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THE SINGAPORE ECONOMY: SOME FACTS AND FALLACIES

I am very pleased to be able to address you today and would like to thank Mr Fred Bartu for inviting me. I have decided to use this opportunity to address certain questions on the Singapore economy which I find myself frequently being posed. Some of these questions, whilst almost always well-intended, reflect commonly-held misconceptions of the Singapore economy. I do not, of course, expect to resolve these questions to the satisfaction of all present. Like economists and indeed all the rest of us, I would be surprised if journalists were of common opinion even when confronted with the same facts and figures. My aims are more modest. I would be happy if, over the next half hour or so, I can give you a fuller understanding of the Singapore economy as I see it.

Let me begin by looking briefly at certin fallacies which one continues to encounter with regard to the 1985 recession. Although the recession is already well behind us, it is important to be clear about what its causes were, and were not, if we are to draw appropriate lessons.

The recession in 1985 was caused by:
(a) the government's high wage policy;
(b) oversavings through high CPF rates; and
(c) a squeeze in money supply in 1983-85

Let me first take up the issue of the government's wage policies. To start with, it must be clarified that the so-called "high wage policy of 1979-81" is more accurately described as a corrective wage policy. The increases over that period merely sought to compensate for low rates of wage growth, that lagged behind productivity growth throughout most of the 1970s. Real wages grew at an average annual rate of 1.7 per cent from 1973 to 1978, while real productivity grew at the rate of 3.3 per cent.

The government-inspired three-year wage hike was designed to bring about a better distribution of the fruits of economic growth, as well as to break out of the vicious cycle of low wages sustaining low value-added and labour intensive industries. It was obvious that Singapore would lose its comparative advantage in such industries unless it relied on a permanent inflow of migrant workers. As a result of the wage hike, real wages grew at an average annual rate of 4.7 per cent over 1979-81, which was virtually the same as the growth in productivity. Thus the 1979-81 increases can hardly be said to have contributed to a loss in competitiveness.

What then caused the erosion in cost competitiveness? The answer lies in what happened after 1981. From 1982 to 1984, the average annual growth in wages was 8.3 per cent, almost double the rate of productivity growth over the period. It became common for companies and unions to settle at the upper ranges of annual National Wage Council (NWC) recommendations for wage increases, and frequently in excess of those ranges. This was perhaps not surprising given the keen competition in a tight labour market, as well as the strong growth expectations on the part of both management and labour owing to the virtually uninterrupted economic

boom which Singapore had enjoyed till then. Centralised wage policy recommendations may not have prevented this overshooting of wages, but they certainly were not its cause. Moreover, from 1982, the government had decided to play a less significant role in the NWC's deliberations, so as to allow unions and management greater scope in setting wage guidelines.

The lesson that was learnt from the recession, however, was that greater flexibility was needed in the wage bargaining process so that wage increases in companies or sectors facing a boom in demand do not unduly influence wage settlements elsewhere. Recent reforms in fact go some way in this direction. The 1986 and 1987 NWC recommendations sought to encourage the linking of wage increases to productivity growth or profitability at a company-level. Wage reform also seeks to promote greater flexibility in the long run by combining a basic wage, that provides a measure of stability in workers' earnings, with a variable component in the form of a bonus to reflect company or individual performance.

The second question with regard to the recession is whether the savings rate in Singapore was excessive owing to high CPF rates, and had a contractionary effect on the economy. It has to be understood, first and foremost, that the sustained rise in the savings rate over the last two decades owes much to demographic factors, in particular the entry of the baby boom generation into the labour force. High savings rates are thus at least partly a temporary phenomenon, reflecting the fact that the bulk of the working population is at a relatively early stage of their life-cycle. As workers get older, and as the proportion of aged dependants in the population gradually increases, the savings rate may be expected to decline over the long-term.

It is also far from clear that increases in compulsory contributions to the CPF have artificially boosted the savings rate. Whilst academic study of this issue is not conclusive, the evidence to date is that changes in the CPF rate have tended to be compensated for by changes in voluntary savings, with little or no effect on the overall savings rate.1/ The main reason for this is the fact that the CPF is fully-funded; a worker's contributions to the CPF are equal to his eventual withdrawals, and hence form part of his lifetime wealth. If he plans his consumption expenses - particularly on large items of expenditure - on the basis of what he expects his wealth to be in the long-term, a change in the CPF rate is unlikely to affect his calculations.

More fundamentally, the savings rate can only be described as high or low in relation to the investment rate. With the exception of 1986, when investment remained in a slump, domestic investment has persistently exceeded domestic savings. Singapore's savings-investment balance has always been in deficit, as reflected in our current account deficit.

A third argument is that the operation of monetary policy in 1983-85 put Singapore through an unintended liquidity squeeze that contributed to the economic recession. This argument probably owes more to academics than to journalists. It is a little surprising to find it cropping up now and again, since the evidence against the notion is fairly clear.

1/ See, for e.g., Choon, C.L. and M.R. Veall, in Public Finance 40, No.2, 1985; and Datta G. and P. Shome, in The Developing Economies, No.19 (1981). More recent empirical studies at the MAS have confirmed this finding.

First, the slowdown in broad money growth only occurred after a decline in the growth of nominal GDP itself. Moreover, money growth remained higher than nominal GDP growth over the period. There is therefore little evidence that there was not enough money to go around. Second, the decline in money growth reflected a sharp decline in the growth of credit itself. The fall in credit demand, particularly outside of the property sector, was itself a result of a prior decline in private investment, and occurred despite a decline in interest rates.

The 'liquidity squeeze' argument also rests on the notion that changes in money supply have a strong impact on economic activity in the first place. The evidence on this has not been significant, although I am not suggesting that liquidity conditions in Singapore have absolutely no impact on GDP. There are two main reasons why a tight causal relationship from money to GDP need not hold in a small, open economy like Singapore. First, the dominance of external demand in the economy implies a weak role for changes in domestic money supply as an independent stimulus of demand. Second, the high exposure of the economy to capital flows from abroad means that domestic interest rates, which affect credit demand, are very largely determined by world interest rates, and not by the domestic supply of money. All in all, therefore, the relationship between money supply and economic activity is not as clear-cut as sometimes believed.

Given Singapore's tight labour market, it is inevitable that wage increases price Singapore out of international markets.

I must first emphasize that rising wages do not in themselves reduce our international competitiveness. There is nothing inherently wrong with wage increases. They are the basis for a high standard of living and a desired goal of economic development. As I mentioned earlier, it is only when wage growth exceeds productivity growth that we start getting into trouble. When this happens, unit labour costs will rise and competitiveness will be eroded.

As we move towards more flexible and localised wage bargaining procedures, wages would tend to follow changes in productivity more closely than in the past. Thus, the important question for the future is not whether we can keep wage growth down, but whether we can keep productivity growth high. On this score, I would like to point out that between 1985 and the middle of 1987, productivity growth has been extremely healthy, at an average of over six per cent per annum, and has accounted for all of Singapore's GDP growth over the period.

There is no reason why the recent restoration of competitiveness cannot be sustained over the medium term. The emphasis of government policy, for its part, would increasingly be in improving productivity rather than attempting to influence wages, through promoting technological improvements, overall business efficiency and the skill level of the workforce.

The government's fiscal stance is geared towards creating budget surpluses irrespective of economic conditions.

It is true that the government budget has been in a state of surplus for the better part of the last two decades, although if we take into account the statutory boards, then the overall public sector surplus has been smaller and sometimes even in deficit. The prudent financial policies which underpinned past public sector surpluses must be seen in the context of the sense of uncertainty faced by a small, and highly open developing nation. However, fiscal conservatism has not been rigidly applied, irrespective of economic conditions. Given the rapidly growing economy of the past two decades, there was no need for an expansionary fiscal policy. Likewise, in recessionary years like in 1975 or in the more recent downturn, a fair amount of pump priming fiscal policy was employed.

From a longer term perspective, the aim of budgetary policy remains one of ensuring that business remains competitive in Singapore, and of providing individuals with the incentive for extra work effort and enterprise. In keeping with this aim, income tax rates have been reduced over the last several years.

The divestment programme is unlikely to succeed because the government is not serious about giving up control over its companies.

Let me reiterate that the government remains committed to the divestment programme. A divestment plan on the scale intended, however, has to be carefully scheduled and planned if it is to succeed in achieving its aims. Our major concern is that it be carried out in an orderly manner, without creating dislocation to either the companies concerned or to the financial markets. This means, first, that the divested companies should not be allowed to decline through lack of management direction and support. It is only prudent for the government to identify capable and deserving groups in the private sector to take over the privatised companies. Second, the government must also consider the capacity of the stock market to absorb the various issues. Even with a bull market, it is not possible for the government to sell off large holdings at once without causing undue distortions in the financial flow of funds, such as a withdrawal of private funds from the banking system.

Having said that, however, I do not think the pace of divestment has been as slow as it is sometimes made out to be. The government has in the last two years fully divested its stake in ten companies, which had involved ownership shares of up to 50 per cent. We have also partially privatised another seven companies, with our average stake of 69 per cent falling to less than 40 per cent in such concerns.1/ Over the longer term, we have

1/ This does not include the divestment of shares in which the Government has an indirect stake.

plans to gradually divest our shares in the bulk of government-linked enterprises, except those which are critical to national interest. The government is also considering the privatisation of certain statutory boards, such as the Public Utilities Board, where it is feasible to do so.

The depreciation of the Singapore dollar since 1985 accounted for a switch to a current account surplus, and has resulted in an undervalued exchange rate.

It must first be understood that developments in Singapore's current account over 1985-86 have been dominated by the essentially cyclical effects of the economic recession, unrelated to the depreciation of the Singapore dollar. In particular, imports were compressed by the slump in domestic investment, by some 27 per cent over the two-year period. It is unlikely that the current account surplus will be sustained with the pickup in investments in 1987 and beyond.

Moreover, there are good reasons for believing that the exchange rate has a very weak effect, at best, on the current account balance in an economy as small and highly open as Singapore's. It would not be easy otherwise to explain the strong improvement in Singapore's current account over 1980-1984, which occurred despite the substantial appreciation of the exchange rate. Part of the reason for this unusual phenomenon is that the negative effect of a stronger exchange rate on our exports is partly offset by its dampening of the cost of imported inputs which are required to produce such exports; imports actually account for over 70 per cent of the content of exports of goods and services. Another reason is that a higher Singapore dollar provides little boost to imports. This is because our imports do not really compete with domestic products to a significant extent. Singapore does not produce raw materials or capital goods, or even consumer durables like cars. Our imports are therefore less sensitive to exchange rate changes than in countries where they are easily substitutable with domestic products.

As for talk of an undervalued currency, it should be noted that the effective exchange rate of the Singapore dollar against a basket of its main trading partners is presently still about 10 to 20 per cent higher than its level in 1980. Even in real terms, i.e. when the effective exchange rate is deflated by unit labour costs, the Singapore currency was still above its 1980 level as at mid-1987. This is not surprising, since the primary objective of our exchange rate policy has always been to check imported inflation.

Let me comment on a further mistaken notion. It has become fashionable, in view of the large and persistent trade deficits of the US, for observers to call on the East Asian NICs as a group to appreciate their currencies so as to reduce what are referred to as their "unfair" trade surpluses with the US.

I have already explained, first, that Singapore's currency is far from undervalued. Second, Singapore's trade surplus is not only very recent in origin, but contributes barely one per cent of the total US trade deficit. Third, Singapore actually runs a large global trade deficit, far in excess of that of the US when viewed as a percentage of GDP. In the first eight months of 1987, Singapore's trade deficit was in fact 30 per cent higher than it was a year earlier, reflecting the cyclical recovery in imports that I spoke of earlier. Finally, Singapore maintains virtually the most open trade regime in the world with hardly any protection imposed on imports. Talk of Singapore maintaining an unfair trade balance is, I am afraid, simply erroneous.

The regulatory and supervisory climate in Singapore is inconsistent with her aim of becoming a major financial centre.

First, it is not true that Singapore has an excessively tight regulatory climate as far as financial institutions are concerned. It would otherwise be difficult to explain why 200 banks and merchant banks from all over

the world have chosen to operate in Singapore. Many of the world's top banks are represented here. Since the early 1970s, a liberal but selective policy has been adopted on the admission of foreign banks as long as they have a good reputation and a long-term interest in Singapore. Regulations on interest rates and foreign exchange are non-existent. There have also been a host of tax concessions and fiscal incentives granted specifically to the financial sector, especially over the last few years.

Banks in Singapore can engage in universal banking. We do not have the US Glass Steagall Act, which prohibits banks from doing securities business; or banks to engage in trust business as in the Japanese context. Our laws and supervisory techniques are adopted primarily from the home countries of the foreign banks such as the US, UK, Switzerland and Germany and they are therefore not entirely foreign to them.

Singapore makes no apology, however, for maintaining high prudential standards with regard to regulation and supervision. The Pan-El crisis has taught us a hard lesson: that self-regulation alone does not work. Legislation, regulations and the proper supervision of the stockbroking industry here had enabled stockbroking firms to escape uninjured from the recent stock market crash. This time round, Singapore did not have to close its Stock Exchange. Banks in Singapore would have exposure to Pan-Electric way in excess of S$400 million if not for our timely revision of the Banking Act in 1984, which reduced the single borrower lending limit from 60 per cet to 30 per cent. Banks tend to complain of regulation in any form when times are good. In the aftermath of the Pan-El crisis, banks have grown to appreciate the need for regulation and supervision.

Indeed supervisory authorities the world over have recognised the need for improved regulatory and supervisory

standards in recent years. As a result, the Basle Concordat, which is an agreement between national supervisory authorities, was revised in 1983 to ensure that banks only operated in jurisdictions in which an adequate level of supervision existed.

The need for high prudential standards is particularly important when we consider the increased volatility and uncertainty which has come to prevail in world financial markets. If there had been any doubt about this, events over the last few weeks should speak for themselves. Concern for the growing proliferation of off-balance sheet activities has also prompted regulatory bodies worldwide to incorporate these activities in their capital adequacy requirements.

It is perhaps trite but true to say that the liberalisation and globalisation of the financial markets have promoted dynamism but have increased the risks to stability. In the long term, few serious observers would disagree that a sound financial system, with prudent regulations and supervision, is essential for the growth of a financial centre like Singapore's. I am glad to say that it has also enabled our financial system to emerge virtually unscathed from the recent turbulence.

The emergence of Tokyo as a leading financial centre will signal the demise of Singapore.

No one can doubt Tokyo's two great advantages as a financial centre - first, as the main source of offshore and foreign-directed funds in the Asia-Pacific region, and indeed the world, and second, the vast Japanese domestic market itself. Singapore can never hope to match this. Singapore's comparative advantage is in its low taxes and basic costs, the latter being approximately a quarter or less of those in Tokyo. This competitive edge has widened further with the appreciation of the yen. Unlike Tokyo, moreover, our offshore markets are generally free of

regulation and enjoy various concessions. Whilst this advantage will be eroded with time as Japan continues its deregulation drive, Singapore nevertheless has a headstart.

The more pertinent point, however, is that Tokyo's development as a major financial centre may in a number of areas have a positive influence on us. Deregulation in Japan has boosted, and will continue to boost, the aggregate volume of international financial business in the Asia-Pacific time zone. Singapore will benefit from the spill-over of greater liquidity and range in the markets for international securities, futures, and foreign exchange. Indeed, the net effects of Tokyo's emergence as a leading financial centre have to date been positive, especially in foreign exchange and fund management activities and, to a lesser degree, in the offshore securities and futures industries.

The development of Singapore, Hong Kong, and Tokyo as the three main regional financial centres need not be mutually exclusive. In fact, they have been complementary to each other and there is little reason why they cannot coexist and develop together in the Asia-Pacific region, in the same way that London, Zurich, and Frankfurt do in Europe.

The internationalisation of the Singapore dollar is required if Singapore is to succeed as an international financial centre.

The extent of restrictions on the internationalisation of the Singapore dollar is often exaggerated. There are no prohibitions on foreigners holding assets denominated in our currency. There are also no restrictions on the free trading of the Singapore dollar in local and international foreign exchange markets. Businessmen can settle trade and other transactions inside or outside Singapore in any currency they wish. The only restriction on internationalising the Singapore dollar applies to the ability of banks in Singapore to lend freely to borrowers abroad.

In the old days, it was considered almost self - evident that foreign lending in one's own currency was necessary before a country could become a major financial centre. Since the early 1960s, however, particularly with the emergence of a large and liquid Eurocurrency market, the linkage between the use of a country's currency and its role as a financial centre has been considerably weakened. For example, we have witnessed the re-emergence of London as a leading international capital market centre, and the corresponding shift away from New York as the major location for foreign and Eurobond issues over the last few years. But this was in no way tied to the growth of sterling or the decline of the US dollar as an international lending or reserve currency; if anything, it coincided with the relative decline in the strength and importance of the British pound.

An international financial centre is essentially an entrepot, acting as an intermediary between the sources and ultimate users of funds, wherever they may be. Success in this role depends not on the currency denomination of lending flows, but on the availability of skilled operators and expertise, a competitive and innovative environment, excellent telecommunication and other infrastructural facilities, as well as a sound financial base and economic stability. It is in these areas that Singapore has sought to find advantage, and to underpin its growth as an international financial centre.

CONCLUSION

Before closing, allow me to make a general point. My main purpose today has been to examine closely some widely-held beliefs about the Singapore economy, so that fact can be differentiated from fallacy. In doing so, I must emphasize that the government remains open to honest, constructive criticism. We have learnt much through such feedback. If it is only the fallacies that I have attempted to identify, it is because they have been remarkably enduring despite being at odds with the facts. I hope you have benefitted from my talk, and would be pleased to receive questions.