Ravi Menon: Monetary Authority of Singapore's Annual Report 2011/12

Opening remarks by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Monetary Authority of Singapore's Annual Report 2011/12 Press Conference, Singapore, 25 July 2012.

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Good morning. Welcome to MAS' annual report press conference.

I will focus on five key areas today. First, what is happening on the growth and inflation front; second, what does it mean for MAS' monetary policy; third, how is MAS managing risks to our economic and financial stability; fourth, what MAS is doing to make our financial sector stronger; and fifth, how we are positioning Singapore's financial centre for growth.

Let me start with the economy.

Growth and inflation

Singapore economy remains on track to grow at 1–3% this year

Singapore's GDP growth averaged 4.2%[1] in the first half of this year. But the growth momentum is clearly slowing. The average growth in the second half of the year is likely to be slower than in the first half of the year. This is not unexpected, and has been factored into whole year growth forecast of 1–3%.

The global economy is slipping into a synchronised slowdown. The latest business surveys in all major jurisdictions have turned more negative. There is greater uncertainty in the US economy compared to three months ago, especially with respect to the labour market. The Eurozone remains mired in recession with no early end in sight. Financial market stresses have eased somewhat but the underlying vulnerabilities remain. In emerging Asia, domestic demand is holding up, but growth is vulnerable to developments in America and Europe. The full extent of weakness in exports, and its effects through regional production and trade linkages, has probably not filtered through completely.

I must add that our forecast is based on three assumptions: no recession in US, no significant escalation of the Eurozone crisis, and no "hard landing" in China. If one or more of these assumptions do not pan out, Singapore's GDP growth could dip below 1% for 2012.

But growth of 1–3% should be seen in perspective. The economy is operating at full employment and capacity utilisation is high. The Singapore economy has expanded by an average of 5.8% over the past five years, faster than economy's underlying potential. The moderation in growth thus brings the economy closer to its sustainable level of output, and will help relieve cost pressures.

Let me touch on inflation now.

CPI-All Items inflation for 2012 is expected to come in at 4.0– 4.5%, but Core Inflation will continue to come down and approach 2% by end of the year

MAS is narrowing forecast range for CPI-All Items inflation in 2012 to 4.0–4.5%, but the forecast for Core Inflation remains unchanged at 2.5–3.0%.

[1] Refers to average growth on a quarter-on-quarter seasonally-adjusted annualised basis. Growth for Q2 is based on Advance Estimates of –1.1%.

Bringing down inflation remains one of MAS' top priorities. The figure we watch most closely is Core Inflation, which excludes the costs of accommodation and private road transport. We were concerned when Core Inflation came in at 3.1% in the first quarter of this year. This reflected high commodity prices and the pass-through of strong wage growth in 2011. In the second quarter, Core Inflation moderated to 2.7%. It is likely to ease further and approach 2% by the end of the year. This is not far from the historical average of 1.7%.

There are several factors driving moderation in Core Inflation during the course of the year.

First, oil prices. Global oil prices were at US$103 per barrel in the first quarter of the year. They are now around US$90. For the rest of the year, they should remain in the US$90–95 range on average, barring deterioration in the geo-political situation in Middle East. The easing of global oil prices is already passing through to prices of domestic oil-related items. Let me give a couple of examples. Electricity tariffs for households came down by 2.5% in July, the first reduction this year. Likewise, petrol pump prices have fallen for three consecutive months, by a cumulative 9% from March. Going into the second half of the year, domestic oil-related prices are expected to keep largely stable.

Second, food prices. Global food commodity prices, as measured by the UN FAO Food Price Index, were 5.4% lower in June compared to beginning of the year. This has started to feed through to domestic food inflation, which came down from 3.8% y-o-y in January to 2.3% in June. Recently, there has been spike in global corn and soya bean prices due to a drought in US. But we do not expect a broad-based surge in global food prices in coming months, and so domestic food inflation should remain relatively contained for rest of year.

Third, domestic wages. The 6% increase in domestic wages last year passed through quite strongly into a variety of services costs earlier this year. We can expect some continued pass-through of wage costs for the rest of this year, but at a more restrained pace compared to early this year.

Like Core Inflation, Headline Inflation – or inflation in CPI-All Items – is also expected to be lower on average in the second half of the year compared to the first half. But, unlike Core Inflation, CPI-All Items inflation will remain elevated at well above the historical average. As mentioned, MAS is narrowing its forecast for CPI-All Items inflation in 2012 from 3.5–4.5% to 4.0–4.5%. This largely reflects two factors.

First, imputed rentals on owner-occupied homes are expected to remain high compared to a year ago. This essentially does not involve an actual increase in spending by households. Imputed rentals on owner-occupied homes are based on actual rentals but, as you know, only a small segment of the population rents their homes. We expect continued tightness in the housing rental market, especially in the HDB segment. While measures have been taken to increase housing supply, it will take some time for this supply to come onstream.

Second, should demand remain resilient, COE premiums are likely to stay high. This could present upside risks to the 4.0–4.5% forecast for CPI-All Items inflation.

In sum, the costs of imputed rentals on owner-occupied homes and private road transport will account for about 60% of CPI-All Items inflation this year.

CPI-All Items inflation will also be volatile from month to month. Two factors are significant: one, the fluctuations in COE premiums; and two, the base effects associated with the timing of the government's disbursement of service & conservancy charges and rental rebates.[2] This factor, for example, accounted almost entirely for temporary rise in inflation from 5.0% in

[2] S&CC and HDB rental rebates were given out in June, September and December last year, but were discontinued after March 2012. This will result in higher temporary contributions from accommodation cost in the corresponding months in 2012.

May to 5.3% in June. We expect inflation in July to fall to around 4%, in part reflecting the reversal of this base effect.

Let me now move on to MAS' monetary policy.

Monetary policy

Monetary policy has had restraining effect on inflation and current policy stance remains appropriate

The persistence in Headline Inflation has led to some questions about efficacy of Singapore's exchange rate-centred monetary policy framework.

MAS has studied this issue very carefully. We are assured that monetary policy framework remains effective and the current policy stance remains appropriate.

Monetary policy in Singapore has been tight for more than two years now. Since April 2010, MAS has put in place a modest and gradual appreciation path for the trade-weighted Singapore dollar policy band. In April this year, MAS tightened monetary policy by increasing the slope of the policy band further.

This exchange rate policy stance has had a restraining effect on inflation through two channels: first, by filtering import prices; and second, by moderating economic activity. First, a stronger exchange rate has helped to filter import prices. Take, for instance, oil prices. Since April 2010, global oil prices have risen by an average of 15% year-on-year, but domestic petrol pump prices have only increased by 8%, reflecting the effects of the exchange rate. Second, the stronger Singapore dollar has had a restraining effect on activity in the economy, especially through the export-oriented sectors. This has helped to dampen business cost pressures.

These two effects have been quite significant in helping to dampen inflation. Since April 2010, the trade-weighted Singapore Dollar has appreciated by 3.3% per annum, reflecting MAS' tighter monetary policy stance. Our simulations show that if this appreciation had not taken place, CPI-All Items inflation this year would have been 6.5–7.0%, rather than the 4.0–4.5% we have projected.

But there is a limit to how far we can use exchange rate policy to contain inflation. First, while exchange rate policy is effective against imported inflation and domestic cost pressures arising from rapid economic growth, it is less so against inflation in housing rentals and car prices. Even so, housing prices and car prices cannot keep rising rapidly in an environment of weakening economic growth. The measures taken to address supply-side issues in the housing market and public transport will also help to ease price pressures in these two areas. Second, too rapid a rate of appreciation of the Singapore Dollar can significantly hurt our economic performance, especially in light of heightened uncertainty in the external environment.

In sum, exchange rate is taking longer than usual to moderate inflation, but it remains our broadest and most effective anti-inflation tool. MAS will continue to keep a close watch on developments in the global economy and price pressures in the domestic economy. The next Monetary Policy Statement will be released as scheduled in mid-October 2012.

MAS remains focused on anchoring inflation expectations as economy undergoes restructuring to reduce dependence on foreign labour

Looking at medium term, the domestic economic environment will remain challenging for monetary policy. The Singapore economy is making a transition towards productivity-driven growth. This will help to reduce our reliance on foreign labour and raise the wages of low-income Singaporeans. But rising wages must mean rising costs and rising prices, at least until productivity improvements kick in. We can expect stronger domestic price pressures over the next few years, and hence slightly higher inflation than we have seen historically. Slightly higher inflation does not mean runaway inflation. MAS will remain vigilant and calibrate monetary policy to ensure that this does not happen. We will not allow inflationary pressures to become entrenched or inflation expectations to build up.

Managing risks to economic and financial stability

MAS is preparing for risks to economic and financial stability posed by escalation of Eurozone crisis

Besides watching growth and inflation trends, MAS has been focusing on downside risks to Singapore's economic and financial stability. We monitor the risks closely, take steps to mitigate these risks where we can, and draw up contingency measures to manage them if they materialise.

The key risk facing the Singapore economy and financial system is the ongoing crisis in the Eurozone. While Eurozone governments have taken important steps to deal with crisis, we must be prepared for a more adverse turn of events.

The escalation of the Eurozone crisis can affect Singapore in three ways: first, the impact on economic growth; second, stresses on our financial markets; and third, the safety and soundness of our financial institutions.

Let me begin with economic growth. A deeper recession and credit crunch in Eurozone can impact our growth through trade and financial channels. The trade channel will be more direct and impactful. The Eurozone is our largest export market, and Singapore's exports to the Eurozone have been declining since Q3 last year. For the financial channel, it will be mainly through a spike in risk aversion and drying up of bank credit, quite similar to 2008. Already, we have seen some retraction in the Eurozone banks' trade finance activities in Asia, but the local and global banks have stepped in to fill the void.

Financial market stresses will be felt most keenly in capital flows, currency markets, and interbank funding. There could be larger and more volatile capital flows. We must be prepared for both excessive inflows as well as outflows. This could in turn have either upward pressures or downward pressures on the Singapore Dollar. Interbank funding could tighten further. We are keeping a close watch on market liquidity conditions, especially in the availability of US Dollar funding.

Finally, the impact on safety and soundness of financial institutions. Financial institutions operating in Singapore have limited direct exposure to peripheral Europe. But if the crisis spreads to core Europe, the contagion could be larger. MAS is closely monitoring banks' lending exposures and funding profiles. Given our close links to global financial networks, we will not be unaffected. But our financial system is sound and we should be able to weather the storm. Our local banks – at the core of the financial system – have strong capital and liquidity positions. They have very good asset quality, with non-performing loans ratio at just 1.3%. We have been carrying out periodic industry-wide stress tests. The tests suggest that major financial institutions in Singapore would be able to withstand adverse financial and economic shocks.

MAS will continue to monitor closely developments in the Eurozone and their potential impact on Singapore's economic and financial stability. The 2008 financial crisis and current crisis in the Eurozone underscore importance of building a sound financial sector through strong regulation and supervision.

A sound financial sector

Singapore will continue to meet or exceed international regulatory standards

Let me touch on efforts on the regulatory front in three areas: strengthening our banks' ability to absorb losses; enhancing our frameworks for consolidated supervision; and extending scope of regulation to cover all fund management companies.

In the area of loss-absorbency, Singapore will fully implement the Basel III capital standards. Singapore-incorporated banks will meet Basel III minimum capital adequacy requirements two years ahead of the Basel Committee's timeline of 1 January 2015. They will then meet, from 1 January 2015, MAS' capital adequacy requirements that are 2% higher than the Basel III global capital standards.

Next, we are stepping up consolidated supervision of financial groups. In banking, MAS has always conducted group wide supervision. We are increasingly focusing on areas such as mitigating intra-group contagion risk, preventing the multiple use of capital within the group, and limiting group concentration risk exposures. For insurance groups, we will be enhancing our supervisory practices. We issued a consultation paper in February this year, with detailed proposals. We will also introduce a new Financial Holding Companies Act. This will cover companies incorporated in Singapore, which hold as their subsidiary or subsidiaries, banks, insurance companies, or both, but does not itself conduct banking or insurance business.

Third, regulation of the fund management industry. All fund management companies will have to meet the enhanced competency, business conduct, and capital requirements by August. Those with assets under management greater than S$250m will have to be licensed, while those below this threshold may operate under the "Registered Fund Management Company' regime, which will replace the existing "Exempt Fund Manager" regime.

I will now touch on the performance and development of Singapore as a financial centre.

Financial centre: well-positioned for growth

Singapore financial sector activity subdued in weak global environment, but longer-term prospects remain bright

Singapore's financial sector contracted on a sequential basis for two consecutive quarters in Q4 2011 and Q1 2012, amidst heightened risk aversion in global financial markets. We expect financial services activity to remain subdued given uncertainty and weakness in the global economic environment. Activities such as trading – which are very sensitive to sentiment – bore the brunt of adjustment. But other activities – tied to Asian demand – have remained resilient. They are well-positioned for growth. Asia's demand for financial services will continue to be driven by rapid urbanisation, the demographics of a growing middle-class, and the rise of regional multinational companies in need of funding. Let me highlight a few of these growth areas.

First, asset management. As at end-2011, total assets managed by Singapore-based asset managers amounted to S$1.34 trillion. This is a slight dip of 1.2% from 2010, but not bad, considering the weak performance of global equity market and the volatile financial markets in general. Indeed, we have seen a more diversified base of asset managers offering a greater variety of investment strategies. The number of investment professionals increased by 15% last year. And we continue to see strong interest from global fund houses seeking to set up or expand their Asian presence. 26 of top 30 global asset managers in the world have a presence in Singapore

Second, the corporate debt market. The outstanding stock of corporate debt – in Singapore Dollars and non-Singapore Dollars – increased by 9% year-on-year to S$203 billion as at end 2011. And despite a more difficult market environment, Singapore Dollar bond issuance remained robust last year, at S$25 billion, compared to S$26 billion in 2010. Non-Singapore dollar bond issuance volume was also buoyant, growing 110% year-on-year.

Third, the insurance industry. Non-life insurance gross premiums recorded growth of 14.5% in 2011. Almost 60% of total non-life gross premiums written in 2011 were sourced offshore, demonstrating Singapore's role as an international insurance centre.

Fourth, the Asian Dollar Market. This is the pillar of the Singapore financial sector. Banks in Singapore draw in foreign currency deposits globally, and deploy these funds to serve the financing and treasury needs of individuals, corporations and institutions in Singapore and beyond. Offshore lending expanded last year, with non-bank loans growing by 17%. The healthy growth has continued into the first quarter of this year, buoyed by regional demand.

MAS will continue to foster sustained growth in our financial sector, underpinned by a conducive ecosystem and a sound regulatory framework.

Conclusion

Before I conclude, a word on MAS' accounts.

MAS made foreign investment gains of S$12.1 billion but recorded an overall profit of S$2.8 billion in Singapore dollar terms due to a strong exchange rate

Excluding exchange rate effects, MAS achieved net foreign investment gains totalling S$12.1 billion during the financial year (FY) ended March 2012, roughly similar to the previous FY. However, in Singapore Dollar terms, this translated to a net profit of S$2.8 billion.

Let me sum up. The global economy is slowing, and financial markets remain vulnerable to renewed stresses. MAS is keeping a close watch. The situation in the Eurozone remains the most significant risk to global financial stability. MAS is monitoring the various channels of spillover to Singapore. Bringing down inflation remains one of MAS' top priorities. Core inflation is likely to moderate to close to our historical average by the end of year. Headline inflation will also moderate but remain elevated due to high imputed rentals on owner-occupied homes and COE prices. MAS will continue to ensure that our financial markets function smoothly and that investors maintain a high level of confidence in our financial system.

I will now be happy to take questions, together with my two deputy managing directors, Chong Tee and Swee Lian.