Ravi Menon: Forces driving the global economic outlook

Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Investment Management Association of Singapore 13th Annual Conference, Singapore, 14 March 2012.

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Mr Lester Gray, Chairman of IMAS,

Distinguished guests, ladies and gentlemen, good morning.

A. Fragile equilibrium

1. The world economy appears to have found a fragile equilibrium. There are weaknesses in key economies balanced by pockets of growth elsewhere. More notably, the worst fears of the last three months of 2011 have not materialised. The last six weeks in particular have shown signs that the global economy has avoided imminent disaster.

2. In the Eurozone, the threat of a major crisis has receded, at least for now.

- A deal has been struck on the second Greek bailout package, allaying fears of a messy default situation.
- The ECB's two tranches of Long-Term Refinancing Operation, or LTRO, amounting to more than 1 trillion Euros, has provided Eurozone banks much needed liquidity to meet their funding needs.
- The LTRO has also helped to compress sovereign yields significantly, particularly at the front end of the yield curve.

3. In the United States, the risk of a double dip recession has waned.

- Employment data have surprised on the upside.
- New orders for both manufacturing and non-manufacturing continue to indicate higher levels of activity for the next six months.

4. In China, the odds have improved in favour of a soft landing.

- While economic growth has continued to ease in the face of weakening external demand, domestic demand has been holding up well.
- Inflation appears to have peaked, providing monetary policy more latitude to support growth if necessary.

5. But the outcome for 2012 is by no means assured. Significant risks remain on the horizon:

- First, resolution of the sovereign debt situation in the Eurozone is still a work-in-progress. With Europe sliding into recession, sovereign and banking vulnerabilities will remain a protracted concern.
- Second, the sustainability of consumer spending in the US remains critically dependent on further improvements in the labour and housing markets – both of which are uncertain.
- Third, a sharp spike in oil prices could potentially derail global economic growth. Oil prices, which have already started rising, are highly vulnerable to geopolitical developments in the Middle East.

6. Barring these potential shocks, the IMF projects the global economy to grow by 3.3% this year. The Eurozone will experience a mild recession. The US and Japan will have positive growth, but below trend. Developing Asia is expected to grow by 7.3%. Under these conditions, the growth forecast for the Singapore economy at 1–3% this year remains on track.

7. But it is not this year's growth that policymakers or asset managers should be most concerned about. It is the medium-term growth and inflation outlook that matters. There are several structural challenges facing the global economy. I want to elaborate on two key driving forces that will shape the medium-term outlook in both the advanced and emerging economies: deleveraging and monetary expansion.

Deleveraging

8. Let me begin with deleveraging. From around 1990, debt levels began to rise rapidly in most advanced economies. Governments ran persistent fiscal deficits that were financed by borrowing. Total government debt in the OECD economies grew relentlessly, from 58% of GDP in 1990 to 98% in 2010. Households went on a consumption binge, financed by easy borrowings on the back of rising property prices and housing equity. Household debt in the developed economies also climbed, from 62% in 2000, to 76% in 2010. Deleveraging is the process by which this excessive debt is brought down to more sustainable levels. This will be long-drawn, only because the build-up of leverage took place over such a long period of time.

Synchronised deleveraging in the US and EU

9. The deleveraging process that is unfolding across the advanced economies is taking place across three fronts:

- Governments in the US and EU
- Households in the US
- Banks in the Eurozone

10. First, deleveraging by governments. The public finances of the US, UK, and the Eurozone, have substantially deteriorated, due to pre-crisis fiscal profligacy and post-crisis discretionary stimulus. These countries have now embarked on fiscal adjustment programmes to varying degrees, primarily through austerity measures. Fiscal consolidation is expected to shave off a cumulative 2–2.5% points from GDP growth in the US, UK, and the Eurozone over the next three years.

11. Second, deleveraging by US households. Since the bursting of the credit bubble in 2008, US household debt has declined by 5% in absolute terms and 15% as a percentage of disposable incomes. More than two-thirds of the reduction in debt stock was due to default of mortgage and other consumer debt. It is hard to tell what is a sustainable level of household debt, but most estimates suggest that US households are just about a third to halfway through the deleveraging process. This means probably another 3–5 years of sub-par household consumption growth in the US.

12. Third, deleveraging by Eurozone banks. There are two factors at work here. One, the quality of Eurozone bank assets has come under pressure. Two, Eurozone banks are required to improve their capital adequacy positions so as to buffer against shocks. In particular, European banks are required to achieve a minimum core Tier 1 capital ratio of 9% by June this year. To the extent that banks cannot achieve the target capital ratios through retained earnings and capital raising, they will have to reduce their balance sheets. They can do this by selling assets or reducing lending. Both will have a dampening effect on economic activity. Given the global footprint of many Eurozone banks, the effects will be felt not just in Europe but elsewhere in the world.

Impact of deleveraging on Asia

13. Emerging Asia will not be immune to this synchronised deleveraging in the advanced Western economies. Fiscal consolidation and household deleveraging in the US and EU will have significant spillover effects on Asia, principally through the trade channel. Asia ex-Japan exports about a quarter of its goods to the US and Europe. Already, Asian export growth has decelerated from 25% at the beginning of 2011 to 10% in the last quarter of the year.

14. While Asian economies have started to restructure their economies towards increasing domestic demand, and intra-regional trade within Asia has been growing, these trends will, at best, cushion only part of the fall in demand from the West. Rebalancing of demand is a long-drawn process. It is unrealistic to expect Asia to become the main engine of growth for the global economy over the next few years.

15. The deleveraging of Eurozone banks will impact Asia mainly through the financial channel, in the form of tighter credit. Euro area banks as a whole provide 36% of global trade finance loans, and French and Spanish banks together account for more than two-fifths of trade finance loans in Asia.

16. To-date, the impact on Asia of deleveraging by Eurozone banks has been quite limited. Through most of last year, many Eurozone banks substituted the drying up of interbank funds in Asia with increased inflows from head office, which enabled them to continue funding activities in Asia. But towards the end of 2011, there was a discernible pullback in trade finance, project finance, and syndicated loans by several Eurozone banks. Specialist lending lines like shipping and aviation also experienced cutbacks.

17. Well-capitalised global and Asian banks with strong liquidity positions have, however, stepped in to fill the gap. For example, Asian banks' market shares of export bills for Singapore-originated trade activities rose from 36% before the crisis to 55% in the last quarter of 2011. A similar pattern can be observed for trust receipts, where Asian banks' market shares rose from 55% to 64% over the same period. In fact, aggregate trade finance activity has continued to grow.

18. 2012 will be more challenging though. On the positive side, the funding situation for Eurozone banks has improved, in the wake of the ECB's LTRO. In January this year, there were net inflows from head offices to the Singapore branches of Eurozone banks.

19. But deleveraging by Eurozone banks is far from over. At the same time, the capacity of Asian banks to fill the trade financing gap is limited:

- First, the US Dollar loan-to-deposit ratios of Asia ex-Japan banks are already at elevated levels and could be a constraint.
- Second, Asian banks may be more selective about the risks they want to take on, given the uncertain global growth outlook.
- Third, Asian banks which are generally smaller may be constrained by counterparty limits from taking over the trade finance lines of the large European banks.
- Fourth, Asian banks will take time to build expertise in areas such as structured trade finance that the Eurozone banks have specialised in.

20. Deleveraging is a process not to be avoided but to be managed. The world as a whole has lived beyond its means in the years preceding the global financial crisis. Many advanced economies grew rapidly on the back of easy fiscal policies, low interest rates, and excessive credit expansion. The emerging economies benefitted from this growth through exporting to the advanced economies.

21. The world must now work off these past excesses. Debt in the advanced economies must come down to more sustainable levels before these economies can return to a

balanced growth trajectory. This must mean lower consumption and higher savings for some time. Emerging economies, especially in Asia, must increase domestic demand to help offset some of the impact of the slowdown in the G3 economies. But they will not be unaffected. They too will see slower growth.

Monetary expansion

22. A second driving force in the global economy is the widespread phenomenon of easy money. Since the beginning of the financial crisis in 2008, central banks in the US, UK, and the Eurozone have embarked on unprecedented monetary expansion. With fiscal policy constrained by sovereign debt concerns, the burden of supporting growth and ensuring financial stability has fallen disproportionately on monetary policy. With interest rates close to the zero bound, central banks have been relying heavily on unconventional measures, especially large scale asset purchases aimed at lowering long-term interest rates and spurring economic activity. Unconventional as these measures may be, they have been effective in preventing financial crisis and preserving market stability.

23. While this unprecedented monetary expansion may be necessary in the context of the current situation in the advanced economies, it is neither without risk nor contagion. The key risk is that if monetary stimulus is not withdrawn at the right time, inflationary pressures could rapidly build up.

24. Monetary expansion in the G3 economies also has significant cross-border contagion effects. Low interest rates in the advanced economies, coupled with relatively favourable growth prospects in emerging economies, have triggered bouts of large and volatile capital flows to the latter.

25. Easy monetary conditions are appropriate in the advanced economies given the stage of the business cycle they are at, with significant negative output gaps. But emerging economies, especially in Asia, are at a different stage of the business cycle:

- Capacity utilisation is above pre-crisis levels in many Asian countries. Labour markets are tight.
- The output gap in many Asian countries has closed and turned positive, although the recent easing of exports has reduced the gap somewhat.

26. Partly due to the tightening of monetary policy earlier on, inflationary pressures in many Asian countries have subsided. But as long as monetary conditions in the advanced economies remain easy, the risk of disruptive capital flows and surges in inflation, especially in asset prices, remains real.

27. The challenge facing Asian policymakers is this: how to adjust policy settings to cope with slower economic growth while inflation has not been entirely tamed? While there has been some normalisation in policy rates over the past two years, real interest rates remain generally low to negative in the region. Credit growth is strong and bears watching. Persistent low real interest rates can distort savings-investment decisions and lead to a misallocation of resources. Risks may build up in specific sectors, like real estate for instance.

28. Asian economies have mostly coped with these pressures by complementing standard macroeconomic responses – such as raising interest rates and allowing some currency appreciation – with a variety of so-called macroprudential tools, such as tightening credit standards and lowering loan-to-value ratios for property purchases. These unconventional measures have been fairly effective to-date in easing asset price inflation. But like unconventional monetary policy in the advanced economies, these measures are also not without risk.

Shift in investment portfolios to Asia

29. What do these driving forces mean for the asset management industry? One clear trend will be the shift of investment portfolios to Asia, as the driving forces accentuate the underlying shift in the world's centre of economic gravity towards Asia.

30. I described capital flows to emerging Asia earlier, largely in terms of cyclical factors relating to monetary policy. But there is a larger secular phenomenon underpinning these flows to Asia – the structural rebalancing of investment portfolios towards emerging economies in general, and Asia in particular. Given the size of developing Asia, there is not enough portfolio investment in Asia and not enough portfolio investment by Asia. There is scope for both to increase – dramatically.

31. First, global investors will invest more in Asia. Advanced economies represent only half of world GDP but three-quarters of global market capitalisation. A reallocation of just 5% of advanced economy equity portfolios to emerging economies translates into a potential flow of US$2 trillion.

32. You know the story well – strong economic growth, sound fundamentals, and favourable demographics will support the valuations of Asian assets and draw a growing tide of institutional investor interest from the rest of the world. At the same time, rapid urbanisation will mean large infrastructure needs in Asia – the ADB has estimated that Asia needs about US$8 trillion through 2020 to upgrade its infrastructure. This financing need cannot be met by public funds alone. Infrastructure funds are set to play an increasingly important role in the asset management landscape in Asia.

33. Second, Asian investors will invest more, both in Asia and globally. Rising affluence and a strong savings culture, coupled with increasing financial sophistication, will mean more Asians moving away from speculation in property and stocks, towards more systematic planning for wealth enhancement through a globally diversified portfolio of assets.

34. There are now more high net worth individuals in the Asia Pacific than in Europe. And they are younger – 41% of the high net worth individuals in the Asia Pacific are aged 45 years and below, compared to only 10% in North America. They have a longer time span for wealth accumulation, and a more global outlook in their investment strategies. At the same time, Asians are living longer and more Asian countries are seeing the need for well-designed pension systems to provide adequate retirement incomes for their people. These pension funds will require professional management.

35. In the same vein, I expect the demand from the official sector for Asian financial assets to grow. Central banks and sovereign wealth funds will likely look to allocate more funds to Asian markets, both to diversify risk and to enhance returns. Speaking for the MAS, we have always invested our official foreign reserves in a highly diversified global portfolio. As Asian markets develop in depth and sophistication, our allocation to emerging markets, especially in Asia, will grow.

36. To be sure, asset management in Asia is not a one-way bet. Asian markets are more fragmented and harder to operate in, compared to the advanced economies. Infrastructure finance is indeed promising, but has been promising for two decades now with little of the promise realised. There are a variety of country-specific risks – institutional and legal – that must be taken into account when operating in these markets. Managing risk and navigating a varied terrain are key to success.

Singapore as the leading Asian asset management centre

37. This is where Singapore comes in. Singapore's strong physical connectivity and trade and financial linkages with the rest of Asia make it a key node in the flow of information and ideas. It is an ideal vantage point for asset managers to understand Asia and manage pan-Asian investments.

38. The asset management industry in Singapore is broad based. Top-tier global funds have centralised a host of critical functions in Singapore, including portfolio management, investment research, trade execution, and product structuring – across both equities and fixed income asset classes. Singapore is also seeing a flourish of alternative investment managers specialising in strategies or asset classes that provide return streams uncorrelated to the broader market, or as the industry terms it, "generating alpha".

New initiatives to develop Singapore's capital markets

39. A key component of the broader ecosystem that supports the asset management industry in Singapore is the capital market. Over the years, MAS has been making concerted efforts to broaden and deepen Singapore's debt capital market. I am pleased to announce today three initiatives aimed at further improving efficiency and liquidity in the Singapore dollar corporate debt market.

40. First, MAS will provide swap liquidity to primary dealer banks handling Singapore dollar debt issuance for foreign corporates. These offshore entities usually have no need for the Singapore dollar funds raised and mostly swap them into a foreign currency, usually US dollars. Although the pricing mechanism in the foreign exchange and cross currency swap market is efficient, swap markets have a tendency towards one-way flow because of Singapore's excess savings over investments. This can lead to uncertainty in the pricing process of the bond issuance. We will therefore support swap transactions at market-determined prices, which will ultimately enable swap market liquidity to build in the longer tenors.

41. Second, MAS will partner the industry to create a Singapore dollar corporate debt securities lending platform, from which key players will be able to borrow securities for market making. By providing greater assurance that banks will be able to deliver any given security, this platform will reduce the risk of market makers being squeezed in the event they are unable to short-cover the bonds they have sold. Improved market liquidity will mean that asset managers can be more certain of their ability to enter and exit their positions with minimal price slippage.

42. Third, MAS has initiated a price discovery platform where market participants will contribute end-of-day prices for a universe of Singapore dollar corporate bonds. This is targeted for completion by the second half of this year. This initiative will significantly improve transparency in the corporate bond market and provide reliable mark-to-market prices for the industry and asset managers alike.

Conclusion

43. Let me conclude.

There are fundamental structural forces shaping the global economic outlook for the next few years. The effects of deleveraging and monetary expansion will be with us for some time. They pose twin risks: lower economic growth and higher inflation.

44. But the Asian growth story remains intact, and Asia's rise as both a source and destination for investment augurs well for the asset management industry. All of you gathered here belong to an industry that has been and will remain one of the star performers of Singapore's financial sector.

45. I wish you fruitful discussions. Thank you.