Heng Swee Keat: A more challenging global and domestic economic environment

Opening remarks by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the Monetary Authority of Singapore's Annual Report 2007/2008 Press Conference, Singapore, 24 July 2008.

* * *

1. There is heightened uncertainty in the global economy and financial markets. The US sub-prime mortgage crisis has led to financial turbulence that hit many American and European financial institutions, forcing them to recapitalize and tighten lending standards. These stresses in financial markets have been a drag on economic activity in the industrialized countries through various channels, including the adjustment in the housing market and wider credit spreads.

2. The pace of US economic growth is slowing, constrained by the ongoing credit crisis, the unprecedented fall in the housing markets across the country, and rising commodity prices. In Europe and Japan, business expectations and consumer confidence continue to weaken. In Asia, growth has held up relatively well, helped in part by the robust expansion in China and India so far. Nonetheless, rising inflation will impact the real earnings of households and corporates in the region, with a concomitant pullback in spending. Overall, global growth is expected to fall to 2.9% this year from 3.8% in 2007. At the same time, inflation has emerged as a significant risk factor. Slower growth, together with rising inflationary pressures, presents challenges for the global economy.

3. In Singapore, economic activity is moderating. After 17 consecutive quarters of sequential expansion, the growth momentum has eased since the fourth quarter of 2007 as anticipated, to around the economy's medium term potential. On average, GDP grew slightly over 4% in the first half of this year, registering 6.9% in the first quarter and 1.9% in the second quarter of 2008. The weaker performance in Q2 was due in part to a sharp decline in the output of the pharmaceutical sector, which can fluctuate significantly from quarter to quarter because of company-specific production cycles.

4. In the coming months, activities which rely directly on G3 demand, such as electronics manufacturing, or are sentiment-driven like stockbroking, will be more adversely affected by the global headwinds. However, other industries including construction, marine and offshore engineering as well as financial intermediation services are expected to continue to provide support to GDP growth over the rest of 2008. Our assessment for full-year GDP growth remains at 4-6%. Given the uncertainty in the external environment, we will be carefully monitoring the incoming data.

5. CPI inflation came in at 7.5% in June, bringing the average for the first six months of this year to 7.1%. Global oil prices had surged towards the end of May, reaching a high of US$147 per barrel (WTI) in mid-July. Though they have pulled back slightly, prices are currently around US$125, up from US$98 in Q1 this year. Our major trading partners are also facing a rise in inflationary pressures, as fuel subsidies were partially lifted in some of these countries. Apart from oil, food prices are expected to remain elevated, even as the rate of increase moderates.

6. These external developments – higher oil prices, continued high prices of food, and inflationary pressures in our trading partners – have affected Singapore because of our openness and heavy dependence on imports. We are thus revising our CPI inflation forecast for this year to 6-7%, compared to the earlier estimate of 5-6%. Given the outcome in the first

half of the year, the new forecast range implies that headline CPI inflation is expected to come down over the rest of the year. There are several reasons for this:

- First, the one-off impact of the GST hike will cease to affect headline inflation in July.
- Second, although global commodity prices are likely to remain high, any further price increases are expected to be milder, compared to the first half of the year.
- Third, there are early signs of an easing of domestic cost pressures as the economy slows and asset markets consolidate. The rate of increase in commercial rentals, for example, appears to have peaked. Recent employment surveys have also shown that employers have become more cautious about hiring, suggesting that the pressures on the labour market could ease.
- Fourth, MAS had pursued a policy of targeting an appreciation of the Singapore dollar nominal effective exchange rate (S$NEER) since 2004. In a pre-emptive move, MAS further undertook a tightening of monetary policy in October 2007 and April 2008, even as there were heightened concerns over developments in the US economy.

7. Between April 2004 and June 2008, the S$NEER appreciated by 12.2%. Against the US$, the S$ appreciated by 23.4%. The policy moves have had a clear restraining effect on CPI inflation. For example, while WTI oil prices in US$ have increased by more than 70% from a year ago, domestic electricity tariffs and petrol prices rose by around 30% each. Similarly, while the IMF global food and beverage index has soared by 43% from a year ago, domestic food prices picked up by a more moderate 9%. The effects of our policy tightening will continue to restrain cost and price pressures going forward.

8. However, we cannot totally insulate ourselves from the increases in global food and oil prices. Hence, we must ensure that inflation expectations remain firmly anchored and that external price changes do not trigger second round effects. For monetary policy, our objective continues to be price stability over the medium-term. At the same time, other policy responses, as well as changes in household and business behaviour have been complementary toward this end.

9. MAS' current monetary policy stance announced on 10 April 2008 remains appropriate given our assessment of current external economic developments. The next monetary policy statement will be released in October as scheduled.

Financial stability

10. The international financial system and the global economy are still facing significant challenges and downside risks. So far, prompt action by financial authorities in the US and Europe has helped avert a wider crisis. But financial markets remain uncertain and volatile.

11. Singapore banks have limited exposure to US mortgage related securities, and they remain well capitalised. Over the past year, MAS has intensified our monitoring of financial markets and our supervision of financial institutions. We have also conducted stress tests of Singapore banks and the domestic operations of the large foreign banks here, and the results reported by the banks showed them to be resilient. Nevertheless, there is no room for complacency. The current crisis provides important lessons on the areas we have to work on to enhance the resilience of the Singapore financial system. MAS is also participating in several international working groups that are reviewing ways to strengthen supervisory practices and standards.

Strengthening resilience: Basel II, liquidity management and standing facilities

12. As new international regulatory standards and practices are finalised, MAS will consider strengthening our standards and market infrastructure where appropriate while taking care to avoid a disproportionate response. Let me highlight three areas, where we had started reviewing our regulatory framework before the crisis and have proceeded to implement these new measures to further strengthen the resilience of our financial system.

13. First, an area found to be wanting elsewhere in the credit crisis was the inadequate capital requirements that Basel I placed on banks in respect of their securitisation activities. On 1 January 2008, all Singapore-incorporated banks have adopted Basel II, a more risk-sensitive capital framework. The greater focus on enhancing internal risk management required under this new framework is especially timely given the volatile and uncertain environment.

14. Second, MAS has been working on improving liquidity risk management of banks before the current crisis. Events in recent months reinforced the critical importance of liquidity management. To enable banks to better manage their liquidity risk, MAS has put in place a revised Minimum Liquid Assets framework. Banks can apply to adopt a more risk-sensitive methodology for determining their regulatory liquidity reserves, which takes into account their risk management capability.

15. Third, at the macro-level, to enhance liquidity management in the system, we will be making some changes to the MAS Standing Facility that has been in place since June 2006.

16. The Standing Facility allows banks to place excess funds with or borrow from MAS against Singapore Government Securities collateral. This has helped to moderate intra-day volatility in interest rates as banks can avoid any undue scramble to square large, and potentially destabilising, positions in the market. The Standing Facility is currently open to the 11 Primary Dealer banks which are the most active banks in the Singapore dollar money market. Non-Primary Dealer banks could access the Facility through the Primary Dealer banks.

17. While the existing arrangement has worked well, experience in other developed markets has also demonstrated that such a facility is particularly useful in times of unusual market volatility, as this enhances confidence that liquidity needs in the banking system will be met.

18. Hence, to enhance the robustness of the system, MAS will widen participation in the Standing Facility to MEPS+ participating banks, subject to necessary documentation. The PSA/ISMA Global Master Repurchase Agreement continues to be a requirement for banks to access the borrowing facility which will remain collateralised against Singapore Government Securities. We will provide more details on this to the banks over the next few weeks.

Corporate governance, market conduct

19. Apart from dealing with issues relating to the safety and soundness of banks, and the stability of financial system, MAS has also been working on improving the responsiveness of our rules, as well as on improving corporate governance and market conduct.

20. MAS is proposing amendments to the Securities and Futures Act and the Financial Advisers Act. The amendments aim to facilitate new business activities and products in response to market needs, to enhance the market misconduct enforcement framework and to fine-tune the legislation to achieve greater clarity, consistency and operational efficiency. Policy and legislative consultation on the proposed amendments to the Acts have already been conducted. We will table the Amendment Bills within the next few months.

21. To continue to strengthen corporate governance, MAS, together with Accounting and Corporate Regulatory Authority (ACRA) and SGX, have established an industry-led Audit Committee Guidance Committee (ACGC). The ACGC will develop guidance to assist audit

committees better understand and carry out their role and responsibilities. MAS, ACRA and SGX are also working with the Singapore Institute of Directors to review the professional development of directors in Singapore.

22. In the area of insurance, we have set out mandatory requirements to strengthen life insurers' internal governance practices on the management of their participating funds and enhance disclosure standards to participating stakeholders. To enable policyholders to access a wider and more cost effective range of Investment-Linked Insurance Products (ILPs), MAS revised ILP rules.

Singapore's financial sector

23. Let me now turn to the performance of our financial sector. Notwithstanding the onset of the global financial turmoil towards the end of the year, the domestic financial services sector recorded strong growth in 2007. Growth was broad-based, across all segments of the industry. Domestic non-bank credit registered strong gains while the Asian Dollar Market also strengthened.

24. Singapore's financial centre continues to grow in diversity. We remain the largest REITs centre in Asia-ex-Japan, and a pipeline of business trusts in sectors such as shipping, aviation and infrastructure is being developed. A broad suite of instruments from FX, fixed income, derivatives to commodities are now traded here, contributing to the growth of Singapore as a trading hub. Activities in Islamic Finance are growing with the entry of new players, and MAS is honoured to host the 6th Islamic Financial Services Board Summit in May next year.

25. The asset management industry in particular has shown robust growth in 2007. Our latest Asset Management survey shows that the industry has continued its strong double-digit growth for the seventh year, with a 32% increase in assets under management (AUM), reaching almost S$1.2 trillion for the year 2007. In tandem with this growth, the number of investment professionals rose by about 22% to close to 2,200.

26. Reflecting Singapore's role as an international financial centre, the sources of assets managed in Singapore as well as their investment destination remains diversified. The Asia-Pacific region continues to be a key driver of growth for the industry. More than 80% of the total AUM was sourced from outside Singapore with Asia-Pacific accounting for 44% of the total. Almost 60% of the funds managed in Singapore are invested in the Asia-Pacific region.

27. The asset management industry has also seen a greater diversity in terms of players, strategies and products. Large traditional managers continue to expand and anchor their investment capabilities here. Singapore has also grown in importance as a centre for alternative investments such as hedge funds, private equity and real estate. The strong growth of the asset management industry has in turn drawn in several ancillary service providers such as fund administrators and prime brokers. All these developments reflect Singapore's ideal position for asset managers to deepen and broaden their activities in the Asian time-zone.

Annual accounts

28. On our financial statements, MAS recorded a net profit of S$7.44 billion for the financial year. The profits comprised mainly interest income, as changes in the valuation of foreign assets and the foreign exchange effects of a stronger Singapore dollar largely offset each other. Total assets, including the Currency Fund, grew by S$35.58 billion during the year to S$253.79 billion at end-March 2008.

Remaining vigilant

29. We need to remain vigilant in the face of a number of risks in the global economic and financial environment. We will continue to work closely with the industry to identify vulnerabilities and threats to financial stability through macro surveillance and stress testing. MAS' work in the coming year will continue to be driven by our mission of supporting non-inflationary economic growth, and fostering a sound and reputable financial centre.

30. Thank you.