



Singapore

While Singapore withstood the region's financial crisis better than its neighbors in 1997, the region's crisis is likely to affect future growth. Industrialization policy remains active, and the financial sector is poised for expansion.

RECENT TRENDS AND PROSPECTS

Except for its currency and stock market, Singapore was only mildly affected by the region's economic crisis in 1997. The economy surged ahead with 7.8 percent growth in GDP as world demand for computer-related electronics, especially semiconductors, rebounded. Manufacturing output rose by 4.3 percent, spurred by chemicals, petroleum, and electronics. Electronics account for roughly half of manufactures, which in turn account for more than three quarters of exports, and Singapore now has the world's largest disk drive industry. While the petrochemicals subsector expanded significantly as new plants came on stream, commerce, and in particular tourism, suffered somewhat from reduced regional demand.

High salaries and property prices relative to those in neighboring countries have taken their toll on Singapore's manufacturing base, particularly for lower value-added and labor-intensive manufacturing, much of which has migrated to Malaysia. While the remaining manufacturing sector has maintained increasing productivity, it has become more concentrated on electronics. The services sector now accounts for more than 66 percent of GDP, while industry accounts for 34 percent. Financial and business services, particularly foreign exchange activity and provision of business hub services, grew by 11 percent in 1997, assisted by tax breaks. The steady rise in net services income has

played an important role in the current account surplus, although this was tempered somewhat in 1997 by the slowdown in tourism resulting from the financial crisis and the haze that affected the region following the forest fires in Indonesia.

The construction industry benefited from public investment in infrastructure in 1997, which included expansion of the mass rapid transit system and port facilities and land reclamation. It expanded by 13.3 percent and led employment growth. Public and private housing projects contributed to the sector's robust growth. Growth in such spending generally offset the slower growth in machinery and equipment, resulting in fixed investment growth of nearly 10 percent.

Activity in the property market remained subdued as restrictions imposed in 1996 to prevent overheating remained generally in force (except for a stamp duty on sellers of properties held for less than three years, which was removed), and property demand from neighboring countries diminished. The resulting glut of private housing prompted the government to halt land sales in late 1997 and extend the time granted to developers to construct their projects.

The labor market remained tight, with unemployment running at less than 2 percent. The concentration on electronics manufacturing has increased the demand for engineers and technicians, and resulting wage increases have been only partially constrained by importing skilled foreign workers.

Table 2.3 Major Economic Indicators: Singapore, 1995-1999
(percent)

| Item | 1995 | 1996 | 1997 | 1998 | 1999 |
|---------------------------------------|------|------|------|------|------|
| Gross domestic product growth | 8.7 | 6.9 | 7.8 | 3.0 | 4.5 |
| Gross domestic investment/GDP | 33.7 | 35.3 | 37.4 | 32.0 | 33.0 |
| Gross domestic saving/GDP | 51.0 | 51.2 | 51.8 | 50.0 | 50.0 |
| Inflation rate (consumer price index) | 1.7 | 1.4 | 2.0 | 3.2 | 3.3 |
| Money supply (M2) growth | 8.5 | 9.8 | 10.3 | 8.6 | 7.5 |
| Fiscal balance/GDP | 7.6 | 6.8 | 3.3 | 1.7 | na |
| Merchandise exports growth | 21.0 | 6.4 | -3.1 | 2.0 | 4.0 |
| Merchandise imports growth | 21.6 | 5.4 | 0.1 | 2.0 | 4.0 |
| Current account balance/GDP | 17.0 | 15.4 | 15.2 | 12.9 | 10.3 |

na Not available

Sources: International Monetary Fund (1997a), Ministry of Trade and Industry (1996), and staff estimates.

Real wage increases have, in turn, supported private consumption, although such increases are likely to moderate because of the regional slowdown. Public sector consumption remained strong in 1997, increasing by 8.6 percent.

The Monetary Authority of Singapore (MAS) practices a managed floating exchange rate system, with a target of a trade-weighted currency basket. As the MAS only adjusts the weights every three to five years, the region's currency turmoil and changing trade patterns may require the MAS to reassess this target. The sensitivity of the small, open economy to trade and capital fluctuations necessitates a focus on monetary stability. Money supply (M2) growth averaged 10.3 percent for the year, and inflation was just 2 percent, aided by lower prices for imported food from neighboring countries with depreciated currencies. Meanwhile, prices for administrative charges, transportation, communications, water, health care, and housing increased. Singapore pledged to assist in the bailout packages for neighboring Indonesia and Thailand led by the International Monetary Fund.

The high savings rate (equivalent to roughly half of GDP), fiscal surplus, current account surplus, limited foreign debt, and the world's highest per capita foreign reserves helped the country come

through the regional currency and financial turmoil less affected than its neighbors. While the Singapore dollar depreciated about 17 percent relative to the US dollar, it appreciated substantially more relative to most regional currencies.

In recent years the emphasis on outward direct investment has increased, and successive current account surpluses and substantial inward bound foreign direct and portfolio investment have led to steady growth in international reserves. With the low level of foreign debt, which consists primarily of long-term borrowing by the private sector, and substantial exports, the debt-service ratio is less than 1 percent.

External demand typically contributes more to Singapore's growth than domestic demand. Singapore's merchandise exports to Southeast Asia may be relatively unaffected by the slowdown there, as many of them are intermediate goods with end markets ultimately in Europe or North America. Of greater significance is the steep depreciation of the Korean won, as the Republic of Korea produces and exports electronic goods that compete directly with those of Singapore.

While the region's difficulties had some negative impact on Singapore's exports, robust future economic activity in Europe and North America is

likely to more than offset this. Of Singapore's five largest markets (the European Union; Hong Kong, China; Japan; Malaysia; and the United States), the financial turbulence has affected only Malaysia. Exports declined slightly in US dollar terms in 1997, but are expected to recover in 1998. Slow growth in imports is expected to compensate to a large extent for the reduced growth in exports, and the current account surplus is expected to decline slightly as a percentage of GDP, but to remain substantial.

Slower regional growth is expected to affect hub-related services, such as entrepot trade, and shipping services, such as freight, insurance, and port charges, leading to slower growth and rising unemployment in 1998. The appreciation of the Singapore dollar relative to other regional currencies is also likely to affect net tourism and retail receipts negatively. In addition, reduced residential construction in 1998 is expected to contribute to slower investment growth. Projections indicate that GDP growth will fall to 3 percent before recovering somewhat to 4.5 percent in 1999.

Given the government's commitment to increasing spending on education and infrastructure, such spending is expected to continue to rise, although at a more moderate pace in 1998 and 1999. The government has maintained its operating expenditure near a constant 20 percent of GDP. Development expenditure is expected to remain high because of upcoming infrastructure projects, including land reclamation, communications facilities, a new rapid transit line and extension to Changi Airport, and light rail projects.

POLICY AND DEVELOPMENT ISSUES

The financial crisis in much of Southeast Asia have brought to the fore a nexus of issues that will affect Singapore's future prospects. Prominent among these are the country's industrial policy and development of the financial services industry.

Industrial Policy

Singapore maintains a concerted effort to broaden and deepen its economy, particularly in relation to the Southeast Asian subregion. The government emphasizes low land-intensity operations, and uses tax incentives, investment allowances, training, research and innovation programs, and capital

assistance schemes to steer investment toward higher value-added activities. The objective is to attract foreign investment, promote and develop service sectors, and develop small- and medium-size enterprises. Within the services sectors, the focus is on serving regional business headquarters (approximately 2,000 of which are located in Singapore), logistics, education and health care services, and communications and media. The authorities also devote substantial effort to promoting financial services.

Infrastructure and technological innovations are necessary to boost productivity and attract foreign investment. The government's Manufacturing 2000 program aims to maintain manufacturing at 25 percent of GDP and 20 percent of employment, but these goals may come into conflict with the expansion of business and financial services. The government is devoting more resources to research and development (R&D) and to technical training of the labor force. Singapore's gross expenditure on R&D has been growing rapidly, expanding at a rate of 19 percent per year over the last five years, but remains lower in relation to GDP than in other industrial countries. The small size of Singapore's population may limit the amount of R&D that can be done domestically.

Singapore is a prominent investor in other countries in Asia, including PRC, India, Indonesia, Myanmar, and Viet Nam. To some extent this is patterned after the Swiss model of obtaining substantial national income from foreign investments. In this effort, the sharp depreciation of other Asian currencies in 1997 may create a buying opportunity for Singapore's regional investment objectives.

The Singapore ONE (One Network for Everyone) plan to link every home by computer and turn Singapore into an "intelligent island" is intended to help establish Singapore as a regional financial and product design center. Singapore ONE aims to bring multimedia services with a broadband network and high-speed links to other economies to most Singaporeans by the end of 1998. Companies that participate in developing products and services that facilitate or use the new network are eligible for income tax exemptions, tax deductions for R&D expenditures, funding from the National Science and Technology Board, and preferential telecommunications tariffs.

The Economic Development Board's Innovation Development Scheme has been allotted S\$500 million to offer companies grants for half their costs in such areas as product and process design. Innovation Development Scheme funding is also available for companies that participate in Singapore ONE for up to 70 percent of development costs.

In addition, the authorities are promoting biotechnology. In 1997 the National Science and Technology Board started an incubator unit for infant biotechnology firms at the Bioprocessing Technology Centre, which makes laboratory space and equipment available for rent.

The concentration of fiscal incentives to benefit particular sectors reflects a government commitment to industrial policy that is likely to deepen. While Singapore appears to be moving toward an industrial policy in which the private sector takes the lead, that transition appears to be some way off. While one could argue that Singapore's industrial policy has been successful at picking industries for promotion, one could also argue that it may have been more a matter of the industries picking Singapore based on comparative advantage. Yet Hong Kong, China succeeded in many of the same sectors with much less government intervention. Some of the industries, such as electronics, that the government has promoted may have made Singapore's economy particularly susceptible to the regional export slowdown in 1996. In addition, some sectors, such as biotechnology, have received considerable promotion with limited results. Whether Singapore can continue to guide the market as well as in the past remains to be seen as the economy expands, diversifies, and moves increasingly into services, and as other examples of national industrial policy (such as in the Republic of Korea) appear less successful in hindsight. Fortunately, Singapore maintains a high degree of transparency in its policy implementation.

Development of Financial Services

The limited size of the domestic market implies that to maintain rapid growth financial activity must be externally oriented. To promote its efforts to expand as a regional financial center, the government has initiated a review of the banking and financial sector. The sector is considered sound, and Singapore maintains an open capital account. The capital adequacy

ratio for banks is set at 12 percent, substantially above that recommended by the Bank for International Settlements, but most banks maintain even higher ratios, all in assets that have the lowest risk. While this ensures that banks are well capitalized, it reduces the sector's return on equity. In 1997 estimates indicated that less than 3 percent of loans were nonperforming, but this ratio may increase as events unfold in Indonesia and Malaysia, with which Singapore has close economic links. The MAS estimates that offshore loans are roughly three times the value of domestic loans. The large banking sector comprises both domestic and foreign institutions, but the former are limited in size. The four largest domestic banks are either family or government controlled, and are too small to compete effectively in financing most of the region's large infrastructure projects. Foreign banks are currently restricted from owning more than 40 percent of any local bank's capital, thereby limiting the prospects for mergers to increase the size of domestic banks to internationally competitive levels. Transparency is also limited as, among domestic banks, only the government-owned bank reveals information about bad loans or provisions made against these loans to the public.

In 1997 the financial services sector benefited from greater foreign exchange trading and volatility-induced trading in the stock market, although Singapore's stock market fell by more than 40 percent, which reduced the benefits for domestically listed financial service firms. The foreign exchange market is active, and a futures exchange has been set up. There are no restrictions on forward exchange transactions. Forward exchange rates of up to one year's term are available for most major and regional currencies, and foreign currency futures are traded at the Singapore International Monetary Exchange. Plans to expand the financial services sector may, however, have to be scaled back if the region's setback results in reduced foreign borrowing from Singapore's banks, as seems likely.

In its July 1997 budget the government introduced a set of tax breaks for income earned from overseas activities of banks, income earned by fund managers in managing nonresident funds, income earned in managing initial public offerings in shares denominated in foreign currency, income earned from trading foreign currency shares, and income earned from credit ratings of foreign currency

denominated securities issued in Singapore. In addition, offshore bond issues no longer need to be underwritten locally to qualify as tax exempt, and the authorities raised the limit on tax deductible bank provisions against unforeseen losses by 50 percent. The number of seats on the stock exchange offered to foreign brokerage houses is expected to increase, fixed commissions on stock sales may be abolished, and the Singapore dollar is likely to be gradually internationalized by eased restrictions on foreigners lending Singapore dollars.

Market reaction has been muted, partly because of skepticism about the government's willingness to ease its traditionally tight control of the country's finances. This control is still apparent in the concentration of national savings in the Central Provident Fund, the large budgetary surpluses, the

substantial deposits of government agencies in the government-controlled savings bank, and a host of regulations covering relatively minor details of foreign bank branch operations. The 1998 budget aims to ease some of this control. Pressure from the United States and the World Trade Organization to liberalize the sector further is likely. However, in November 1997 the government announced that in future, the MAS will focus on supervision rather than on strict regulation of financial markets, and that listing requirements on the stock exchange would be eased. These modest efforts are in the right direction, but more can be done. The success of the government's efforts to establish Singapore as a regional financial center will depend critically on the government's willingness to cede more of its control over national savings.