-exports saw sequential declines in Q2. In year-on-year terms, GDP growth averaged ***4.7%*** in the first half of this year.

Looking at the second half of this year, the prognosis for global economy has taken on a more cautious tone. There is more uncertainty in US and Europe compared to three months ago.

But we expect growth in our external markets to continue, albeit at a slow and uneven pace. In the US, weaknesses in housing and labour markets are persistent. Uncertainty over employment prospects will cap the strength of consumer spending. But business sentiments (as measured by the purchasing managers' index) and new orders for capital goods point to continued economic expansion, though at a slower pace.

In Europe, the core economies such as Germany and France should continue to perform well. Industrial output and business investment have been robust. But sovereign debt concerns in peripheral EU economies have escalated. They cast some uncertainty over Europe's near-term growth prospects. In Japan, the economy has been hit hard by the earthquake and tsunami. But there are signs that the worst has passed as production has begun to gradually recover. Emerging Asia remains on a relatively firm footing. Domestic demand continues to be resilient, supported by robust income growth and generally healthy household and corporate balance sheets.

On balance, the Singapore economy should register moderate growth for the rest of this year. Some industry-specific factors that dragged down growth in electronics and pharmaceuticals are expected to be transitory and the manufacturing sector should pick up from the soft patch we saw in Q2. The services industries, especially financial and tourism-related activities, should remain firm due to strong regional demand.

MTI and MAS are reviewing Singapore's GDP growth forecast. For now, our sense is that the ***5–7%*** forecast range remains intact. But if the pick-up from the downturn in Q2 is weaker than currently expected, growth could come in at the lower half of the range.

Beyond current uncertainties, significant risks remain in the global economy and financial system that could derail growth. In Emerging Asia, there are upside risks to inflation. If central banks are forced to tighten monetary policy more, growth could be jeopardized. In the

US, there are concerns about fiscal sustainability. If these lead to volatility in the financial markets against the backdrop of a still-weak labour market, then GDP could decelerate sharper than expected.

But the chief global risk is the ongoing sovereign debt crisis in peripheral Europe. If there is contagion and banks in core Europe are affected, there could be a severe credit squeeze and pullback in economic activity. MAS is closely monitoring the developments in Europe.

Let me now go on to recent developments on the inflation front.

Headline inflation is now expected to be 4–5%, but forecast for core inflation is unchanged.

I mentioned two months ago in a speech that headline CPI inflation had probably peaked. This remains technically correct but less clearly so in substance. Inflation has indeed eased from ***5.5%*** in January to ***4.5%*** in April and May. But inflation is expected to creep back up to slightly above 5% for the next couple of months before slowly trending down towards the end of the year.

Therefore, for 2011 as a whole, we are revising CPI inflation forecast to ***4–5%***, from the current 3–4%. This upward revision and renewed volatility reflect two factors. First, accommodation costs. Over the past few months, CPI accommodation costs were boosted by an unexpected surge in the number of tenancy contract renewals at current higher rental rates. This resetting of old rental contracts could persist into the second half of this year. We therefore expect accommodation costs to impact CPI inflation more strongly than previously. Second, private transport costs. COE premiums have risen faster than expected, reflecting rising incomes and sharp cuts in COE quota to its lowest in more than a decade.

This uptick in headline inflation should be seen in perspective. A better measure of underlying price pressures in economy is MAS' measure of core inflation. Core inflation excludes private road transport and accommodation costs, as these items are subject to short-term fluctuations. These items also do not affect the day-to-day outlay of most Singaporean households. Core inflation is the measure MAS monitors most closely, among a range of indicators.

Compared to headline inflation, core inflation was much lower at ***2.2%*** in April and May. This reflects in part MAS' pre-emptive tightening of monetary policy in April and October last year, which has helped to dampen some cost increases. A stronger Sing Dollar has helped, not just by filtering oil and food price increases, but also by providing a restraining effect on the economy. The strong exchange rate has capped upward pressure on prices. For the whole of 2011, the projection for MAS' core inflation remains unchanged at ***2–3%***.

This is not to suggest we are entirely satisfied with the inflation situation. Core inflation remains slightly above the historical average of 1.7%. Inflationary pressures in the economy, while not acute, bear very close watching. First, there is tightness in the domestic labour market. The unemployment rate has dipped below 2%. Second, domestic spending remains firm, supported by strong income growth and generally favourable sentiments. Third, global commodities prices remain elevated, reflecting short-term supply constraints.

MAS will continue to keep a close watch on inflationary pressures and developments in our key export markets. At this juncture, the current monetary policy stance of appreciating the S$NEER policy band set in April this year remains appropriate. The next Monetary Policy Statement is scheduled for October.

I will now go on to MAS' accounts.

MAS made investment gains of S$12.3 billion but recorded overall loss of S$10.9 billion due to a strong exchange rate.

Excluding exchange rate effects, MAS achieved income and net capital gains totaling S$12.3 billion during the financial year (FY) ended March 2011. Stronger global growth led to an upturn across many asset classes; MAS' diversified investments posted valuation gains. With the recovery in asset markets over the past two years, MAS' portfolio, excluding exchange rate effects, has more than recovered from effects of the global financial crisis.

However, the strength of the Sing Dollar has had a bearing on the valuation of MAS' foreign assets. Over the FY, the Sing Dollar strengthened considerably against most currencies: 10% against the US dollar and 5.5% against the Euro. Including exchange rate effects, in Sing Dollar terms, MAS recorded a net loss of S$10.9 billion.

In short, we made good investment gains, but when measured in Sing Dollars, these gains were more than offset by the strength of the currency. If we had reported our P/L in an international currency it would show a healthy profit.

The effect of a strong Sing Dollar on our reserves should be seen in a broader context.

First, the international purchasing power of our reserves is unaffected by strength of Sing Dollar. MAS' foreign reserves serve two primary purposes in times of crisis: they finance our imports from the rest of the world, and safeguard the value of our currency. On both fronts, it is foreign currency value of the reserves that matters.

Second, the strength of the Sing Dollar has safeguarded our domestic purchasing power. It has helped to moderate the increase in Singaporeans' cost of living. For instance, while global oil prices rose by 20% in FY2010, domestic prices of oil-related items increased by only 10%. Or take another example of food prices. During FY2010, the rate of increase in food prices in Singapore was about half of that in our major trading partners, which includes both advanced and emerging economies.

Last, I will elaborate on our efforts to maintain high regulatory standards.

MAS is well-placed to meet higher global standards emerging from international regulatory reforms following the crisis.

Singapore's regulatory regime already meets or exceeds international norms, and this has enabled us to weather the financial crisis relatively well. Following the crisis, international regulatory standards are being raised. We are well-placed to meet them.

Let me start with banking. MAS announced last month we will require Singapore-incorporated banks to meet Basel III capital requirements earlier than the Basel Committee's schedule, and at a higher standard. Market reaction to this announcement has been positive because Singapore-incorporated banks are well-capitalised and in a strong position to meet MAS' revised requirements. These requirements will help keep our banking system strong and safeguard our financial stability.

Likewise for liquidity. Singapore was one of earliest jurisdictions to require banks to maintain minimum liquidity levels. Over the years, this has evolved to a risk-based liquidity risk supervision framework. Singapore banks are therefore well positioned to meet the new Basel liquidity ratios.

Effective regulation is not just about setting high standards. It is also about creating market conditions that enable financial institutions to meet the standards. Take for instance the higher liquidity requirements under Basel III. MAS has taken steps to increase the availability of liquid assets in the market and collaborate with other central banks to expand eligible collateral in the MAS Standing Facility. Let me elaborate.

We started issuing one-month MAS Bills in April this year. This has added about $6 billion of high quality liquid assets for financial institutions. We have seen good interest in the Bills. We are looking to issue more and in longer tenor, in the future.

As for the MAS Standing Facility, we have, in the last two years, progressively expanded the range of eligible collateral. MAS has signed cross-border collateral arrangements with other central banks. Banks can now use as collateral, Euro and Sterling cash, as well as French, German and British government securities. We are now finalising similar arrangements with the US Federal Reserve, so that banks will be able to pledge US Treasury bills and notes to obtain Singapore dollar liquidity at the Standing Facility. These initiatives significantly enhance banks' flexibility to tap on global sources of liquid assets.

Let me now touch on the regulation of financial markets. A key focus of international regulatory reforms has been on the trading of OTC derivative contracts. MAS will meet objectives set by G20 Leaders on regulation of OTC derivatives as well as recommendations by the Financial Stability Board (FSB). We are now reviewing our detailed policies and will conduct consultation by the end of this year on all aspects of FSB's recommendations. MAS aims to meet FSB target to implement the recommendations by end 2012.

There are four key thrusts in FSB's recommendations on OTC derivatives trading.

First, standardise derivative contracts. MAS is working with Singapore Foreign Exchange Markets Committee (SFEMC) to encourage further standardisation of derivative products. The SFEMC will formulate a code of conduct for financial institutions operating in the OTC market.

Second, mandate central clearing of all standardised contracts. Since 2006, the Singapore Exchange has operated a clearing facility for OTC derivatives. It started with derivatives contracts for commodities, energy and freight; and introduced interest rate swaps in November 2010. It will clear FX forwards by the end of this year. Our policy consultation will provide further details on how mandatory clearing will be implemented.

Third, move trading to platforms where appropriate. International discussions on implementation issues are still ongoing. MAS is actively participating in these discussions. We will use the findings to help develop our own regulatory framework for organised platforms for trading.

Fourth, report trades. We are assessing the need for a local repository and the appropriate regulatory regime. Our aim is a practical and efficient system that avoids duplication.

On the insurance front, Singapore was among the first in Asia to introduce a risk-based capital framework back in 2005. Unlike in banking, there is no common global capital standard for insurance companies. The closest is the EU's new standard known as Solvency II which is expected to be implemented by 1 January 2013. Many non-EU countries are looking to modernise their own capital frameworks along similar lines. To ensure that our risk-based capital framework in insurance keeps pace with these developments, MAS will embark on a review of our framework. We expect to issue a consultation paper by the end of this year.

In the post-crisis landscape, there is a premium placed on well-regulated financial centres that have strong economic fundamentals. Singapore is in a good position to benefit from this. We have high prudential standards and rigorous supervision that give market players confidence. And we are at the crossroads of Asia, which is growing significantly faster than the Western economies.

2010 was a good year for Singapore's financial centre. The financial services sector grew by 12% last year. Several specific factors in Asia underpin the demand for financial services provided by Singapore: increase in trade, demand for infrastructure investments, rise of Asian corporates, and growth of individual wealth. As a well regulated and diversified international financial centre, Singapore plays a natural role in facilitating trade and

investments in the region. High regulatory standards and a conducive business environment will continue to support stable growth in financial services.

Conclusion

Before I conclude, I want to highlight one more significant theme. This year marks MAS' 40th anniversary. MAS is where it is today because of the outstanding contributions of its staff – both past and present. The economic and financial stability that Singapore has enjoyed is the result of tireless efforts of generations of MAS officers. They have helped to secure for Singaporeans a low rate of inflation, preserve the purchasing power of our official foreign reserves, keep our financial sector safe and sound amidst crisis and change, and grow Singapore as a vibrant and trusted financial centre.

But MAS could not have done this alone. I would like to thank the financial services industry and all our partners for working alongside MAS to meet its objectives. We will continue to Sustain Stability and Serve Singapore in the years to come.

Thank you.