IPS-ESS Workshop

Monetary Policy in Singapore

October 2004

This is a summary report of a workshop on "Monetary Policy in Singapore" jointly organised by the Institute of Policy Studies (IPS) and the Economic society of Singapore (ESS), on 23 October 2004. We offer this as an additional input to the policy-making community and others with a keen interest in the monetary policies of Singapore.

We would greatly appreciate any comments or feedback you might have on this report. Please send them to Mr Manu Bhaskaran, Adjunct Senior Fellow at IPS (manub@pacific.net.sg).

Institute of Policy Studies

INSTITUTE OF POLICY STUDIES – ECONOMIC SOCIETY OF SINGAPORE
WORKSHOP ON MONETARY POLICY IN SINGAPORE
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KEY THEMES

The following is a summary of key themes that emerged at the Workshop on Monetary Policy in Singapore jointly organised by the Institute of Policy Studies and the Economic Society of Singapore on 23rd October 2004.

In brief,

- There was general support for the basket-band-crawl exchange rate regime that Singapore currently employs. The discussion was more on specific features of the regime not on whether the regime itself was appropriate.

- Specific recommendations were made by participants but there was no strong consensus in favour or against them:

    - A wider band for the exchange rate to fluctuate in to enable smoother and more timely adjustment to external shocks and to forecasting error.
    - Monetary policy objectives be more clearly articulated – regarding the trade-offs between inflation and growth in particular and also with other policy objectives.
    - Monetary Policy Statements be issued on a quarterly rather than a semi-annual basis though the Macroeconomic Review can remain semi-annual.
    - The MAS should consider providing more information to the market such as issuing its own version of the Federal Reserve Beige Book, based on the extensive feedback it receives from companies
    - In the current environment characterised by low inflation and inflation volatility and weak growth and high growth volatility, monetary policy could afford to be used more actively as a counter- cyclical tool.
    - In this environment, monetary policy should also be considered for more active use in structural adjustment rather than an excessive reliance on deflationary price and wage adjustment

(I) Keynote Presentation by Mr Robert N McCauley, Bank for International Settlements

In his paper, Mr McCauley made the following key points:

1. Assessment of Singapore's Monetary Policy

Mr McCauley felt that there was no compelling case for a substantive change in Singapore's approach to monetary policy which he characterised as a flexible form of implicit inflation targeting (IT) which uses the nominal effective exchange rate (NEER) as an intermediate target, and which responds to price pressures and the output gap.

1.1 No need for greater transparency

Mr McCauley felt that the Monetary Authority of Singapore (MAS) was already a lot more transparent than many realise. Market participants had enough information to work out the weights used by MAS in its currency basket, as could be seen in several efforts by economists associated with financial institutions. Moreover, the market also had a clear set of data releases it knew it had to focus on such as non-oil domestic exports as well as the consumer price index. The MAS had also signalled to the market from time to time where the spot currency rate was in relation to the centre of the currency band. The only uncertainty was over the slope of the central tendency for the currency.

Mr McCauley examined the case of the April 2004 policy announcement of monetary tightening which had taken many market participants off guard. He argued that this surprise did not reflect a problem with the transparency of the exchange rate policy regime. Rather it reflected an asymmetry of information – MAS had, through its regular meetings with key companies, realised that the economy was far stronger than the market had estimated, something which the market realised soon after the policy announcement. Mr McCauley's recommendation in this regard was for MAS to consider the release of a document akin to the Federal Reserve Bank's Beige Book, which summarises the feedback that the Federal Reserve Bank's economists receive from companies across the US.

1.2 No compelling case for more frequent policy changes/announcements

Mr McCauley considered the advice of some economists and market participants that the MAS make more regular policy announcements. He felt that very frequent announcements would be at the expense of other good work that MAS undertakes in economic research to no real advantage.

1.3 Not in favour of a wider band

Mr McCauley counselled caution in regard to the proposal that the MAS shift to employing a wider band, as advocated by Mr Adam Le Mesurier (see below). Trend-following speculative funds such as CTA accounts are more active now in foreign exchange markets, and could raise the risks of having a wider band.

2. The experience of inflation targeting in emerging market countries

Mr McCauley's research showed that emerging market countries were finding it a challenge to hit inflation targets in the presence of large effective exchange rate changes. In particular, a 10% or larger appreciation/depreciation (which is precluded by the MAS band) is strongly associated with an inflation target undershoot/overshoot. This relationship was not significant in the case of industrial countries. Singapore's openness to international trade makes it more similar to emerging economies, while its high income leaves its consumption basket more concentrated in services that are sheltered from global trends, as in industrial economies.

Mr McCauley's work also showed that East Asian countries were not employing US Dollar shadowing exchange rate policies as widely argued. His analysis of local currency responses to changes in the US Dollar and Japanese Yen suggested that East Asian policy makers were actually targeting a NEER rather than virtually pegging to the US Dollar. For example, a more detailed examination of Korean exchange rate movements and official reserve changes demonstrated the revealed preference of Korean policy makers for a NEER approach akin to that employed by Singapore.

3. The future

The key change that Singapore's policy regime would have to manage would be the eventual shift in China and Malaysia towards a more flexible exchange rate regime. Mr McCauley's analysis suggested that because Singapore's currency basket was an inclusive one that incorporated weights for all major trading partners, it would be able to adjust relatively easily.

(II) Presentation by Mr Adam Le Mesurier[1]: How Should Singapore Evolve Its Exchange Rate Regime?

In his paper, Mr Le Mesurier argued that the MAS should consider changing its policy regime by shifting to a wider band for the exchange rate.

1. There is greater uncertainty over economic direction, raising risks of policy error.

The last year had seen an external recovery finally feed through to domestic demand. Looking forward, neither trend looks well entrenched. Uncertainty over growth prospects for 2005 is higher than usual, with considerable scope for downside risks in the outlook for three important exogenous factors: the global industrial cycle, regional/China inflation and oil prices. Mr Le Mesurier felt that with

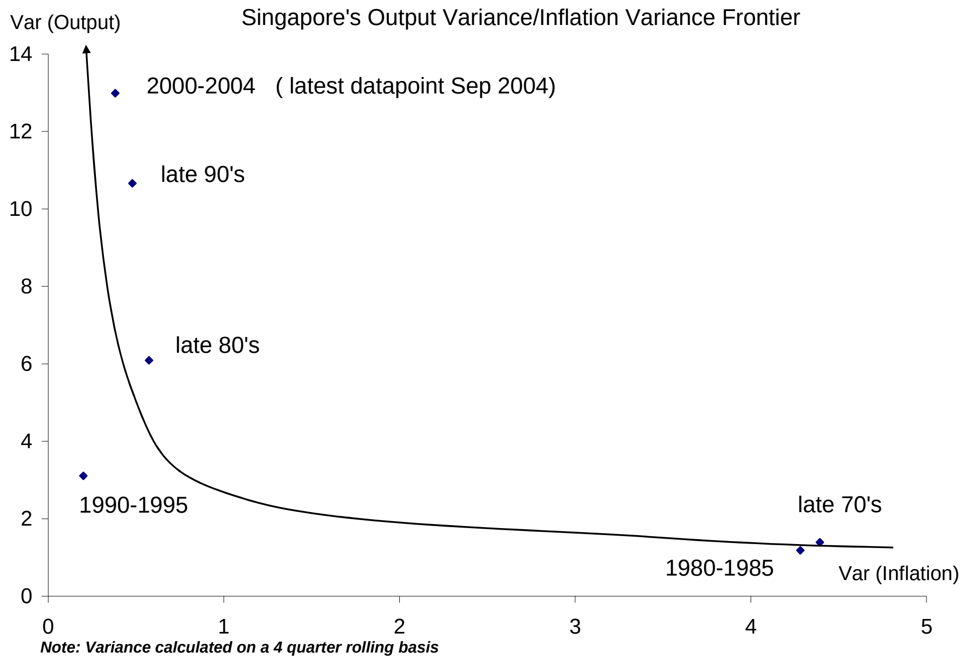
[1] Vice-President, Asia-Pacific Economic Research, Goldman Sachs (Singapore). His paper is based on a report issued by Goldman Sachs, "Singapore: The case for a permanent widening of the exchange rate band" dated 3 September 2004. Please note the disclaimers contained therein.

so little pricing power in Singapore, there was limited scope for domestic demand to hold up in the face of such possible external shocks. In this context, there was thus a risk that the recent tightening of monetary policy by the MAS could turn out to be pro-cyclical rather than counter-cyclical.

2. A wider band would help mitigate this risk

Mr Le Mesurier felt that there was a case for permanently moving to a wider band, which would guard better against the risk that policy makers might mis-read the economy.

His analysis of trends in the variance of Singapore's economic output versus the variance in Singapore's inflation seemed to suggest that adoption of the "hard" basket-band-crawl (BBC) exchange rate system had led to a change in the trade-off between inflation volatility and output volatility. This analysis seemed to imply that policy makers had effectively overshot on inflation stability, at the growing expense of higher output volatility. Whilst some of the rise in output volatility was attributable to higher external volatility, he still felt that monetary policy had a "non-trivial" role to play in the trade-off position; otherwise the economy would never have shifted from the bottom-right quadrant in the first place.



Mr Le Mesurier felt that, in a low inflation environment, the current "hard" BBC does not leave enough room for inevitable cyclical "policy errors". A permanent band widening would inject more flexibility into the current system, without sacrificing any of the credibility, whilst also helping to socialise some of the uncertainty risks of forecasting the business cycle.

He did not believe that a wider band would result in a higher risk of the market driving the exchange rate substantially out of line with MAS objectives. He noted that speculators were rational and that they had a their profit/loss accounts as a major constraint that prevented them from pushing the exchange rate beyond rational levels. He further noted that the risks were particularly lower in Singapore given the high level of accumulated policy credibility – there was little evidence that speculative activity had decisively worked against MAS objectives in the past. Should a situation occur in future where speculators appeared to be doing this, the MAS had enough credibility to force them to change course by sending the appropriate signals.

In short, Mr Le Mesurier wanted to see the MAS return to the pre-1997 MAS framework when the only parameter was the crawl, unlike the current regime which has three parameters: besides the crawl, authorities can also change the width of the band or re-center the band.

(III) Discussion by Dr Ramkishen Rajan, University of Adelaide and Visiting Fellow, IPS: Currency Basket Pegging or Inflation Targeting: Does it Really Matter?

1. A tightening bias?

Dr Rajan's analysis of monetary policy statements (MPS) issued in the period January 2001 to October 2004 seemed to him to indicate a general tightening bias on average. He noted that while there was mention of tight labour market conditions or a labour market recovery, there was little discussion of labour market sluggishness. This did not mean that the MAS was totally averse to depreciations. There was, for instance, the *de facto* depreciation with the recentring of parity in July 2003. There was also the altering of the band width between October 2001 and January 2002.

2. Is there a need for greater flexibility?

The greater uncertainty in the regional and global environments spoke of the need for constant domestic structural changes. This raised two issues: the degree and the type of flexibility required in the exchange rate regime.

2.1 Degree of flexibility

The degree of flexibility boiled down to three questions:

(a) Do NEER changes translate to REER changes? In other words, what is the extent of the pass through? Dr Rajan noted that research showed pass through was incomplete in the short run but virtually complete in the longer run. This suggested that NEER changes could have a short term impact on the real economy.

(b) Do "marginal" REER changes (not misalignments) impact the real economy? This in turn depended on a host of factors, including the import content of domestic value added, the signficance of balance sheet effects and price elasticities of net exports. There is also the issue of how important real exchange rate variability is to FDI and trade.

(c) How flexible are domestic factor and product markets and how costly are such adjustments compared to adjustments via NEER changes?

2.2 Type of flexibility

As for the type of flexibility, Dr Rajan argued that the type of flexibility entailed a choice between:

(a) Narrow (and hard) bands but reasonably frequent alteration in the parity ("re-centering); or

(b) Wide (and soft) bands and limited intra-band intervention but relatively fixed parity (so-called "Monitoring Band" arrangement).

Such a choice would boil down to answers to the following questions:

(a) Does MAS really know how the equilibrium exchange rate has changed?

(b) Do tighter bands (assuming they are credible) lead to stabilizing expectations?

His recommendation was as follows:

	Does MAS know equilibrium exchange rate?	**Is a tighter band stabilising or not?**	**Policy Choice**
Scenario 1	Yes	Yes	Narrow and Hard Band with frequent re-centring.
Scenario 2	No	No	Wide and Soft Band with limited intra-band intervention and relatively fixed parity.
Scenario 3	Yes	No	Narrow but Soft Band
Scenario 4	No	Yes	Wide but Hard Band Option

Dr. Rajan felt there was need to do some deeper thinking about the appropriate level of transparency of monetary policy. There has thus far been limited academic research on the subject.

(IV) Discussion

1. What are the appropriate objective and trade-offs for monetary policy?

Some participants felt that there was a need for policy makers to come up with a more explicit articulation of monetary policy. Greater clarity on what more precisely is the trade-off between inflation and growth which policy makers intended ;(eg many central banks publicised clear desired inflation or employment target ranges) was preferable. The market would then be better able to understand and anticipate the appropriate monetary stance.

Secondly, what is the appropriate role of monetary policy relative to fiscal policy, other administrative policy measures (such as adjustments to the Central Provident Fund [CPF] rate), changes in banking supervision rules and cost cutting measures that Singapore has employed before in macroeconomic management.
Most participants agreed that in general in a highly open economy such as Singapore's, there were limitations in the scope for monetary policy to be used to fine tune the economy. Consequently it had been more appropriate to employ monetary policy to primarily target price stability – which MAS has done effectively for many years.

The real debate now, however, was over the extent to which this traditional approach should be followed if it resulted in undesirable or excessive impact on other variables such as the volatility of growth or employment or competitiveness - and on the different methods that were best used to implement monetary policy.

2. Has monetary policy in Singapore been asymmetrically biased to tightness?

A considerable part of the discussion thus focused on the question of whether monetary policy has shown a systemic and excessive bias towards tightness in recent years. In particular, should monetary policy now play a greater counter cyclical role than it traditionally had, given the increasing tendency over the last decade towards low inflation and very low inflation volatility on the one hand and sub par growth and high growth volatility on the other (see Chart on Singapore's output variance vs inflation variance from Adam Le Mesurier above).

A number of participants suggested that they thought that such a systemic bias to tightness existed and asked if there was a deeper reason for this (eg was an unspoken policy priority to retain the real value of assets or to preserve very low inflation). A few questioned the appropriateness of this bias given the current environment, suggesting that monetary policy could afford to be used more actively as a countercyclical tool as well as a tool of structural adjustment. One financial market economist pointed out that in an environment of asset inflation, a bias towards monetary tightness represented by a gradually appreciating currency resulted in lower interest rates and exacerbated asset inflation. In the current environment, however, it could be worsening asset deflation.

The same participant opined that given the current global downturn and what he thought could be a deeper than expected fall in the IT cycle, the tightening or appreciating exchange rate bias of the current monetary policy stance was inappropriate. Adam Le Mesurier agreed, but conceded that this was a matter of judgement on the downside risks in the global economic environment.

The same financial market economist also cautioned that the benefits of a more activist counter cyclical monetary policy only held in an environment with unemployment and asset deflation. He suggested that in the long run, a narrower inflation target and central bank independence were perhaps necessary to safeguard price stability in the contingency of a change in political regime that could be very different from the current financially prudent one. It was counter-argued, however, that given the political dominance of the current regime, a regime that used monetary policy more flexibly, also targeting employment or even structural policy objectives would be more optimal, and inflation targeting and strict central bank independence unnecessarily limiting.

There was no clear consensus on the benchmarks to use to judge whether policy was too tight or too loose or just right. However, a number of such benchmarks were put forward for consideration:

- If inflation turned out to be persistently negative for a prolonged period of time, that was in the eyes of one participant a clear sign that policy had been too tight. He suggested that, alternatively we could say that Singapore's monetary policy had been too tight if its inflation rate was persistently much lower than the average for countries of the Organisation for Economic Co-operation and Development (OECD).

- Another way to judge whether monetary policy was appropriate could be to look at the volatility of real activity variables – if volatility was too high, then it might suggest an overly tight bias in policy.

- Another suggested indicator was if employment growth was too low or unemployment remained unexpectedly high. This implied using a measure of "internal balance" to judge if the exchange rate were too strong and thus monetary policy too tight.

3. Competitiveness

Another way of judging whether monetary policy had been too tight – or indeed whether the exchange rate regime in use was appropriate - could be to assess the impact on competitiveness:

- Some argued that the cost cutting measures that Singapore had used in the past were becoming less and less feasible to use in the future. This is especially true of the CPF cuts given the increasing need for CPF to focus predominantly on its role as a fund for retirement income because of the ageing population. Should this place a greater burden than before on monetary policy – since policy makers would have less scope to use the CPF instrument the next time there is a loss of competitiveness?

- Some participants focused on the disproportionate impact the real exchange rate level might be having on the services sector. This was because unlike manufacturing where the negative impact on domestic costs of a rise in the exchange rate was partly offset by cheaper imported inputs, services had a much larger domestic cost content. The net surplus on services-related trade had fallen sharply in the past decade from around 13% of GDP to around 2% right now. It could be that the sharp depreciations of the currencies in Korea and Southeast Asian trading partners during the 1997-98 financial crisis had made many of Singapore's services for the region uncompetitive, and that this was inhibiting broader service sector recovery.

- This was particularly worrying, since dynamic service sector growth, especially service sector employment growth, was crucial to Singapore in its current stage of economic development. This was especially so in terms of competitiveness, more stable, sustained growth and maintenance of full employment in the medium term. There were thus also concerns that the current measure of the real effective exchange rate was biased towards the manufacturing sector and did not reflect the appropriate country weights for traded services or the relevant unit labour cost deflator.

4. Should MAS shift to a wider band?

Again, there was no clear consensus on this issue.

Many participants took note of the risks posed by a wider band, particularly in view of the speculative nature of financial markets in general and the momentum trading strategies used by some hedge funds in particular. While Mr Le Mesurier's argument that speculators were largely rational was not disputed, there were some concerns that currency markets were prone to prolonged overshoot and could cause damage if factors driving the overshooting were not the same as those needed to stabilise the economy or inflation. McCauley pointed out that due to its liquidity, the Sing dollar was often used as a proxy for broader Asian currency risk. It was also pointed out that such overshooting could be driven by changes in fundamentals of other currencies eg a revaluation of the Malaysian Ringgit, RMB or an overshoot of the US dollar or Yen.

5. Transparency

While participants generally saw value in greater transparency, there was a view that excessive transparency could lead to rigidity. Some participants thought that an element of vagueness in articulating monetary policy was perhaps desirable to accord the policy makers with greater flexibility, particularly when reversing policy moves that had been based on a mis-reading of economic trends. In addition, excessive clarity in spelling out desired exchange rate trajectories might have unintended consequences on interest rates owing to the uncovered interest parity condition. For example, if the SGD was perceived to be weak, Sing $ interest rates might rise towards or above US interest rates as opposed to trading at a discount to them. McCauley pointed out that this could be problematic in an economy like Singapore's with a highly leveraged household sector that was directly exposed to floating rate debt. An implication of this could be that easier monetary policy stance needed to be implemented more by discreet changes in the central parity and accompanied by wider softer bands rather than explicit depreciation paths within narrow bands.

(V) Comments by Dr Khor Hoe Ee, Monetary Authority of Singapore

Dr Khor noted that the divergence of views that had been expressed in the workshop reflected the complexity of monetary policy.

1. Policy stance: getting the level of the exchange rate right

The MAS watches the level of the exchange rate very carefully and in a detailed manner that takes into account (a) not just relative costs but also, importantly, (b) relative returns on capital; and (c) the unemployment rate. While there were many estimates of relative returns on capital and some differences of opinion on the actual trend and what they meant, the MAS felt that the data on returns on capital on balance did not suggest that our competitiveness was significantly out of line with those of our competitors. The MAS was also watching the employment situation carefully, particularly the job creation capacity of the economy. – If the unemployment rate remained high despite continued economic growth and measures such as cost cutting and re-training workers, then MAS would certainly look into whether an overly tight monetary policy resulting in an overly strong exchange rate might be responsible.

The MAS also conducted econometric modelling of the equilibrium exchange rate – which showed that the Singapore Dollar was not out of line with the equilibrium rate. This was used as an additional check to see if the Sing dollar was misaligned with fundamentals.

The MAS accepts that it cannot get the equilibrium level of the exchange rate right all the time and so recognises the need for a margin of error. This is reflected in the use of both a band and a crawl.

2. Objective of monetary policy

The MAS had a modest view about what monetary policy could realistically achieve. The MAS's studies indicated that the exchange rate was a far more important price for the Singapore economy than interest rate given the openness of the economy. Thus it was appropriate for monetary policy to use the exchange rate rather than interest rates as a policy instrument, in view of the open economy Trilemma.

The MAS felt that monetary policy was too blunt an instrument to employ against speculative bubbles in asset prices. The last time such a bubble appeared in Singapore, the government had used administrative measures as well as banking supervisory measures to curtail the excesses.

3. Asymmetry of policy?

The MAS accepted that the market was usually rational but also recognised that markets also moved on momentum. Thus, it was important for speculation to be bounded so that there would be some discipline in the way that markets operate.

The fact that the NEER tended to be mainly in the upper part of the band did not necessarily reflect a policy bias. Singapore's large external surpluses tended to push its exchange rate into the upper part of the band. In fact, a study by the MAS showed that if one plotted the output gap against NEER changes, by and large, NEER appreciation was associated with positive output gaps and NEER depreciations with negative output gaps. In other words, monetary policy was generally countercyclical as in most cases, exchange rate changes produced by the MAS policy stance appropriately reflected the cyclical state of the economy.

In response to comments from a participant that latest data from US Bureau of Economic Analysis suggested that Singapore's return on capital had continued falling in 2003 relative to its neighbours, Dr Khor said that internal studies by the MAS suggested that the declines in ROEs in recent years were cyclical to a large extent and that returns on capital had recovered and begun to improve more recently. In addition, the economy had been able to create significant numbers of jobs recently. Finally, MAS recognised the importance of service sector competitiveness and the trade weights in the currency basket already incorporate estimates of the importance of traded services. These were updated every few years. While he acknowledged disagreements still existed about whether the exchange rate was too strong, the MAS was looking at similar issues and a constructive objective debate was thus possible in future.

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