

Singapore Macro Update: Necessary Conditions for Monetary Tightening Not Met

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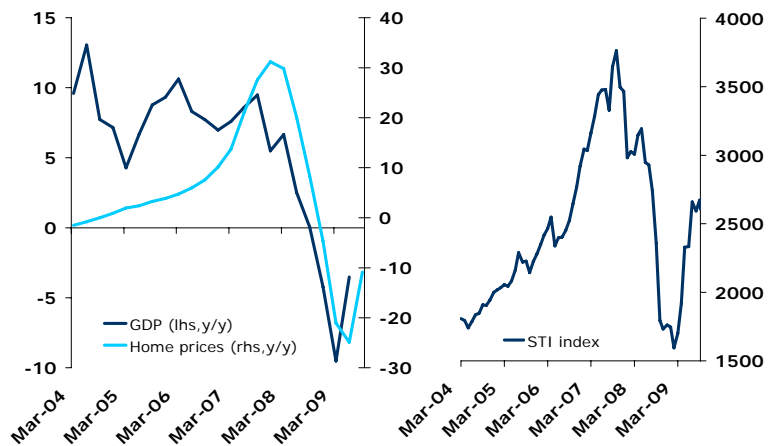
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We believe that the necessary conditions for the Monetary Authority of Singapore (MAS) to reinstate the tightening bias have not been met, notwithstanding the strong rebound in economic data in the past two quarters. Our baseline scenario is for the MAS to revert to a “gradual and modest” S\$NEER appreciation bias in October 2010.

Singapore Economy Rebounds Strongly

Economic data released in recent months indicate a recovery is now underway in Singapore. The rebound in asset prices was evident in the property market (prices up 16% q/q in Q3), which prompted the government to implement tightening measures in September. Final Q2 GDP data showed that the economy rebounded more than expected at an annualised pace of 20.7% (q/q), with the unemployment rate unexpectedly stabilising at 3.3%. Exports and industrial production showed clear signs of a recovery, and the pickup in PMI signalled sustained expansion in manufacturing activity. The strong industrial production outturn in August (12.3% y/y) almost guarantees that the Singapore economy will maintain a strong pace of GDP growth in Q3. The official forecast of a 4% to 6% contraction in 2009 now appears overly pessimistic; an upgrade can be expected when the government releases Q3 GDP on 12 October.

GDP and Asset Prices Rebounded in Q2



Sources: Bloomberg, ANZ Economics.

Necessary Conditions for Tightening

While market expectations of central banks rolling back emergency policy settings have risen across the world, the necessary conditions for MAS to exit from the neutral S\$NEER policy bias—namely 1/ a sustainable export recovery, 2/ rising inflation pressure, and 3/ an improving labour market—are not met. We discuss these conditions in the following sections.

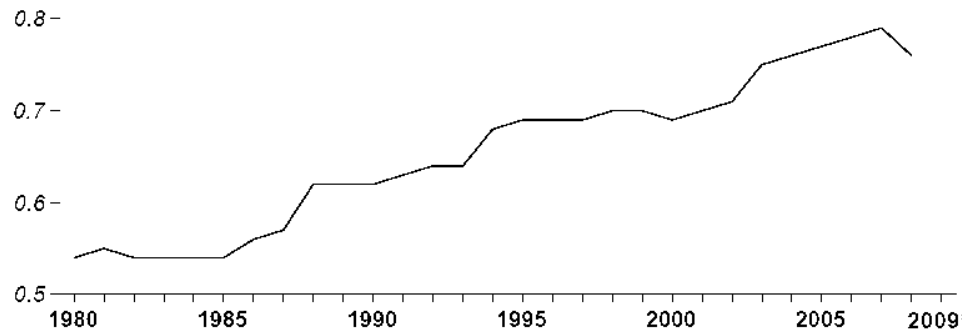
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1. Export recovery should be broad-based and sustainable.

Given Singapore’s high dependence on external demand, a recovery in exports would be one of the major pre-conditions for a policy tightening. In addition, the dominance of the “G3” economies (i.e. US, Europe and Japan) implies stronger import demand in these markets would be an important policy consideration. According to the MAS’s estimates, the Singapore economy has become more externally-oriented in recent years, with the share of external demand to total demand rising steadily in the past two decades.

Ratio of External Demand to Total Demand

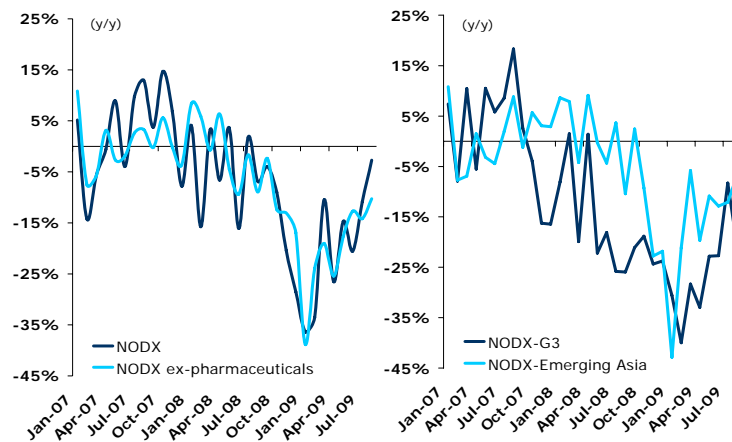


Source: Monetary Authority of Singapore.

While headline non-oil domestic exports (NODX) have rebounded in recent months, the narrow base of recovery leaves exports vulnerable to a correction. Stripping out the 25.5% (y/y) rise in pharmaceuticals shipments in August, NODX growth was -10.3%, almost 8ppt lower than the reported headline rate of -2.7%. With pharmaceutical output intrinsically tied to production schedules of global drug companies rather than underlying demand, growth support from the sector could falter quickly, as seen in past episodes of sharp reversals in output and shipments. Moreover, any spill over from the strong pharmaceutical sector is likely to be limited. The sector employs around 4,100 workers, or 0.7% of the manufacturing workforce. The bulk of the SGD10.6bn value-added in 2008 (4.1% of GDP) is returns on investment in research and development. The processing trade nature of the sector also limits its linkages with other sectors.

In contrast, the electronics sector, which accounts for close to 40% of NODX and employs more than 90,000 workers, remained weak in Q3, indicative of the still-sluggish recovery in discretionary foreign demand. The relocation of the last remaining hard disk manufacturer from Singapore will add to the drag next year, when foreign discretionary demand is expected to improve. Meanwhile, the current fiscal path pursued by the advanced economies—supporting growth through large budget deficits and rapid accumulation of public debt—is clearly unsustainable.

Pharmaceuticals driving export recovery, G3 demand still weak



Source: CEIC.

Indeed, Singaporean policymakers showed little inclination to tighten despite the sharp rebound in GDP growth and asset prices. Official commentary in the past two months suggests the government remains concerned over the sustainability of the recovery into 2010.

Official Commentary Suggests No Rush for Tightening

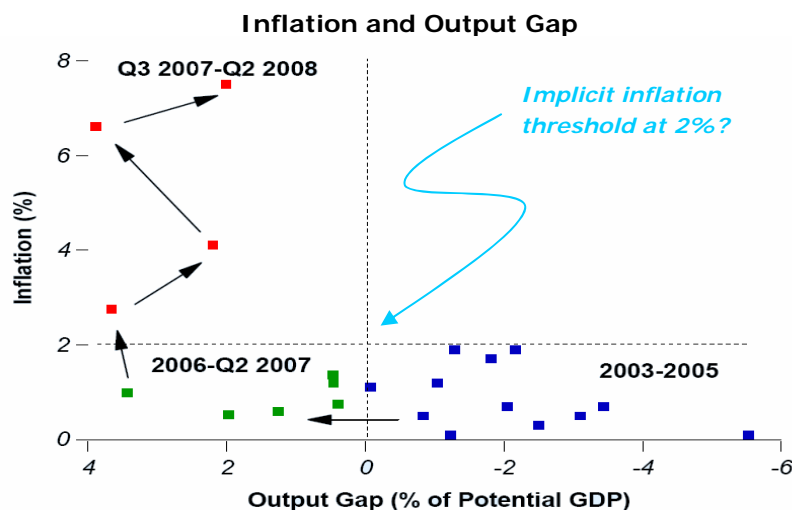
Date	Who	Comments
9 Sep	Thaman Shanmugaratnam, Finance Minister and MAS Board Member	"(We) have to be prepared for the possibility of a sluggish world economy or even a double-dip in 2010... we have yet to see a firm or sustainable rebound in private spending that can underpin global growth in 2010 and beyond."
11 Aug	Ong Chong Tee, MAS Deputy Managing Director	"We believe [the current policy stance] remains appropriate. We will review it again in October."
11 Aug	Ravi Menon, 2 nd Permanent Secretary, Trade & Industry	"More green shoots have emerged... but recovery will be neither quick nor strong."
8 Aug	Lee Hsien Loong, Prime Minister	"The outlook remains clouded. The advanced economies are not expected to bounce back soon."
6 Aug	Lim Hng Kiang, Minister for Trade & Industry and MAS Deputy Chairman	"The volatility of our exports suggests that it is premature to assume exports have stabilised, and the labour market outlook has yet to improve."

Source: Reuters.

2. Inflationary pressure must rise

The MAS's monetary policy is primarily centred on promoting "price stability as a sound basis for sustainable economic growth," similar to a conventional inflation targeting regime. The policy objective is to moderate imported inflation through managing the exchange rate, thereby keeping domestic inflation subdued in the medium-term. A study conducted by the IMF in 2004 concluded that Singapore's monetary policy has a forward-looking horizon of nine months, with an orientation toward stabilising inflation and output.¹

While the central bank does not have an explicit inflation target, the CPI trend in recent years suggests that the threshold is around 2%. This is in line with a recent MAS study, where a neutral output gap is seen to be consistent with a 2% annual headline inflation rate.² However, a positive output gap is not a necessary condition for inflationary pressure to rise. For example, another MAS research note³ in 2006 concluded that "*changes in the output gap contained more useful information on inflationary dynamics than the size of the output gap itself. Specifically, the evidence suggests that **inflationary pressures could emanate from the rapid closing of a negative output gap**, even though output remains below potential. In addition, the results also imply that **sustained inflationary pressures are likely to persist only in periods where output persistently deviates from potential**" (our emphasis).*



Source: Monetary Authority of Singapore.

Taken together, price pressures could intensify in the coming quarters on the rapid narrowing of the negative output gap in H2 2009, but this is likely to be transitory. Into 2010, we expect the more moderate growth trajectory to slow the pace of adjustment in the output gap. While headline inflation might exceed the 2% mark on less favourable base effects in 2010, a *persistent* deviation

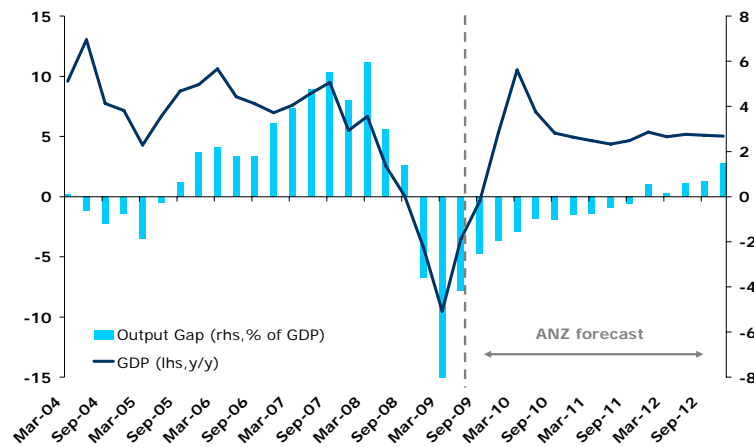
¹ See "Singapore's Unique Monetary Policy: How Does It Work?", IMF Working Paper 04/10, January 2004.

² See MAS Macroeconomic Review, October 2008.

³ See "Assessing the Relationship between Output Gap and Inflation", MAS Macroeconomic Review, April 2006.

from the threshold appears unlikely amid our baseline scenario of a gradual global recovery and moderate inflationary environment. Our forecast is for CPI to average 2.7% and 2.3% in 2010 and 2011, respectively.

Negative Output Gap to Persist Until End-2011

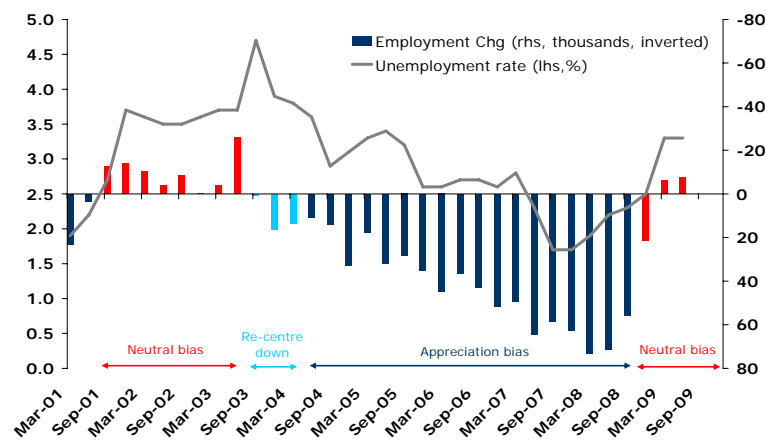


Sources: CEIC, ANZ Economics.

3. Labour market conditions should improve.

A narrowing output gap and rising inflation might not be sufficient for the MAS to switch to a tightening stance; the central bank's policy response in the previous recession suggests improvement in the labour market is likely an important policy consideration too.

Policy Tightening Lags Labour Market Recovery

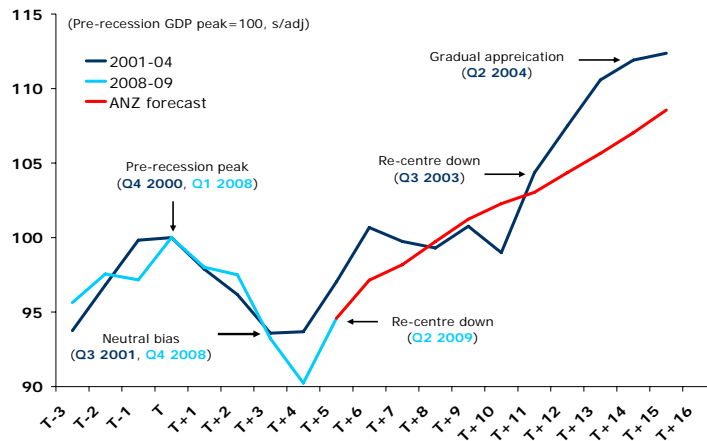


Note: The MAS's policy bias was not explicitly disclosed before 2001.

Sources: CEIC, ANZ Economics.

The MAS adopted a neutral bias in July 2001 at the onset of the recession, but did not exit the neutral policy stance until April 2004, when employment growth had stabilised above 10,000 per quarter, and the jobless rate had eased almost 1ppt from the peak rate of 4.7% in Q3 2003. In between, the MAS lowered the policy band in July 2003, following a sharp deterioration in the labour market in the aftermath of the SARS outbreak. By the time the MAS exited from its neutral stance in April 2004, output levels had risen to 10.6% above the pre-recession peak in Q4 2000. The negative output gap was virtually eliminated (from around 5% of GDP just three quarters before), and inflation was rising steadily toward the 2% mark.

MAS Policy Responses: 2001 and Present



Sources: CEIC, ANZ Economics.

To be sure, the current labour market adjustment is much shallower than the past recessions. This could be attributed to the success of the SGD20.5bn Resilience Package introduced in the FY09/10 budget. The fiscal impulse⁴ was estimated to be 5.7% of GDP, much larger than during the past two recessions in 1998 and 2001. The key element of the package is the Jobs Credit Scheme, which provides incentives for companies to retain their workforce during the downturn.⁵

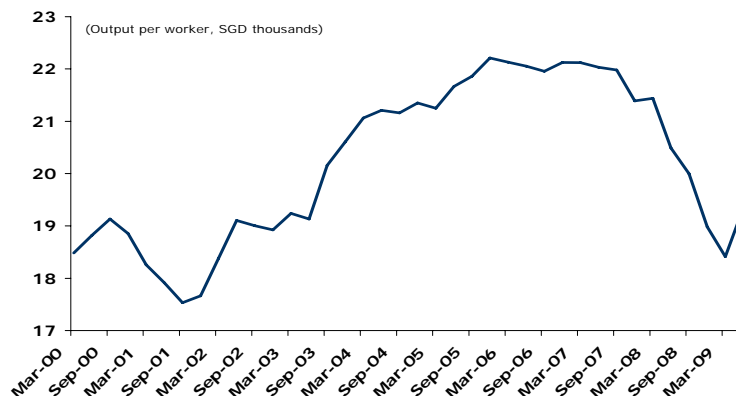
Major Components of the Resilience Package, FY09/10

(SGD billion)	Spending in 2009
Employment support	5.1
Bank lending support	5.8
Business cash flow and competitiveness	2.6
Household support	2.6
Development spending	4.4
Total	20.5

Source: Monetary Authority of Singapore.

While the wage subsidy has minimised the extent of job destruction during the recession, labour demand could remain weak in the coming quarters. As of Q2 2009, labour productivity is still some 10% off pre-recession levels, compared with a 8% peak-to-trough decline in 2000 to 2001 (14% in the current downturn). In the absence of a strong economic rebound in 2010, the surplus labour could constrain the pace of job creation.⁶

Labour Productivity Still At Depressed Levels



Sources: CEIC, Bloomberg, ANZ Economics.

⁴ The fiscal impulse is a measure of the direction of change in the budget stance from year-to-year. It provides a measure of the *initial* stimulus to aggregate demand arising from the fiscal policy. According to the MAS, the fiscal package will contribute 4.2% to GDP growth in 2009, one of the largest stimuli among G20 economies.

⁵ The scheme provides cash grants to employers to subsidise part of their wage bill, which amounted to an effective 9ppt cut in the employers' pension contribution rate.

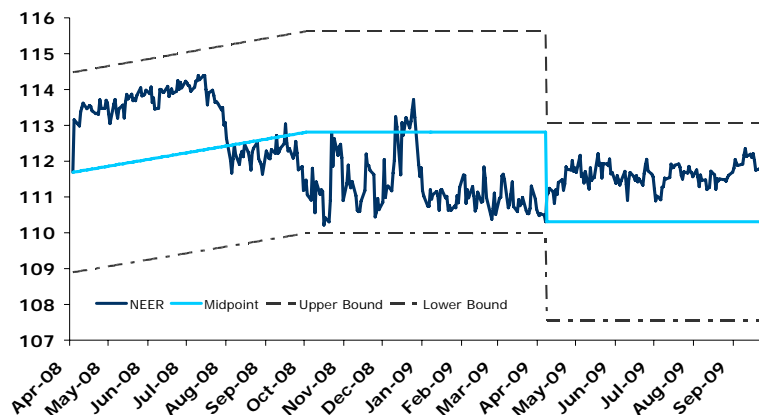
⁶ The government is reviewing the subsidy scheme, with a decision due on 13 October.

Monetary Tightening in 2010

All in all, we expect the MAS to reiterate its neutral policy stance on 12 October, with no changes to the policy bandwidth or the midpoint of the policy band. Such an outcome is unlikely to be a surprise for market participants; the prevailing consensus is for the MAS to tighten only in 2010. The rapid rise in FX reserves and forward USD positions are also indicative of the MAS's preference to keep the exchange rate basket stable. We expect the S\$NEER to continue trading in the familiar range of 0.5%-1.5% above midpoint in the next two quarters.

To be sure, global economic conditions have improved substantially since the April monetary policy review, and the Singapore economy has also surprised on the upside. However, the necessary conditions for an exit from the neutral bias have yet to be met, and there remains a high degree of uncertainty over the shape of the global recovery in 2010 and beyond.

S\$NEER to Remain in Familiar Ranges for Now



Sources: Reuters, ANZ Economics.

Our baseline scenario is for the MAS to revert to a “gradual and modest” S\$NEER appreciation bias in 2010, when conditions for a sustainable global recovery are likely to be more clearly established. The duration between the trough of various economic indicators and monetary tightening suggests a policy shift will likely take place in October 2010. However, an earlier move in April cannot be ruled-out, if the pace of recovery continues to surprise on the upside in the coming quarters.

Duration Between Trough in Indicators to Tightening (Quarters)

Indicator	Past recessions		Current recession		
	July 2000	April 2004	Current Trough	To Apr 10	To Oct 10
Inflation (y/y)	7	9	Q2 2009	4	6
GDP (q/q)	10	11	Q4 2008	6	8
Output gap (% of GDP)	7	10	Q1 2009	5	7
NODX (y/y)	15	11	Q1 2009	5	7
Employment (q/q)	7	10	Q2 2009	4	6
Start of neutral bias	9	11	Q4 2008	6	8

Note: The MAS maintained a neutral policy stance in Jul97–Jul00 and Jul01–Apr04.

Sources: Bloomberg, CEIC, MAS, ANZ Economics.

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