Recent developments in the Singapore economy

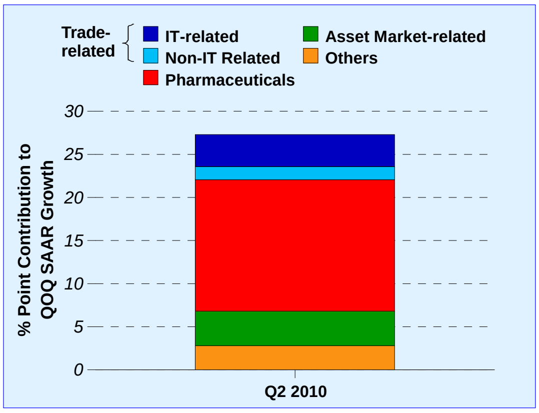
Monetary Authority of Singapore[1]

Outlook for the Singapore economy

Amidst continued growth in external economies, the Singapore economy strengthened further in the second quarter of 2010. The economy expanded by 27.3% quarter on quarter, on a seasonally-adjusted annualised rate (SAAR) basis, following an unprecedented 45.9% increase in the previous quarter. This brought GDP levels for the first half of 2010 to about 18% higher than in the same period in the previous year. The second quarter's strong sequential growth was largely due to a 356% surge in pharmaceuticals production, as manufacturers continued to increase output of high value-added pharmaceutical ingredients (Graph 1). The uplift extended to the rest of the economy, with the other trade-related, financial and tourism-related sectors recording robust growth. Graph 2 shows that all the major sectors had surpassed their pre-crisis peaks by the second quarter of 2010.

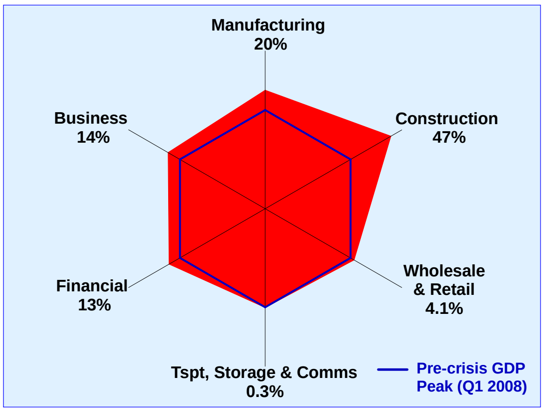
Graph 1

Singapore's GDP growth



Graph 2

Q2 GDP levels compared with previous peak



Sources: EPG; MAS estimates.

Following the unprecedented expansion in the first half, the Singapore economy began to moderate in the middle of the year, in line with a loss of recovery momentum around the world. In the third quarter, the Singapore economy contracted by 18.7% quarter on quarter SAAR, led by a 53.6% fall in manufacturing value-added, which was weighed down by a plunge in pharmaceuticals output. The construction sector declined by 10.4%, while growth in the services sector slowed significantly to 1.4%. Excluding pharmaceuticals, the economy eased by 2.0%, following five straight quarters of sequential gains.

[1] The following is an excerpt from MAS's biannual Macroeconomic Review, published in Oct 2010. The full report is available online at: http://www.mas.gov.sg/publications/macro_review/index.html

Regarding the outlook, final demand in the developed economies is expected to remain sluggish, even if the risk of the global economy relapsing into recession has subsided. In comparison, the prospect for the Asia ex-Japan economies is more positive. Although growth in the region will likely slow, it should continue to be supported by firm domestic demand. Against this backdrop, the level of economic activity in Singapore is projected to remain high across a broad range of industries, though it could ease further in the near term. GDP is on track to grow by around 15% for 2010 as a whole, before easing to a more sustainable growth rate of 4–6% in 2011.

While manufacturing and services contributed fairly evenly to GDP growth in 2010, services will play a larger role next year, on the back of a relatively sanguine outlook for the region. After a sharp rebound from the trough, the domestic manufacturing sector is likely to take a breather going into 2011 as global IT demand cools off. Concomitantly, the services sector could account for up to two thirds of Singapore's GDP growth next year, from around half this year. In particular, the financial, trade and tourism-related sectors are likely to see relatively stronger growth, as these sectors are highly geared towards Asian markets and together would contribute to slightly more than half of GDP growth next year.

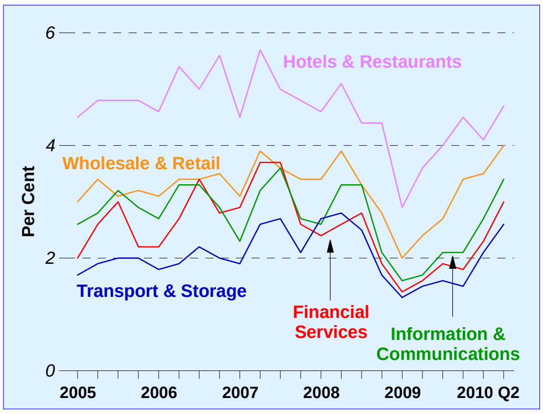
Cost pressures likely to increase in the near term

On the labour front, the current pace of hiring in the labour market is likely to be sustained in the near term. In particular, job creation in the services sectors is expected to remain strong. Employment growth in the tourism-related industries will be supported by the high number of visitor arrivals, while the information and communications sector will also hire more workers, driven by increased spending on IT and telecoms services. In the financial services sector, demand for workers in private banking will continue to be boosted by Asia's strong growth prospects, although hiring could abate in other segments as a significant proportion of the hiring plans made earlier in the year have already been realised.

Strong demand for service workers amidst the tight labour market will cause staff turnover to increase and wage pressures to build up. The former is already evident from the increase in the recruitment and resignation rates in most services sectors (Graph 3(a) and (b)). The increase in services wages will boost overall wage growth over the next few quarters before it eases as the low base effects dissipate. For both 2010 and 2011, nominal wage growth will be relatively strong compared to the average of about 3% over the last 10 years.

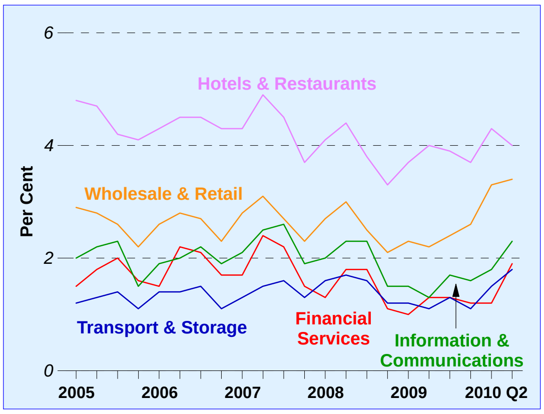
Graph 3(a)

Average recruitment rates in the services sectors



Graph 3(b)

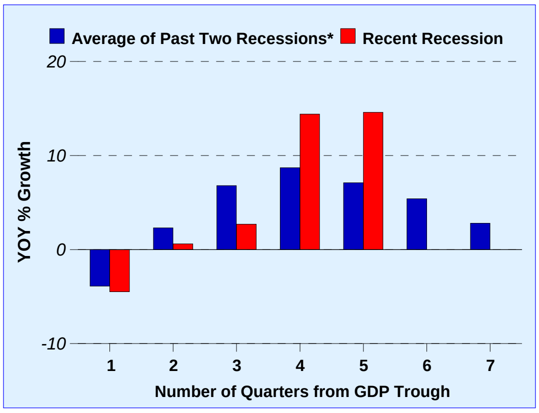
Average resignation rates in the services sectors



Meanwhile, labour productivity growth is likely to slow after surging by 15% year on year in the first half of 2010. Compared to the recovery period following the Asian financial crisis and 2001 IT downturn, the initial increase in productivity at the turn of the business cycle this time round was much weaker. This reflected the resilience in the labour market as firms held on to workers during the downturn in part due to the Jobs Credit Scheme. However, labour productivity growth subsequently picked up sharply on the back of a surge in manufacturing output (Graph 4). Based on the profile in the previous two recessions, labour productivity growth should moderate substantially in the next few quarters. Slower productivity growth, strong wage pressures and changes in labour-related policies will result in an increase in unit labour cost (ULC) over the next few quarters, thereby reversing some of its previous decline (Graph 5).

Graph 4

Labour productivity growth across recessions



Graph 5

Unit labour cost index

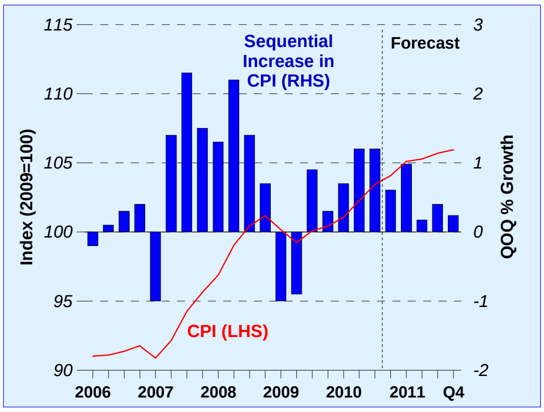
* Past two recessions refer to the Asian financial crisis and 2001 IT downturn.

Turning to price developments, headline CPI inflation will continue to increase in the next quarter on account of strong domestic cost pressures, notably the costs of accommodation and domestic services. In comparison, external sources of inflation will be generally capped by weakness in the global economy. After reaching 3.4% year on year in the third quarter of 2010, CPI inflation is expected to climb to around 4% at the end of 2010 and stay high in the first half of 2011 before moderating.

On a sequential basis, the CPI will continue to rise, albeit at a more moderate pace compared to the last two quarters (Graph 6). The build-up in the sequential price increases will result in CPI inflation reaching around 4% on a year ago basis at the end of 2010. It will likely stay high in the first half of 2011 before moderating to around 2% in the second half (Graph 7). For the whole year, headline CPI inflation is projected to be 2.5–3% in 2010 and 2–3% in 2011. The Monetary Authority of Singapore (MAS) underlying inflation measure, which excludes the costs of accommodation and private road transport, is expected to rise to 2–3% next year, from around 2% this year. Close to half of the CPI inflation this year will come from private road transport costs and another one third from oil/food commodity prices. Next year, the domestic non-tradables, namely services and accommodation, will account for about half of CPI inflation while food prices will account for about one fifth.

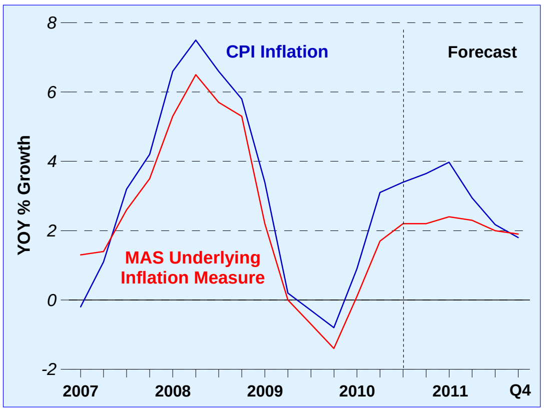
Graph 6

Forecasts of sequential CPI increases



Graph 7

CPI inflation and MAS underlying inflation measure forecasts



Sources: EPG; MAS estimates.

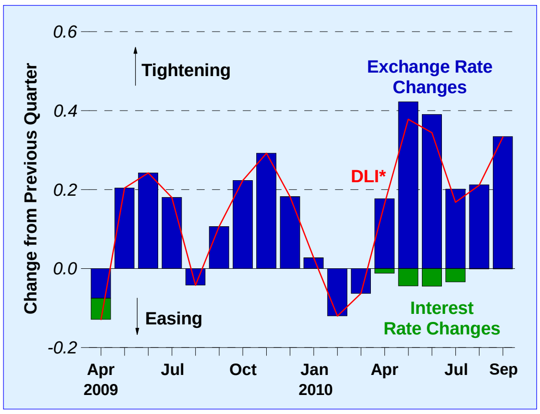
Liquidity conditions have tightened since May this year

From April to September, the domestic liquidity indicator (DLI) was positive, suggesting a tightening in overall liquidity conditions alongside the return to a modest and gradual appreciation stance of the Singapore dollar NEER (Graph 8). Changes in the DLI were predominantly driven by the exchange rate component, while the three-month domestic interbank rate has remained at low levels since the beginning of last year.

Indeed, the benchmark interest rate stayed at 0.69% between January 2009 and April 2010, before edging down to a historical low of 0.56% since May this year and further to 0.50% at end-September (Graph 9). In comparison, the three-month US dollar SIBOR picked up from 0.25% at the end of January to 0.54% by the end of June, before falling back to 0.29% at end-September. As a result, the domestic interest rate, while continuing to trade at a premium to the US dollar, saw a narrowing of the differential to near zero in May and June. However, as market expectations shifted back to that of a prolonged low interest rate environment in the United States, the differential widened back to 0.21% by the end of September.

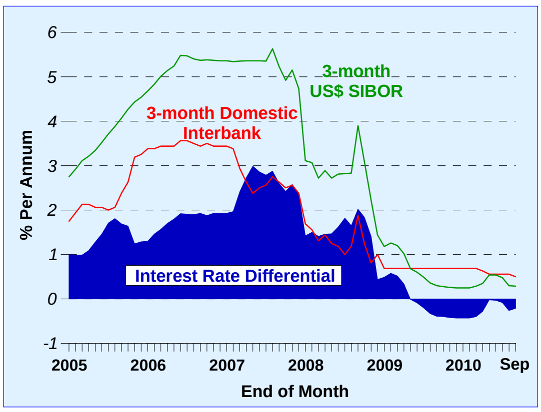
Graph 8

Domestic liquidity indicator



Graph 9

Three-month domestic interbank rate and US dollar SIBOR

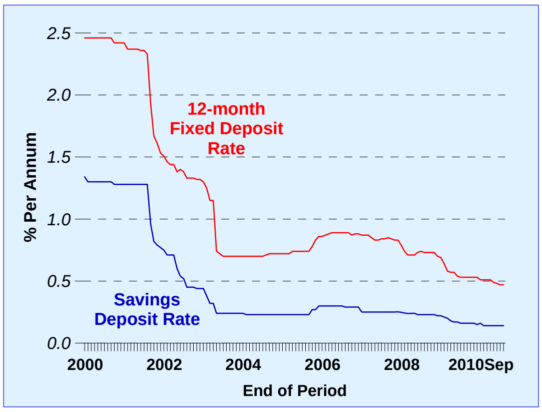


* EPG; MAS estimates.

Due to the record low domestic interbank rate, deposit rates have been depressed at low levels, and have been largely unchanged since the beginning of the year (Graph 10). Mortgage rates pegged to the Singapore dollar SIBOR have fallen, although some banks had raised the spread over the base rate. Nonetheless, increasing competition in mortgage lending will continue to put pressure on consumer home loan rates.

Graph 10

Deposit rates



Note: This is the simple average of the top 10 banks' deposit rates.

Macroeconomic policy

Singapore's macroeconomic policies provided countercyclical support during the downturn

When Singapore slid into recession in 2008, the macroeconomic policy stance was adjusted to provide support to the domestic economy in the face of the significant deterioration in external demand. In October 2008, MAS eased monetary policy by shifting to a zero percent appreciation of the Singapore dollar nominal effective exchange rate (S$NEER) policy band in response to the weak economic environment, continued stresses in the financial markets and easing inflationary pressures. This was followed by a downward re-centering of the policy band to the prevailing level of the S$NEER in April 2009. The responses of monetary policy were deliberately graduated and underpinned by the core objective of maintaining price stability in the medium term, with the exchange rate as an anchor of stability for a small and open economy. In comparison, fiscal policy – as contained in the Resilience Package in the FY2009 Budget – contributed more significantly to the required adjustments in the overall macroeconomic stance during the downturn.

The macroeconomic policy stance was tightened in line with the strong economic recovery

The Singapore economy recovered swiftly towards late 2009 and early 2010. By the first quarter of 2010, it had recouped the GDP that was lost over the recent recession. Output had risen by 17% from the trough in the first quarter of 2009, and was about 7% above the previous peak level. Given this, the Singapore authorities began to withdraw the monetary and fiscal stimulus that had been put in place during the crisis, returning policy settings to levels deemed conducive to sustainable growth and medium-term price stability.

On fiscal policy, the government announced late last year its plans for the gradual phasing out of two key components of the Resilience Package: the Jobs Credit Scheme and the Special Risk-Sharing Initiative. The focus of the FY2010 Budget also shifted from recession relief to restructuring the economy through investments in skills and encouraging innovation. This followed from the recommendations of the Economic Strategies Committee (ESC), and was aimed primarily at shifting the economy towards productivity-driven growth. The Budget thus contained measures to spur the upgrading of the workforce, such as the expansion of the Continuing Education and Training Scheme, additional transfers for low-wage workers to encourage them to stay on in the workforce, and new incentives for low-wage workers to undergo training. Various schemes to encourage companies to invest in productivity were also announced. These included the Productivity and Innovation Credit Scheme, the National Productivity Fund, tax incentives for qualifying mergers and acquisitions and higher levies for unskilled foreign labour.

In April 2010, MAS pre-emptively tightened monetary policy by re-centring the S$NEER policy band upwards and restoring its modest and gradual appreciation path. This policy shift marked the end of the accommodative monetary policy stance in place since October 2008 and was judged to be appropriate given the strong recovery path of the economy at that time. In October 2010, MAS tightened further by shifting to a slightly steeper appreciation of the S$NEER policy band without altering the level at which the band was centred. At the same time, the policy band was widened slightly.

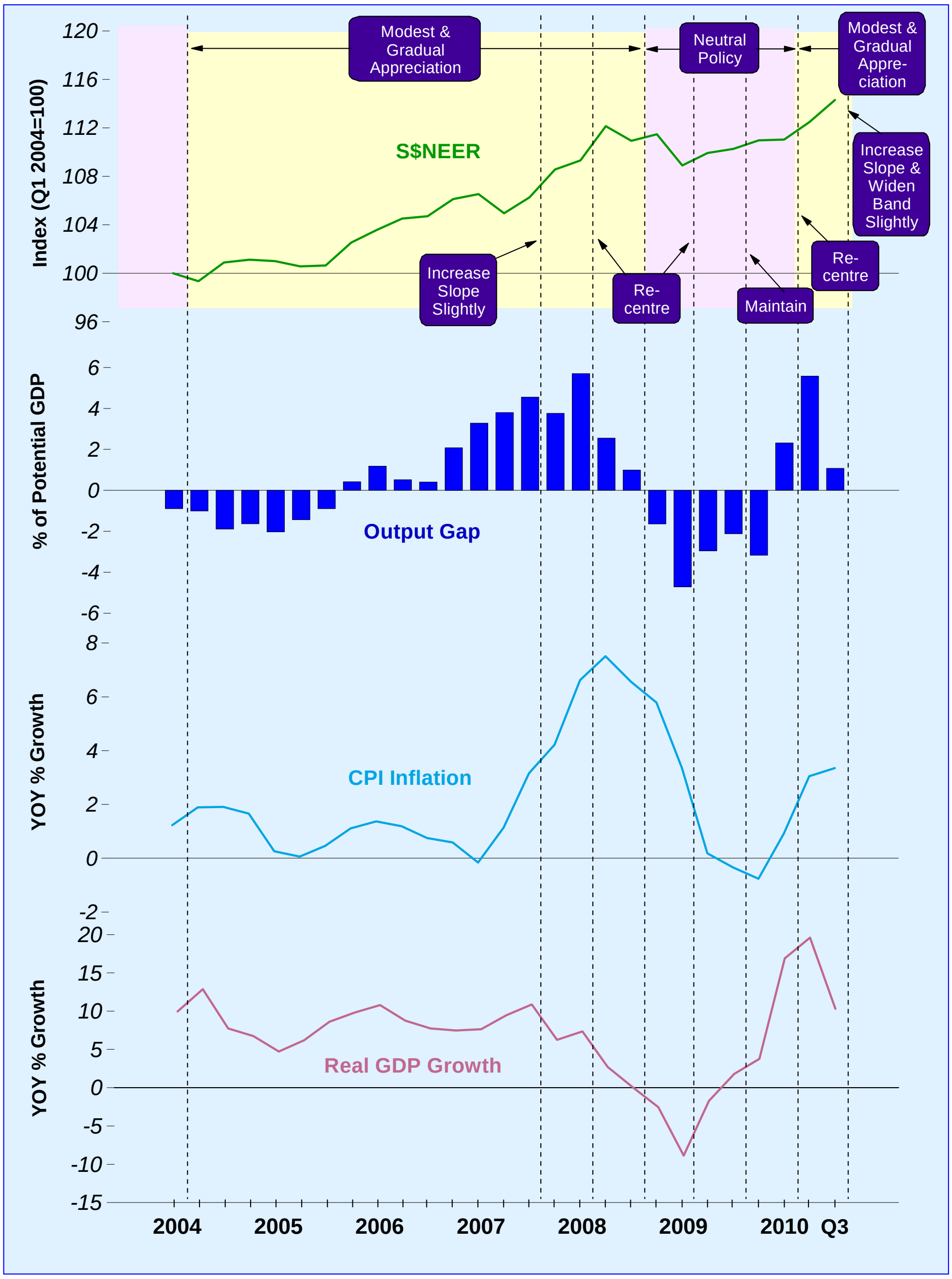
The policy decision was made on the assessment that the level of economic activity would remain high, as the domestic economy would continue to expand, albeit at a slower and more sustainable pace. At the same time, domestic cost pressures have been rising amidst high rates of resource utilisation in the economy. Strong income growth has also placed upward pressure on the prices of some domestic non-tradable consumption items.

Given these upside pressures to inflation, MAS deemed it appropriate to tighten monetary policy at this juncture to dampen external inflation – particularly from global food commodity prices – as well as to provide the necessary macroeconomic restraint on domestic economic activity, thereby ensuring that cost and price pressures do not become entrenched. The October policy decision also took into account the volatility of international financial markets given the lingering effects of the global financial crisis.

In sum, following the withdrawal of the accommodative monetary stance in April, MAS's latest monetary policy decision continues to be guided by the medium-term orientation of price stability, and is calibrated to support the economy's transition to a more mature phase of expansion. Graph 11 traces the evolution of monetary policy, as indicated by movements in the S$NEER, against the backdrop of growth and inflation developments.

Graph 11

Key macroeconomic variables and changes in the monetary policy stance



Some policy considerations

As the economy reverts to its potential output trajectory, macroeconomic policy settings have been pre-emptively adjusted to ensure that the medium-term price stability objective is attained.

At the same time, capital flows into Singapore have increased, given Singapore's open capital account and the importance of its financial sector in the economy. The reason why capital flows into Asia have increased has to do with with the very different stages of economic recovery being experienced in different parts of the world economy. Expansionary monetary policies in the industrialised economies, aimed at supporting their still-fragile economic recovery and avoiding further escalation in financial market stresses, have led to record low interest rates. In contrast, the Asian and emerging economies generally have rebounded strongly from the crisis, and have begun to tighten their macroeconomic policies. The increase in capital flows into Asia reflects these underlying divergences, notably the differences in prospects for both growth and inflation between the advanced and emerging economies. Capital has flowed to this part of the world in search of higher returns.

Policymakers in the region are fully aware of the risks posed by the increased capital flows. Much of it has comprised short-term investments rather than longer-term direct investments and hence can be volatile and easily reversed. In Singapore, MAS has taken into account this volatility in global financial markets in its most recent monetary policy move in October, which involved a widening of the band in which the Singapore dollar exchange rate can fluctuate.

The capital inflows are generally being intermediated efficiently through Singapore’s financial markets and banking system. Nevertheless, MAS is closely monitoring the impact of capital flows on the economy and asset markets in particular. MAS is not contemplating the introduction of capital controls, but will continue to rely on a range of policy tools to ensure that capital flows do not threaten financial stability or cause a property market bubble.

With Singapore’s economic recovery more firmly entrenched, the government has been withdrawing the expansionary macroeconomic policies implemented during the crisis. A series of pre-emptive measures have also been introduced since September 2009 to promote a more stable and sustainable property market. These have had some calming effects on the market. The government will continue to monitor the situation closely and take additional steps, if necessary, to ensure financial stability and sustainable asset markets.