

Capital Flows and Exchange Rate Volatility: Singapore's Experience

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Introduction

Singapore's macro-economic history sets it apart from the other countries discussed in this volume. A number of developing countries have lurched from crisis to crisis, plagued by a variety of economic ills such as unsustainable fiscal positions, current account deficits, lax monetary policies, rampant inflation, high unemployment rates, and weak corporate governance mechanisms. In contrast, Singapore's economic good fortune is one of budget and current account surpluses, a high savings rate, low inflation, good institutions, a sound financial system and last but not least a stable currency.

Closer examination reveals that a cornerstone of Singapore's policy on capital account openness is the non-internationalization of the Singapore dollar. Banks are required to follow a policy of non-internationalization in large part because the government is concerned about the build-up of offshore deposits of the Singapore dollar that could be used by speculators to destabilize the currency. The policy is applied to a broad range of financial instruments including bond issues and derivatives products.

The policy is in part also designed to help Singapore maintain the "soft peg" that has been crucial for its export-led strategy of development. Singapore's successful maintenance of its soft peg defies the conventional wisdom that soft-pegs are not viable (Eichengreen, 1999).

It is worth noting that following revisions in March 2002, only two core requirements of the policy on capital controls remain. First, financial institutions are not allowed to extend Singapore dollar credit facilities in excess of S\$ 5 million to non-

resident financial entities, if have reason to believe that the proceeds may be used for speculation against the Singapore dollar. Second, for a Singapore dollar loan to a non-resident financial entity exceeding S\$ 5 million, or for a Singapore dollar equity or bond issue by a non-resident entity, that is used to fund overseas activities, the Singapore dollar proceeds must be swapped or converted into foreign currency before use outside Singapore. According to the Monetary Authority of Singapore, the policy continues to be necessary to prevent offshore speculators from accessing the liquidity in Singapore's onshore foreign exchange swaps and money markets (MAS, 2002).

In these comments I will argue that the policy of non-internationalization has perhaps outlived its use and may in fact be a factor that hinders the development of an active bond market in Singapore.

Destabilizing Speculation versus Deteriorating Fundamentals

Basant Kapur argues that Singapore has adopted a policy of non-internationalization to ward off financial instability of the sort experienced by Hong Kong in 1998. Hong Kong and Singapore are often thought of as being very similar. Indeed, both are city-states with a British colonial heritage and both have been in the set of "Asian tigers" that achieved extremely rapid economic growth from the 1960s until very recently. Mr. Kapur contends that it was the "double play" by foreign speculators of simultaneously shorting the Hong Kong stock index futures as well as selling the Hong Kong dollar forward was the root cause of the crisis in 1998.

There has been a long-standing academic and policy debate about the factors that drive currency crises. In this context, the role of large players has been particularly

important. On the one hand, large traders and arbitrageurs may improve the efficiency of the price mechanism because they are well-suited to collecting and processing information. Alternatively, following crisis episodes, the machinations of large players have been blamed as catalysts of market panic and short-termism (Corsetti, Pesenti and Roubini, 2002). The literature provides many an example in which market efficiency is jeopardized by the behavior of large traders as destabilizing speculators (Krugman, 1997).

According to Mr. Kapur, Hong Kong in 1998 provides an important example of an economy that came close to the collapse of its currency board regime as a result of aggressive speculation against its foreign exchange and stock markets. In this example, only direct intervention by the authorities in the stock market prevented the collapse of the currency peg and a further meltdown of its stock market. However the effects of defending the peg, likely exacerbating the recessionary effects of the Asian crisis on the domestic economy, were quite costly (Corsetti, Pesenti and Roubini, 2002).

In fact, it is rather hard to prove that speculation by large traders alone caused a currency or stock market crisis episode. Crisis episodes generally take place against a backdrop of deteriorating macro-fundamentals, policy uncertainties and structural weaknesses (Corsetti, Pesenti and Roubini, 2002). In other words, was the “Double Play” in Hong Kong a rational response to deteriorating fundamentals?

Mr Kapur concedes that the empirical findings do not find evidence of market manipulation, per se. Indeed, Hong Kong experienced a sharp recession in 1998 with GDP growth in the first quarter was negative. Coupled with worsening macroeconomic conditions in East Asia, a falling Yen, and the threat of Chinese devaluation may have led

to a loss of confidence about Hong Kong stock market and the survival of the currency peg.

Shorting both the Hong Kong stock market and its currency at that time could therefore be interpreted as a rational strategy for all investors, domestic and foreign, highly leveraged or not (Corsetti, Pesenti and Roubini, 2002). In other words, the hypothesis of rational investors taking short positions in two markets (based on an assessment of economic fundamentals) and the hypothesis of a double play (suggesting market manipulation) are observationally equivalent. Mr. Kapur acknowledges this point. The rationale for the continued maintenance of the policy of non-internationalization in Singapore is therefore not apparent.

Developing a viable bond market

The second issue that Mr. Kapur focuses on is the concerted effort being made by Singapore to develop its bond market. Separate from the policy of non-internationalization, it is interesting to note the unique factors hindering the development of the bond market in Singapore. In many countries, the need for developing active bond markets stems from a public finance motive--namely, to finance government deficits. In contrast, Singapore has consistently run budget surpluses since the 1980s. Therefore, the government's borrowing needs have not spawned a domestic bond market. Many large companies in Singapore also do not require bond financing as they tend to be cash-rich.

Moreover, Singapore has a sophisticated bank lending network and equity capital market that provide viable financing alternatives in the absence of bond markets. Hence, the need to develop the debt markets in Singapore must be governed by other imperatives.

One imperative may be the desire on the part of the government to develop the island-state as a financial services hub for the region. In the longer term, Singapore may aspire to become a center for the issuing and trading regional currency bonds. Like Switzerland, Singapore has all the necessary ingredients to have an active corporate bond market--low borrowing costs, political stability, sound fundamentals, a stable currency, and a AAA sovereign rating.

Despite these attractive features, Singapore has been characterized by a historic underdevelopment of its bond market or suffers from original sin on the supply-side. It is important to note that the major part of international bond issuance take place in relatively few currencies. For example, international bonds and notes denominated in the US dollar, the Euro and the British Pound account for approximately 88% of the total amounts outstanding for these instruments (BIS Quarterly Review, March 2005). This may prove to be an obstacle for a small country like Singapore as it tries to develop as a regional hub for international bond issuance in its own currency.

Interestingly, despite the fact that the government has run budget surpluses since the 1980s and maintains huge reserves, the government has actively promoted the development of a government bond market. In fact, the government securities market remains the biggest segment of the debt markets in Singapore. In part, developing the government bond market may fulfill the important purpose of providing a benchmark yield curve as a reference for the term structure of corporate issues.

The second measure that Singapore has undertaken to develop its bond market has been the opening up of the Singapore dollar bond market to foreign issuers. Foreign issuers may be attracted to the Singapore market because of low borrowing costs and a

large pool of Singapore dollar funds. However, the policy of non-internationalization continues to apply to Singapore dollar bond issuances by foreigners. If Singapore dollar proceeds from the bond issuance are not used for economic activity in Singapore, they must be swapped into a foreign currency before being remitted abroad.

Note that a Singapore dollar loan combined with a currency swap results in a “synthetic” foreign currency loan. Also note that the swap market involving the Singapore dollar is illiquid and has wide bid-ask spreads. It is therefore not evident why foreign issuers would prefer to issue Singapore dollar bonds and incur heavy costs of swapping rather than directly issuing foreign currency bonds in the Eurodollar bond market. By imposing swapping costs on foreign issuers, Singapore may in fact deter potential foreign issuers from the Singapore dollar bond market.

However, there is another point worth noting in the context of the currency denomination of international bond issuance. It further highlights the idea that the policy of non-internationalization may have outlived its purpose. Corporate risk management strategies require companies to swap foreign currency denominated loans (here the Singapore dollar) into their domestic currency (say, the US dollar) so as to avoid a ‘currency mismatch’ between domestic assets and liabilities. The rationale for the government maintaining the non-internationalization ‘requirement’ is therefore unclear.

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