Asian Currency Research

SGD policy – a balancing act

DBS Group Research **5 April 2013**

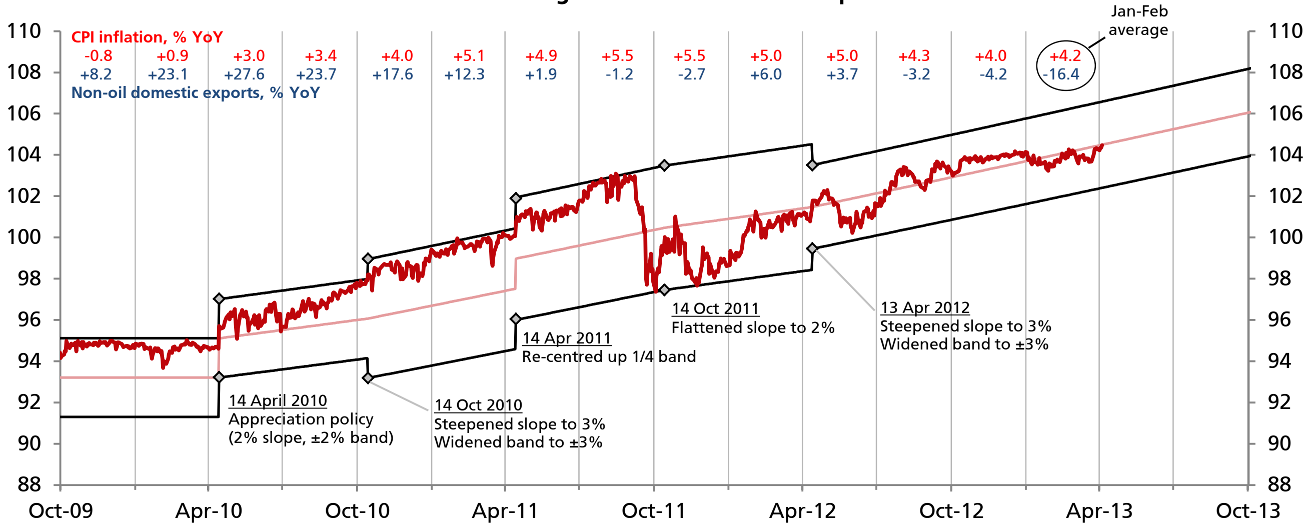
- **The MAS is expected to maintain its modest and gradual appreciation policy when it meets on April 12**
- **We expect no change to the centre, width or slope of the NEER policy band**
- **Our DBS SGD NEER is at the mid-point of the band. Policy is balanced between addressing high inflation and weak exports**
- **To augment the exchange rate policy in fighting inflation, measures have been employed to tighten credit in the housing and transport sectors**
- **USD/SGD should test its pre-crisis low below 1.20 in the second half the year**

To keep a fine balance between high inflation and weak exports

The Monetary Authority of Singapore (MAS) is scheduled to conduct its semi-annual monetary policy review on April 12. We expect no change to the present policy to appreciate the Singapore dollar nominal effective exchange rate (SGD NEER) policy band at a modest and gradual appreciation pace.

According to our model, this implies a SGD NEER policy band continuing to appreciate at an annual pace of 3% a year within a ±2% band around its mid-point. Our parameters are consistent with the official inflation forecast of 3.5-4.5% for 2013.

DBS SGD NEER takes the middle road between high inflation and weak exports



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After stabilizing from an initial shock at the start of the Eurozone crisis, the SGD NEER has fluctuated around the mid-point of its policy band. This reflects an exchange rate policy working to strike a balance between high inflation and weak exports.

As a general rule of thumb, the upper half of the policy band is where inflation worries outweigh export fears, and vice versa.

From the perspective of exports, the SGD NEER should be in the lower quartile of the policy band. In year-on-year terms, non-oil domestic exports have fallen to extreme lows not seen since the 2008-09 global financial crisis and the 2000-01 global tech recession. SGD bears would point out that during these two periods, the exchange rate policy shifted to a neutral stance or a zero appreciation path for the SGD NEER policy band.

So, why didn't the MAS do just that?

The exchange rate policy is, first and foremost, a monetary policy tool to manage inflation. Unlike the above two crises, Singapore did not, during this Eurozone crisis, enter into a full-blown recession that brought inflation down into negative territory.

Neither did the two crises experience unconventional and ultra-loose monetary policies in the US and other advanced economies. This resulted in capital inflows, which coupled with exceptionally low interest rates, kept asset prices and consumer inflation strong, not only in Singapore but also other countries in Asia ex Japan.

Indeed, inflation remained high at 4.9% YoY in February. This was well above the official inflation forecast of 3.5-4.5% for 2013. Theoretically, this would have, in a normal times, lifted the SGD NEER into the upper quartile of its policy band.

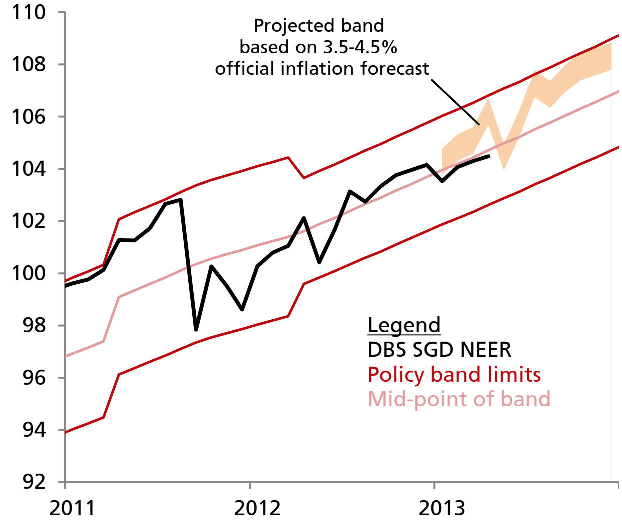
What to do?

If unconventional policies in the advanced economies keep local inflation high, domestic policies have to extend beyond exchange rate policy to tackle the price pressures.

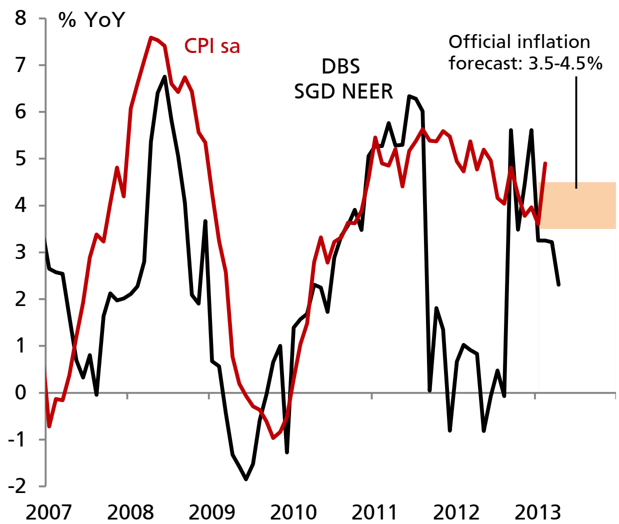
Due to the currency link that keeps Singapore's real borrowing costs negative, inflation has been highly correlated with loan growth. Moreover, the loan-to-deposit ratio at domestic banking units rose rapidly to 94.6 by end-2012 from 71.9 in 2009.

Under the circumstances, policymakers became obliged to pursue macro-prudential measures to tackle inflation at its source. This was achieved by tightening credit in the property and transport sectors, the two components in the CPI basket where price pressures are strongest. Indeed, private home price increases moderated to 0.5% QoQ in 1Q13 from 1.8% in 4Q12. As for automobiles, the certificate of entitlement (COE) premium fell to SGD65.9K in March from SGD91.6K in the previous month.

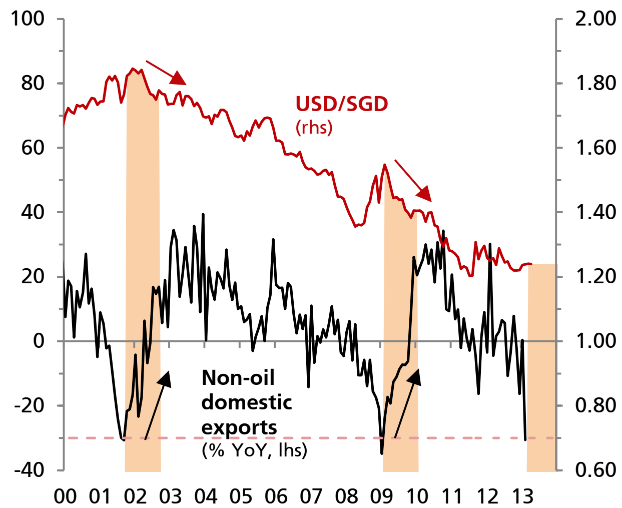
Policy band is consistent with inflation forecast



DBS SGD NEER correlated with inflation



SGD recovers once exports bottomed



Historically, the full-year appreciation of the SGD against the USD has consistently exceeded the average inflation rate for the corresponding year.

This is attributed to two factors.

First, there is a strong correlation between inflation and the trade-weighted appreciation of the SGD.

Second, the USD will need to stay weak against the currencies of the republic's major trading partners.

Admittedly, these relationships are not ironclad. They can break down from external shocks that hurt the world economy and undermine international financial markets. The 2008 global financial crisis and the 2011 Eurozone crisis were two recent examples.

Looking ahead, the policy environment is also particularly challenging this year.

Domestically, Singapore needs to balance between high inflation and an export recession. Between the two, inflation takes priority. That's why USD/SGD is now below 1.25, well off its 1.32 peak seen at the start of the Eurozone crisis in early October. This was in spite of the 30.6% YoY contraction in non-oil domestic exports (NODX) in February. During the 2008 global crisis and 2001 tech crisis, USD/SGD came off its peak only after NODX bottomed around -30% YoY.

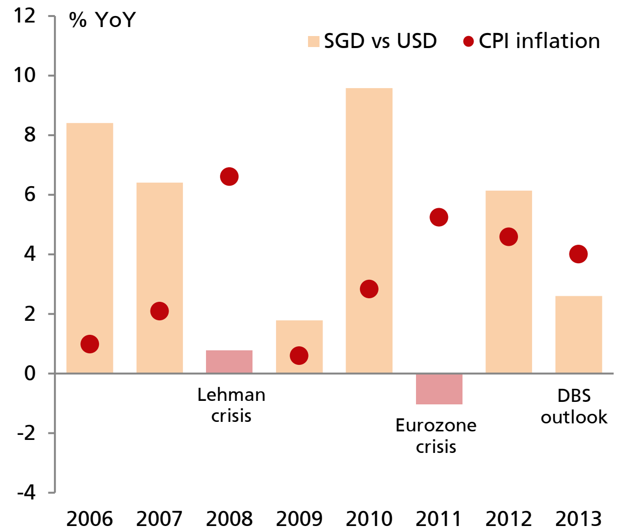
Externally, Singapore and emerging Asia appeared caught between a strong Chinese yuan and a weak Japanese yen. Between the currencies of Asia's two largest economies, the CNY is definitely more important to the SGD than the JPY. In terms of price action, the post-crisis SGD has been significantly more correlated with Asia ex Japan currencies (or the ADXY index which includes the CNY) compared to the major currencies (or the DXY index which includes the JPY). In terms of relevance, China has designated Singapore as the third offshore CNY centre, after Hong Kong and Taiwan.

Looking beyond exchange rate levels, the weak JPY could also turn out to be a blessing in disguise if Abenomics succeed in revitalizing the stagnant Japanese economy. The Abe government is due to unveil a growth and competitiveness strategy in June to deregulate and open Japan Inc to more competition.

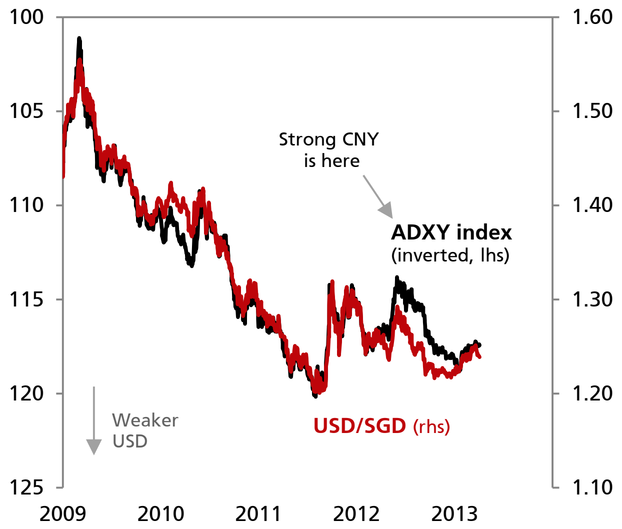
If successful, Singapore and the region stand to benefit from improving growth in Asia's two largest economies. This will help to balance the fiscal drag from deleveraging in the world's two largest blocs, America and the Eurozone.

Together, the world's largest economies will set the stage for Asia to return as the growth pole of the world economy. With its new leaders in place, China is also showing signs of being ready to lead surplus-led Asian countries, including Singapore, into allowing more currency appreciation to help put the world economy on a more sustainable recovery path.

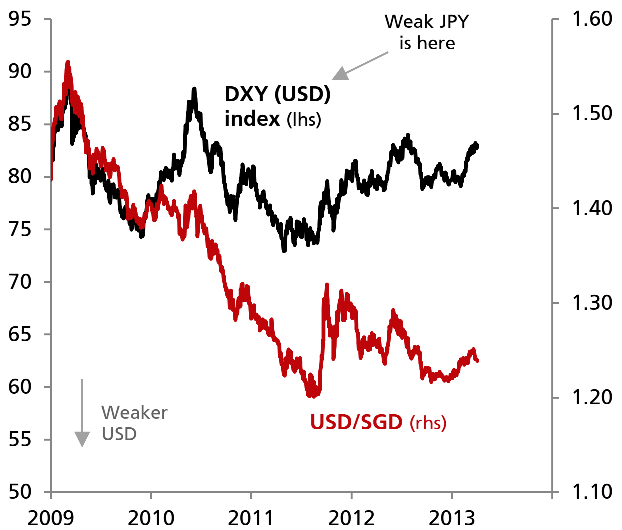
SGD appreciation beats inflation in normal years



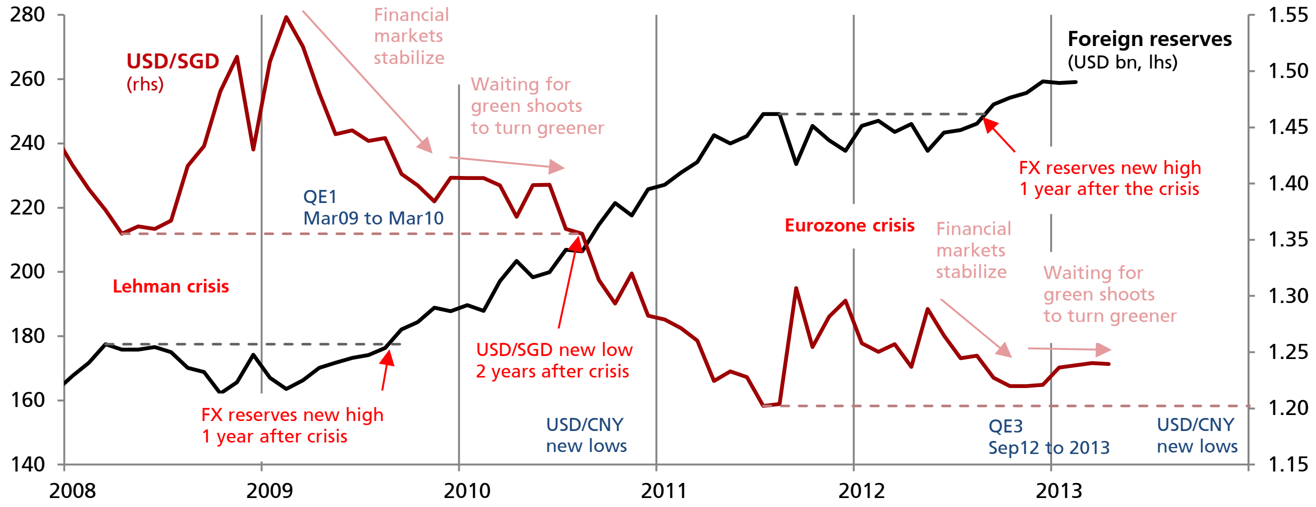
SGD tracks Asia ex Japan currencies more closely...



...than the major currencies after the 2008 crisis



USD/SGD sees a new low in the second year after a major crisis



Strong SGD policy to lower USD/SGD in 2H13

By year-end, we think USD/SGD will test the pre-crisis low of 1.1986 seen in July 2011 and our forecast is 1.19 accordingly. Measured against the end-2012 level of 1.2210, this translates into a full-year appreciation of 2.6% this year. The target is conservative when measured against the official inflation forecast of 3.5-4.5% for 2013. In our view, it is also consistent with the fact that macro-prudential measures are helping to share the burden with the exchange rate policy to address inflation.

The above expectations are also based on the parallels observed in the SGD's recovery from the 2011 Eurozone crisis with the 2008 global crisis. First, USD/SGD fell after financial markets stabilized from the crisis. In both cases, this came after the US Federal Reserve delivered quantitative easing measures. Capital inflows returned on hopes for an economic recovery to follow the stable financial markets. This led foreign reserves to rise to new record highs one year after the crisis started.

USD/SGD was, however, unwilling to trade below pre-crisis lows during this period because the nascent recovery had yet to gain traction. The currency pair chose to consolidate at the lower ranges instead. It was only after the green shoots became greener that USD/SGD started to post new all-time lows. During the 2008 crisis, this occurred two years after crisis started, and about three months after China started to allow its yuan to appreciate to new highs.

Today, China has fixed the USD/CNY central parity at a new all-time low on April 2. The second anniversary of the start of the Eurozone crisis is coming in September, just before the next SGD policy review in October.

Sources:

All data are sourced from CEIC Data, ThomsonReuters and Bloomberg. Transformations and forecasts are DBS Group Research.

GDP & inflation forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2010	2011	2012	2013f	2014f	2010	2011	2012	2013f	2014f
US	3.0	1.8	2.3	1.7	2.5	1.6	3.1	2.1	1.9	2.0
Japan	4.5	-0.6	2.0	1.8	0.6	-0.7	-0.3	0.0	0.0	2.0
Eurozone	1.9	1.6	-0.5	-0.3	0.1	1.6	2.7	2.5	1.9	1.9
Indonesia	6.1	6.5	6.2	6.3	6.5	5.1	5.4	4.3	5.3	5.4
Malaysia	7.2	5.1	5.6	5.5	5.5	1.7	3.2	1.7	2.8	3.2
Philippines	7.3	3.9	6.6	6.0	6.0	3.8	4.8	3.1	3.8	4.2
Singapore	14.8	5.2	1.3	3.2	4.0	2.8	5.2	4.6	4.0	4.2
Thailand	7.8	0.1	6.4	5.0	5.0	3.3	3.8	3.0	3.6	3.7
Vietnam	6.8	5.9	5.0	5.6	6.0	9.2	18.6	9.3	7.5	6.8
China	10.3	9.3	7.8	9.0	8.5	3.3	5.4	2.6	3.5	3.5
Hong Kong	7.0	4.9	1.5	5.0	4.0	2.4	5.3	4.0	3.5	3.5
Taiwan	10.7	4.1	1.3	4.2	4.0	1.0	1.4	1.9	1.3	1.3
Korea	6.2	3.6	2.0	3.5	3.9	2.9	4.0	2.2	2.3	2.9
India*	8.4	6.5	5.1	6.0	6.7	9.6	8.9	7.4	7.0	6.8

* India data & forecasts refer to fiscal years beginning April; inflation is WPI
Source: CEIC and DBS Research

Policy & exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	2Q13	3Q13	4Q13	1Q14	current	2Q13	3Q13	4Q13	1Q14
US	0.25	0.25	0.25	0.25	0.25	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	96.4	98	100	102	104
Eurozone	0.75	0.75	0.75	0.75	0.75	1.293	1.33	1.35	1.36	1.37
Indonesia	5.75	5.75	5.75	5.75	5.75	9,749	9,600	9,550	9,500	9,450
Malaysia	3.00	3.00	3.25	3.50	3.50	3.08	3.08	3.04	3.00	2.96
Philippines	3.50	3.50	3.50	3.75	4.00	41.2	40.1	39.7	39.3	39.0
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.24	1.21	1.20	1.19	1.18
Thailand	2.75	2.75	2.75	3.00	3.25	29.3	29.6	29.5	29.4	29.3
Vietnam^	9.00	8.00	8.00	7.00	7.00	20,925	20,750	20,750	20,750	20,750
China*	6.00	6.00	6.00	6.25	6.50	6.21	6.15	6.11	6.07	6.05
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.76	7.78	7.79	7.80	7.80
Taiwan	1.88	1.88	1.88	2.00	2.13	29.9	29.1	28.8	28.6	28.4
Korea	2.75	2.75	2.75	2.75	3.00	1124	1050	1040	1030	1020
India	7.50	7.25	7.00	7.00	7.00	54.9	54.0	53.5	53.0	52.5

^ prime rate; * 1-yr lending rate

Market prices

	Policy rate	10Y bond yield		FX		Equities		
	Current (%)	Current (%)	1wk chg (bps)	Current	1wk chg (%)	Index	Current	1wk chg (%)
US	0.25	1.76	-9	82.8	-0.3	S&P 500	1,560	-0.2
Japan	0.10	0.45	-7	96.4	-2.2	Topix	1,038	0.1
Eurozone	0.75	1.24	-5	1.293	0.8	Eurostoxx	2,684	-0.4
Indonesia	5.75	5.54	-3	9749	-0.1	JCI	4,923	-0.1
Malaysia	3.00	3.47	0	3.08	0.6	KLCI	1,688	0.9
Philippines	3.50	3.32	-20	41.2	-1.0	PCI	6,784	1.8
Singapore	Ccy policy	1.46	-10	1.240	0.0	FSSTI	3,308	-0.2
Thailand	2.75	3.50	5	29.3	-0.1	SET	1,528	-1.0
China	6.00	...	...	6.21	0.1	S'hai Comp	2,225	-3.3
Hong Kong	Ccy policy	1.11	-10	7.76	0.0	HSI	22,337	0.4
Taiwan	1.88	1.32	0	29.9	-0.1	TWSE	7,942	0.6
Korea	2.75	2.79	6	1124	-0.9	Kospi	1,959	-1.7
India	7.50	7.96	0	54.9	-1.3	Sensex	18,510	-1.0

Source: Bloomberg

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