

## Manu Bhaskaran: Should Singapore's policies change with the emerging recovery?



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WITH THE ECONOMIC data now clearly pointing to recovery, policy makers are raising the issue of the exit from the ultra-loose monetary and fiscal policies they employed to prevent a major economic depression last year. US Treasury Secretary Timothy Geithner recently observed that while it was still premature to withdraw policy accommodation, it was not too early to talk about it. In Asia, South Korean Finance Minister Yoon Jeung-hyun has said his country would implement an exit plan only gradually, noting at the same time that countries had to co-operate in doing so. Clearly, as the global economic and policy context changes, Singapore will also have to consider changes to the monetary, fiscal and other policies it undertook in response to the crisis.

### **The economic and policy context: Volatile and unpredictable**

Formulating policy for a small and highly open economy such as Singapore's is difficult even in the best of times. In a post-crisis era marked by the unpredictable economic effects of new structural changes, this will become doubly difficult. There are several big issues for which forecasts cannot be made with great precision or confidence:

- **Strength and pattern of recovery:** The available economic lead indicators combined with the huge amount of global liquidity point to strong upward surprises in economic data in 2H2009. Given Singapore's high leverage to global trade and finance, the city state's economy will rebound very strongly in the coming months. However, there remain strong headwinds to economic growth in the developed economies — unavoidable policy tightening, deleveraging by financial institutions and households, rising savings rates and higher oil prices. Once the initial rebound is over by early 2010, economic activity in the US, Europe and Japan will be mediocre and marked by further financial and other stresses erupting every now and then.
- **Policymakers in a dilemma:** Policy-makers will be hesitant to tighten monetary or fiscal policy proactively, preferring to take the risk with inflation rather than risk a double dip caused by premature tightening. After all, history has provided them with many warnings of the likelihood of a double dip caused by ill-timed policy tightening. The US saw its initial recovery from the Great Depression reversed in 1937 when fiscal policy was tightened too early. In Japan, a slow recovery from the bursting of the asset bubbles was halted in 1997 when the Hashimoto government raised the sales tax in an effort to correct fiscal imbalances. But, financial markets may not provide policymakers with enough room to manoeuvre. As economic recovery progresses, the voices clamouring for policy tightening to avoid inflation or to prevent a fiscal blow-out will become louder and more influential. Bond yields may rise well before central banks desire and currencies of countries deemed to be too tolerant of inflation may come under attack.

### **Some major policy changes likely early next year**

Singapore will have to take the above factors into account. In all likelihood, the policy environment around Singapore will be characterised by the following:

- Central banks in Europe, Australia and some parts of Asia will probably raise rates ahead of the US or Europe; this monetary tightening cycle will probably begin by around 2Q2010. Australia is already recovering smartly and some policymakers in Asia, like the Bank of Korea, are already worrying about keeping monetary conditions too loose for too long.
- Special arrangements established last year to stabilise the financial sectors are likely to be withdrawn in stages, beginning in the next few months. Deposit guarantee schemes, special facilities to increase liquidity for banks and unconventional central bank purchases of bonds and other securities are likely to end or be replaced by new and restrained arrangements.
- Fiscal deficits in the US will come down only very slowly while the promised new spending by the new government in Tokyo could postpone fiscal rebalancing in Japan as well.
- All these developments are likely to generate substantial financial market volatility in the developed economies next year. A differential pace of monetary tightening (if Europe tightens faster than the US) will make the US dollar less favoured, putting more pressure on the greenback. Bond yields are likely to rise in response to greater appreciation of the high cost of the policy response to last year's crisis.
- China will probably have to shift back to a gradual pace of appreciation of the renminbi. Its appreciation will give more room for currencies of China's competitors in Asia to also rise. Domestic factors to consider The domestic factors affecting Singapore policymaking can be sketched out as follows:
  - Economic activity will see a strong rebound from the sharp falls of late 2008. But we will still likely have some unused industrial capacity and unemployment, while improving, may not fall back to pre-crisis levels quickly.
  - With economic recovery boosting confidence and low interest rates continuing, asset markets are likely to continue surging, especially the real estate sector.
  - If there is under-utilised capacity in the economy and global inflation only picks up a little, the risk of a material rise in domestic inflation — while higher than now — will probably remain low.
  - Companies will have to switch their focus from surviving the crisis and enjoying the current rebound to reacting to a post-crisis world where growth will be slower and incremental demand will be coming more from poorer emerging market economies than in the past. Singapore companies which have been geared substantially towards servicing demand in the developed economies will have to undergo some degree of re-engineering in their operations and rationalising of capacity to survive and prosper in this new world.

### **What to expect?**

This shifting environment will require changes in the macro-economic levers Singapore uses to keep its economy on a stable track. Investors need to watch out for the following developments:

First, monetary conditions may be too loose by the later part of this year. As it is, the increasingly feverish activity in the real estate sector seems to suggest that the risk of a future bubble fuelled by easy liquidity and low interest rates is material. It is possible that the authorities might consider a return to a gradual appreciation of the

trade-weighted exchange rate as early as this October.

Second, several of the special schemes introduced to stabilise the economy in late 2008 and early 2009 have either outlived their usefulness or need to be institutionalised here in some form. The deposit guarantee scheme and special schemes to support bank lending to small- and medium-sized enterprises should continue in a more targeted manner and be institutionalised, rather than remain an ad hoc measure with a limited time frame. The Jobs Credit Scheme should also be replaced by a more focused programme that helps a more selective category of enterprises.

Third, fiscal policy should probably remain relatively loose compared with previous years. With risks remaining in the global economy and the likelihood of some restructuring by corporates here, it might be prudent for fiscal support to the economy to continue.

Fourth, it might become increasingly necessary to “lean against the wind” if real estate prices continue to surge. The use of “micro-prudential” measures such as restrictions on loan-to-value for housing loans might become increasingly necessary. In other words, investors should not only play the liquidity cycle but keep an eye out for the policy and other fundamentals.

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