Ong Chong Tee: Financial economics

Opening address by Mr Ong Chong Tee, Deputy Managing Director of the Monetary Authority of Singapore, at the SKBI Annual Conference on "Financial economics", at Singapore Management University (SMU), Singapore, 7 May 2012.

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Professor Arnoud De Meyer, President of Singapore Management University

Distinguished guests, ladies and gentlemen, good morning.

Introduction

It gives me great pleasure to join you today at SKBI's second Annual Conference on Financial Economics. Since its establishment in 2008, SKBI has pursued research on topics in economics and finance relevant to Asia and the Singapore economy. A recent working paper on "Testing for Multiple Bubbles" by Phillips, Shi and Yu, for example, sheds light on techniques for identifying asset price bubbles, and has useful implications for the surveillance strategies of central banks.[1]

I am privileged to join an outstanding line-up of speakers including keynote speaker Professor Sir James Mirrlees. I think some of you may be familiar with his groundbreaking work on optimal tax policy, and his modelling of the key role uncertainty plays in economics. The Mirrlees Review, a recent review of the UK tax system chaired by Sir James, offers invaluable practical lessons on optimal tax design, including specific recommendations for the taxation of savings and wealth.

Structural change in the Singapore economy

The perfect financial storm of the recent crisis severely disrupted markets and economies, and also shook key tenets fundamental to our understanding of economics and finance. Established beliefs in efficient markets, asset price dynamics, and more, have all been called into question.

Amid the flux in the global financial and economic landscape, Singapore also has its own challenges. Resource constraints mean that we have to restructure the economy to depend less on the labour force and more on productivity increases for growth.

During this period of transition, important adjustments in domestic resource costs and consumer prices are taking place, alongside the usual cyclical developments confronting the economy. Dealing with the confluence of factors affecting domestic prices has been particularly challenging, for us at the central bank and equally so for consumers and businesses. CPI-All Items inflation, for instance, has been elevated coming out of the recent financial crisis, averaging 4.1% since 2010, much higher than the historical norm of below 2%. MAS Core Inflation, which excludes changes in accommodation and private road transport costs, averaged a lower 2.0% over the same period.

Consumer price pressures have picked up more recently. CPI-All Items Inflation reached almost 5% in Q1 this year and households may face higher price increases for specific expenditure items. MAS is monitoring these and other cost indicators closely. Allow me to take this opportunity to highlight some conceptual issues concerning price adjustments in the

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[1] Phillips, P, Shi, S and Jun, Y (2011), "Testing for Multiple Bubbles", Working Paper No. 03–2011, Singapore Management University.

economy and their implications for monetary policy. In other words, why is inflation higher than what we have experienced historically, and is monetary policy responding in an optimal way?

Implications for Inflation

First, it is important to recognise the complex interplay of demand and supply factors underpinning the recent price developments in Singapore.

Demand-side pressures on prices have built up as domestic economic activity rebounded strongly from the Great Recession of 2008/09. Regional demand has been firm, supporting the continued expansion of many of our services industries, while strong employment conditions in Singapore have underpinned robust consumption growth for a range of goods and services. Sustained low global interest rates and capital inflows have supported the demand for housing – a point I will return to later.

At the same time, supply-side factors have become more significant, with the immediate constraints in labour and housing markets pushing up domestic costs. These reflect structural capacity constraints in the economy. Policy measures are being put in place to help the economy transit to a more sustainable model of productivity-led growth, as Singapore's reliance on foreign workers is reduced. As the economy adapts and productivity growth rises, price pressures are likely to subside and provide a lift to real wages, making Singaporean workers better off.

Implications for monetary policy

My ***second*** observation is that the monetary policy stance has to be carefully calibrated to take into account the multiple influences on consumer prices.

Monetary policy should act decisively to ease short-term inflationary pressures driven by strong demand, through applying an appropriate constraint on overall economic activity. Our studies continue to show that in our small, open economy, the exchange rate has a significantly greater impact on growth and inflation compared to domestic interest rates. Hence, MAS has been tightening monetary policy by allowing a stronger rate of appreciation of the S$ nominal effective exchange rate since April 2010.

However, with respect to cost pressures arising from the supply-side, monetary policy should aim to temper, but not fully offset. Higher labour costs in the short term due to permanent supply-side shifts are part and parcel of the market's equilibrating process to guide the economy to a sustainable growth path. But MAS will be vigilant to the risks that these price developments can set off second-round price effects if left unchecked.

The appropriate monetary policy response thus depends on the nature and persistence of the shocks that are affecting prices. Herein lies the monetary policy challenge: how do we distinguish between the relative importance of demand and supply factors in driving cost and price increases in the economy? On one hand, there could be a risk of keeping policy too loose and unhinging inflation expectations. On the other hand, stamping out inflation aggressively could forestall the important signalling role of relative price adjustments, as well as add to transitional costs, including the negative impact on growth.

Let me illustrate with the example of ongoing changes in our labour market. While the shift in foreign worker policy is necessary to allow for a more efficient allocation of resources and a more productive workforce, the latter will take time to come to fruition. During this transitional phase, business costs are likely to rise somewhat as a result of tight labour market conditions, before productivity gains catch up to offset the cost increases. In the short term, the prices of some consumer services – especially those with high labour content – can rise and indeed, have increased in the early months of this year.

Reflecting these considerations, the tighter monetary stance adopted by MAS in April 2012 was a calibrated move to facilitate the ongoing supply-side adjustments, while anchoring inflation expectations. The policy stance was aimed at keeping the economy on an even keel with GDP growth expected to come in at 1–3% this year. We expect that headline and core inflation will ease gradually through the year, but along a somewhat elevated trajectory. Over time, the cumulative appreciation of the exchange rate will temper the pace of price increases in the economy. MAS is firmly committed to our objective of price stability over the medium term, even as productivity improvements arising from the significant economic restructuring will help to prevent higher costs from fuelling strong price increases.

To ease the immediate burden of price and cost pressures faced by households and businesses during this period of transition, the government has implemented a wide-ranging package of relief measures. These include targeted utility rebates that directly alleviate the higher cost of living for households. Similarly, SMEs received a one-off cash grant in this year's Budget to help offset higher business costs.

Implications for asset prices

My ***third*** point is that it is important to respond appropriately to rising asset prices, including in the housing market.

Following the recent financial crisis, major central banks reduced policy interest rates to historical lows. Credit growth in this region has recovered strongly, in Singapore and other Asian economies. There is a danger that systemic risk can develop and crystallise in a number of ways. For instance, low interest rates may encourage risky borrowing and lending practices, to create a build-up of leverage in households' and banks' balance sheets. Capital flows into Asia can also contribute to higher bank leverage, as well as asset price inflation, with the risk of sharp corrections in asset prices should these capital flows reverse quickly.

Past experiences have shown that when highly leveraged asset markets correct sharply, they can lead to enormous stress on the banking system and significant collateral damage on the real economy. The views among central bankers have therefore increasingly shifted towards the need to take pre-emptive measures at an early stage.

The global experience with monetary policy, however, suggests that broad policy instruments like exchange rates and interest rates have very significant collateral effects, and are often subject to long and variable lags before impacting asset markets. Instead, it is preferable to consider a greater reliance on macro-prudential tools and other administrative measures targeted at specific asset markets such as property, in an environment of strong capital inflows and domestic economic growth. This will allow the central bank to better achieve its financial stability objective, as well as serve as a counter-cyclical tool to dampen excessive credit growth and price increases. But macro-prudential policy cannot be a substitute for sound macroeconomic policies. Monetary and fiscal policies need to continue to focus on correcting macroeconomic imbalances, with macroprudential policy focused on ensuring that systemic risk is well-contained.

In Singapore and elsewhere in the region, authorities have implemented measures such as Loan-to-Value (LTV) ratios and buyer/seller stamp duties to prevent the formation of asset price bubbles. Our approach in Singapore has been targeted and incremental. Measures are focused on discouraging short-term speculative activity that can distort underlying prices, while encouraging greater financial prudence among property purchasers. Where supply constraints can be ameliorated to relieve cost pressures in the housing, commercial and industrial property segments, the government has done so directly.

Conclusion

I have highlighted a few issues and challenges arising from structural changes in the Singapore economy. In these areas, there is much scope for further study including joint collaboration between academia and policymakers. First, in robust statistical techniques to identify demand and supply shocks in a dynamic economy. Second, in formulating robust monetary policy rules in the context of ongoing supply-side changes in the economy. And, finally, in developing early warning indicators for different types of inflationary pressures, and assessing the efficacy of various macroprudential instruments. Partnerships with academia can also play a key role in public insights and understanding of structural issues, challenges and the policy trade-offs. In this regard, I encourage SKBI to be at the forefront of applied financial and economic research that can help shape policy thinking.

An American opera soprano and actress turned self-help guru, Dorothy Sarnoff, once said: “Make sure you finished speaking before your audience finished listening”. This morning, I am sure many of you are looking forward to the keynote address by Sir James Mirrlees as much as I am. So allow me now to end my opening address here. Thank you for your kind attention.