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Singapore Macro View

Highlights from the MAS Macroeconomic Review

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- **Uneventful (if uneven) 2014 growth of 2-4% —** Global growth prospects have brightened, anchored by a G3 recovery, counterbalancing a more cautious outlook for Asia. MAS's baseline scenario incorporates a mild pick-up in US capex which, given higher import intensity, should lift Singapore's exports. Services are another important domestic growth driver. Firms will continue to face margin squeeze from labour costs – while MAS likely accepts there has been some loss in firm and industry profitability in tradable sectors amidst restructuring, this is likely seen as a redistribution between sectors rather than a nationwide loss of competiveness.

- **Tight labour market keeps focus on core CPI, despite divergence vs headline —** Wage pressures have intensified and broadened. With Budget measures having muted the impact of tighter foreign worker policies thus far, we understand the peak impact on wage pressures has yet to be felt and MAS expects core inflation pressures to rise and broaden in 2H14, possibly creeping into inflation expectations. The fall in car prices and accommodation costs, which will contribute to greater volatility in headline inflation, probably played a larger role in the recent policy review, which explains the 0.5%pt cut in the official forecast. We suspect policymakers are not overly concerned about housing price declines for now, which reflects the cumulative impact of policy tightening and remains within expectations.

- **High hurdle for policy changes; slight hawkish bias despite headline disinflation —** With supply constraints keeping the output gap positive, we suspect the MAS sees the balance of risk as tilted towards inflation, with the risk that core inflation exceeds MAS's implicit tolerance levels (estimated at 2-2.5%). Despite headline disinflation, core remains more important for policy formulation, especially against the backdrop of a tight labour market. But in an (unlikely) tail risk scenario where a collapse in asset prices has knock-on effects on the rest of the economy, this would fundamentally change the baseline scenario and, by extension, the policy stance. As before, MAS eschews over-reacting to short-term uncertainties in the outlook, opting for a stable policy stance correctly calibrated to the medium term.

- **Intervention doesn't only take place at the edges of the band —** MAS lost US$1bn of spot FX reserves in Mar, confirming intervention to prevent excessive NEER weakness within the band. This tactical "steering of the NEER" allows MAS flexibility to manage the exchange rate between policy meetings. We see the "crawl" of the mid-point as consistent with the MAS's baseline scenario for GDP, with the band width allowing for some FX fluctuations to accommodate deviation from baseline. Excessive volatility within the band – especially if accompanied by a strong directional momentum not consistent with MAS's assessment of the fundamentals – will be met with intervention. As noted, tug-of-war between headline (dis)inflation and slight hawkish policy bias/FX intervention implies range trading in the NEER in the upper half of the band may be the preferred strategy for now.

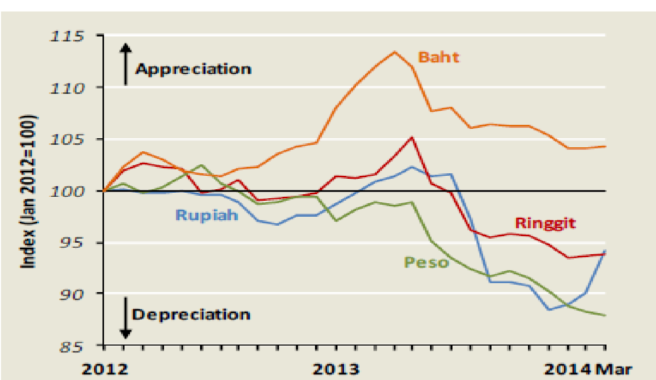
Highlights from the MAS Macroeconomic Review

Overall prospects for global growth have brightened, anchored by the G3. While strengthening trade in Asia offset a slight moderation in the G3 to lead a pick-up in global growth towards the end of 2013, global growth in 2014 will likely ride on a more assured upturn in the G3. US consumer demand and business spending will be supported by a strengthening labour market and higher capacity utilization even as larger firms in the Eurozone are enjoying lower costs on debt issuance on a recent decline in credit risk premia. Fiscal measures to offset the consumption tax hike should also buttress Japanese domestic demand.

Meanwhile prospects for Asia ex Japan have waded deeper into uncertainty. Political uncertainty is rearing its head, most notably in Thailand, even as India and Indonesia have entered their election cycles, while the risk of a China hard landing cannot be ruled out. Corporate debt accumulation across Asia has also increased exposure to higher funding costs as global monetary conditions normalize – should corporate profits falter on slower economic growth, debt servicing and repayment could come under pressure.

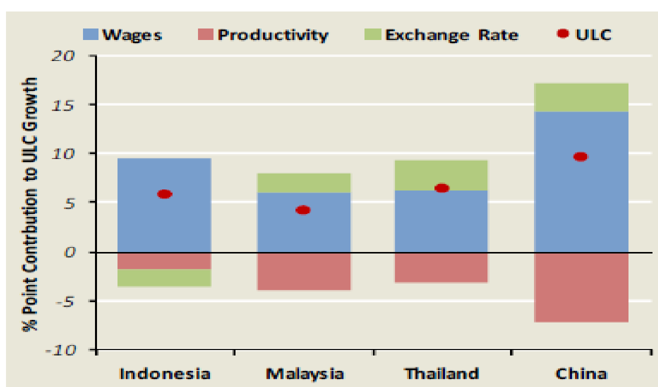
The ASEAN-4 however shine relatively brighter within Asia. REER depreciation and the G3 recovery should boost ASEAN-4 exports and facilitate rebalancing at a time of slowing domestic demand, though risks remain – Indonesia and Malaysia are vulnerable to growth disappointments in China, Thailand is drifting in political limbo, and prospects for post-election structural reforms in Indonesia will hinge on the emergence of a dominant party. Meanwhile as we had flagged in our ASEAN Economics Long View - Singapore Swing – Refocusing on ASEAN Regionalization, ASEAN-4 has becoming increasingly attractive for FDI relative to China with the former still enjoying demographic dividends even as labour costs climb in the latter amid Sino-Japanese political tensions.

Figure 1. Real Effective Exchange Rates in the ASEAN-4



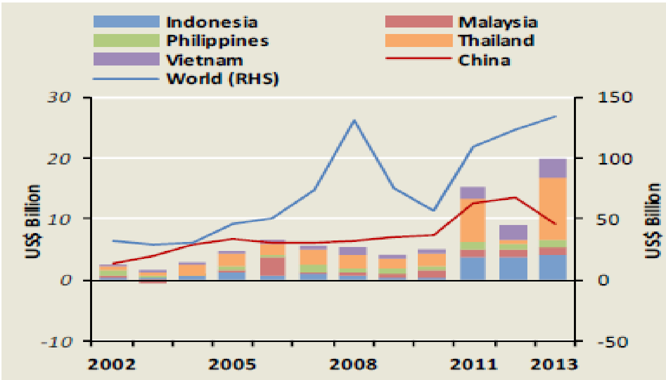
Source: MAS Macroeconomic Review Apr 2014

Figure 2. Breakdown of Unit Labour Cost in Selected Asian Economies, 2004–13



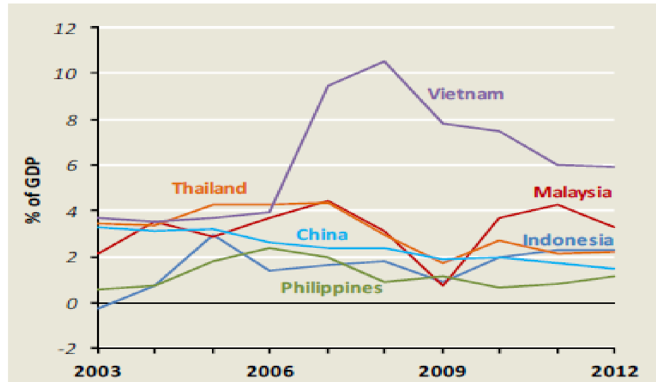
Note: Productivity growth has the opposite sign due to its dampening effect on ULC.
Source: MAS Macroeconomic Review Apr 2014

Figure 3. Japan's Outward FDI Flows



Source: MAS Macroeconomic Review Apr 2014

Figure 4. FDI Flows into Selected Asian Economies

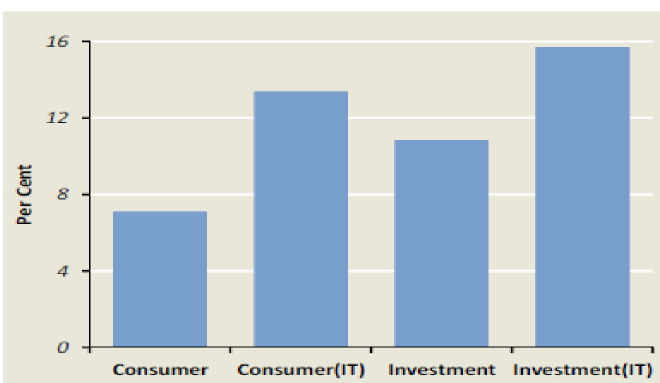


Source: MAS Macroeconomic Review Apr 2014

The overall projected upward trajectory of global growth is thus expected to generate uneventful growth 2-4% for the Singapore economy in 2014. After the strong sequential uptick in 1Q14, the almost flat growth in 1Q14 likely came as no surprise with the weather-related softness in the US posing a drag to the external-oriented sectors even as the domestic-oriented sectors remained firm – into Mar, we noted the IP data already hints at an upward revision to the 1Q GDP figure (see Singapore Macro Flash - Mar IP Implies 1Q GDP Upward Revision, But Tech Lacklustre).

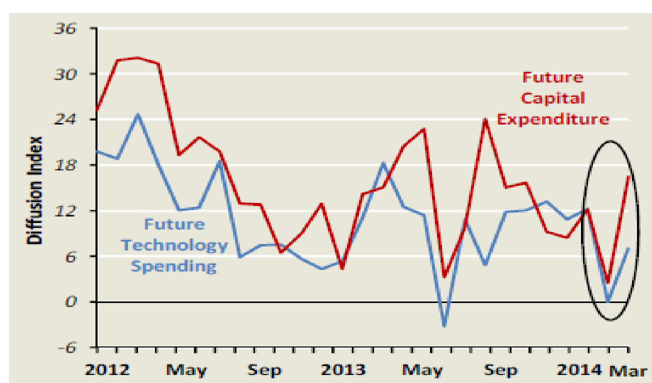
Improvements in US investment – which is relatively more import-intensive – after the earlier consumption-driven recovery should be of particular benefit to Singapore. There are signs of a firmer recovery in the US electronics capex cycle and forward-looking indicators are also pointing upwards, though any rebound in the global IT industry is not expected to match the magnitude of previous rebounds.

Figure 5. US Import Intensity by Product Type



Note: Import intensity is defined as the share of imports as a percentage of output.
Source: MAS Macroeconomic Review Apr 2014

Figure 6. US Technology Indicators

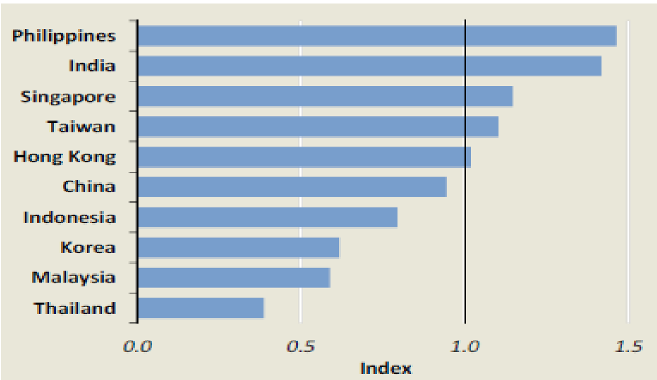


Source: MAS Macroeconomic Review Apr 2014

Notably IT-related manufacturers in Singapore have seen a shift towards "servicisation" in line with the global electronics industry. Services-related activities account for an increasing share of global revenues for the largest electronics firms in Singapore, playing into Singapore's relative strength in modern services. With manufacturers increasingly venturing out of strictly manufacturing, the primacy of the IP and NODX figures may be fading – more attention on re-

exports as well as indicators of services activities may be warranted for a better grasp on Singapore's growth dynamics, including its role as a regional services hub.

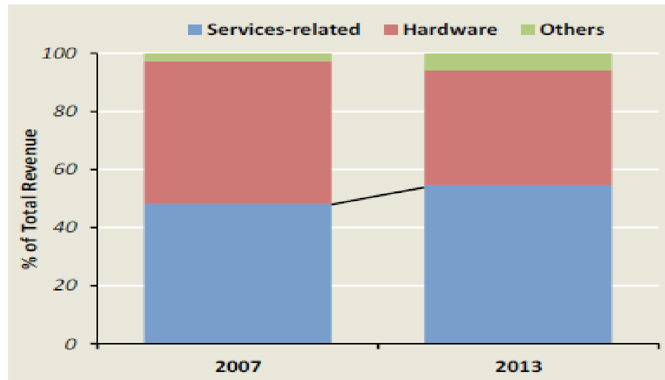
Figure 7. Revealed Comparative Advantage in Modern Services, 2011



Note: Modern services refers to Financial, Telecoms, Computer & Information and Other Business Services.

Source: MAS Macroeconomic Review Apr 2014

Figure 8. Decomposition of Global Revenues of Largest Singapore-based IT firms

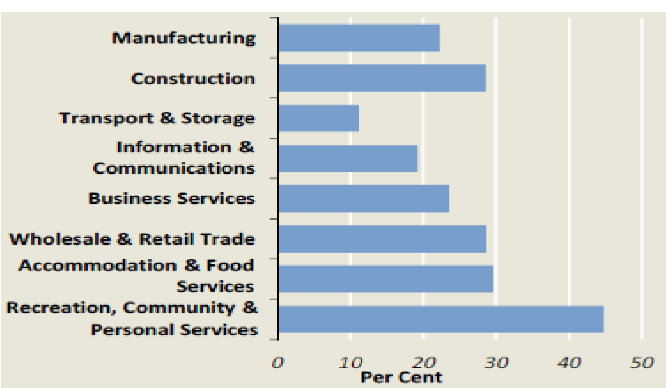


Note: The largest IT firms account for over 60% of domestic electronics output in 2012, according to DP Information Group Top 1000 Database.

Source: MAS Macroeconomic Review Apr 2014

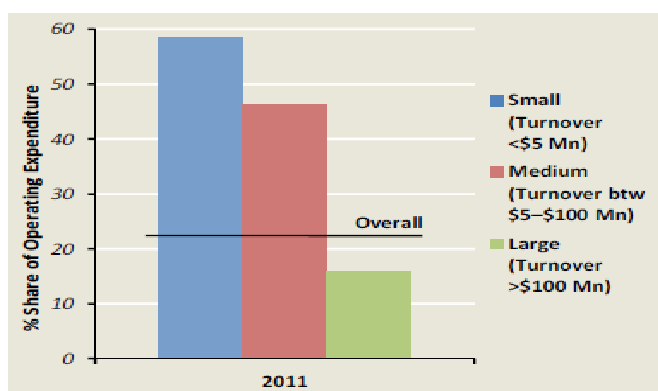
The G3 recovery should drive growth in Singapore's external-oriented sectors (though financial services could slow) even as domestic-oriented sectors remain resilient on infrastructure investments – nonetheless firms will likely still face margin pressures from higher labour costs, though the impact is likely uneven across sectors. Firms which are relatively more dependent on labour inputs will obviously be hit harder – these include consumer-facing services sectors, construction, as well as smaller manufacturing firms. While some firms can pass these cost pressures on to consumers, others may not – product prices have in fact been declining in some sectors, such as transport and storage, construction, and selected segments within manufacturing. Overall, we suspect the MAS sees some loss of firm profitability in the tradeables sectors as inevitable, though this need not necessarily imply a national decline in competitiveness, but a rather a redistribution in profitability across firms and sectors, i.e. creative destruction.

Figure 9. Share of Remuneration in Operating Expenditure, 2011



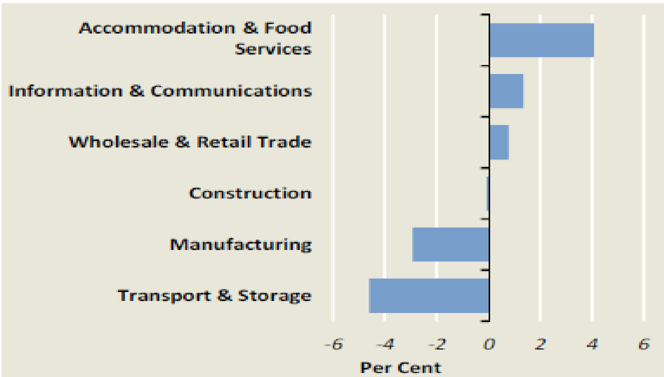
Source: MAS Macroeconomic Review Apr 2014

Figure 10. Manufacturing Sector Remuneration



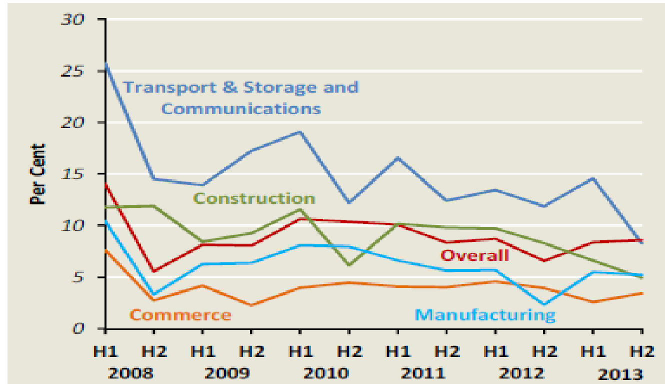
Source: MAS Macroeconomic Review Apr 2014

Figure 11. Average Change in Product Prices 2011–13



Source: MAS Macroeconomic Review Apr 2014

Figure 12. Median Profit Margin of Listed Companies in Singapore (by Sector)

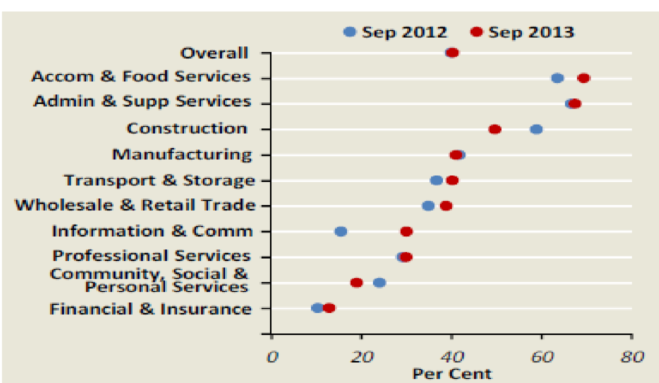


Note: Profit margin is defined as earnings before interest and taxes as a percentage of revenues.

Source: MAS Macroeconomic Review Apr 2014

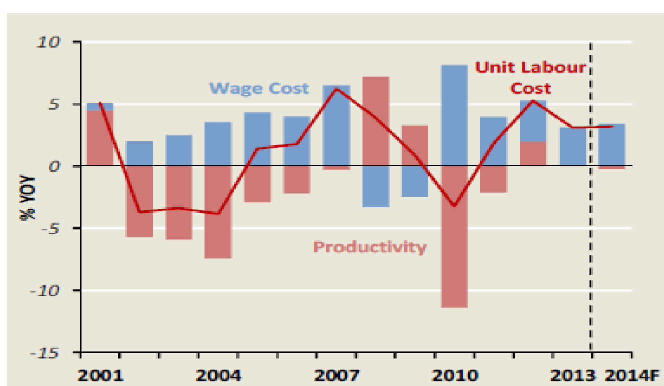
Still strong hiring intentions point to no let-up in wage pressures from the tight labour market. The breadth of wage pressures in fact mounted strongly into 4Q13 as a net weighted 27% of all sectors saw wage growth above their historical averages, above the 3.6% for the first three quarters of 2013. Even as resident labour force growth slows, firms will continue to find filling job vacancies a challenge. Budget measures such as the Wage Credit and PIC have muted the impact of tighter foreign worker policies thus far. But with qualifying monthly salaries for new Employment Pass applicants rising in Jan followed by higher foreign worker levies as well as the lapsing of the grace period of earlier DRC cuts in July – the peak in the inflation impact of foreign worker tightening may only be felt in in 2H14 . While demand factors have a roughly neutral effect on the output gap, mitigated as they were by REER appreciation, supply-side factors, i.e. the tight labour market, will likely keep the output gap positive despite some narrowing to likely below 1% this year.

Figure 13. Percentage of Vacancies Unfilled for At Least Six Months by Sector



Source: MAS Macroeconomic Review Apr 2014

Figure 14. Contribution to Changes in Unit Labour Cost



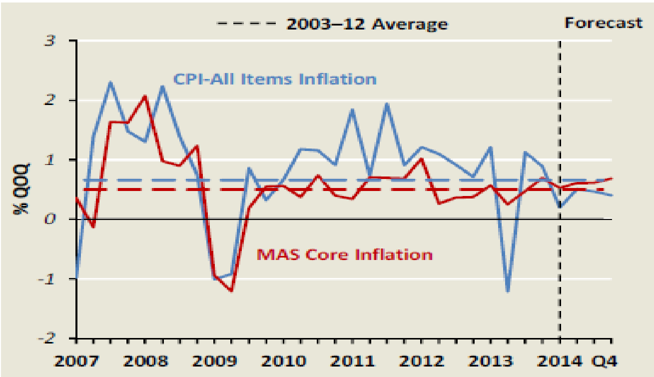
Note: Productivity growth has the opposite sign due to its dampening effect on ULC.

Source: MAS Macroeconomic Review Apr 2014

This should fuel core inflation of 2-3% in 2014 despite the recent cut in the official headline inflation forecast to 1.5-2.5% (prev: 2-3%) due to weaker imputed rentals. With unit labour costs likely to rise another 3% in 2014 as

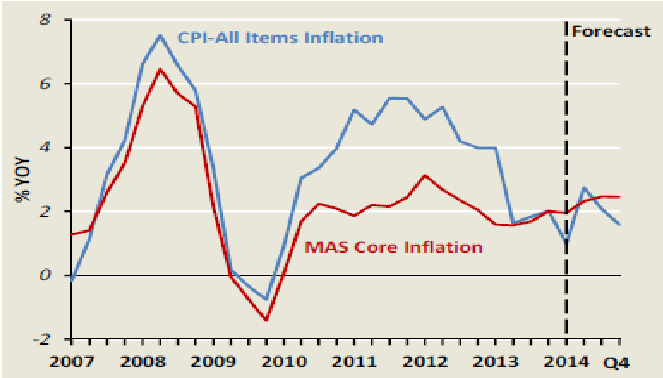
productivity growth provides only a modest offset, services fees are projected to hit 2.5% in 2014 – broadly similar to 2013 – and account for around two-fifths of headline inflation.

Figure 15. Sequential Q-O-Q CPI Inflation Forecasts



Source: MAS Macroeconomic Review Apr 2014

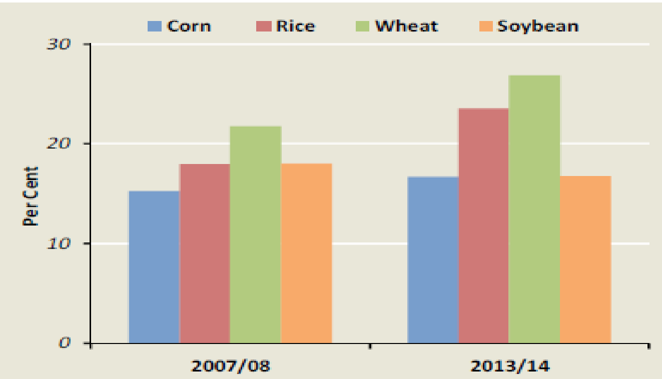
Figure 16. CPI-All Items Inflation and MAS Core Inflation Forecasts



Source: MAS Macroeconomic Review Apr 2014

Imported inflation is rising from a low base, but expected to contribute only modestly to headline inflation. Food items for example are expected to contribute about a third of inflation, with growing signs that the El Niño weather phenomenon may materialize in 2H14 and pressure food prices upwards amidst likely subsidy rationalization in Malaysia and Indonesia, though sufficient supply buffers could limit the impact. Oil prices however are projected to edge down slightly.

Figure 17. Stocks-to-use Ratios for Major Food Commodities in the Year Before the Onset of El Niño



Source: MAS Macroeconomic Review Apr 2014

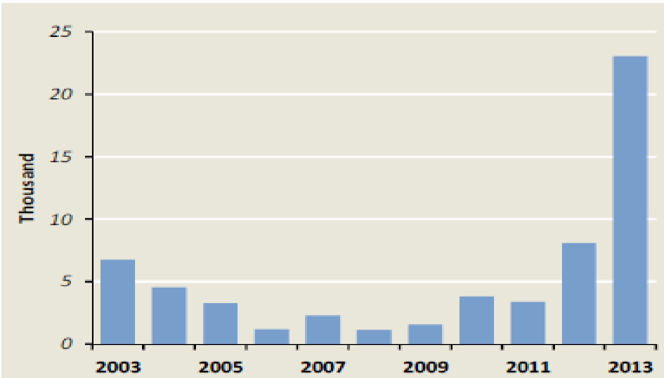
Figure 18. Ranking of Malaysia and Indonesia in Singapore's Food Import Sources, 2010–12

	Food Import Source Ranking (Import Share)	
	Malaysia	Indonesia
Live animals	1 (78%)	2 (12%)
Cereal products	1 (19%)	9 (2.1%)
Seafood	1 (14%)	2 (14%)
Vegetables	2 (19%)	4 (10%)
Beverages & spices	2 (16%)	1 (20%)
Dairy products	3 (16%)	12 (1.1%)

Source: MAS Macroeconomic Review Apr 2014

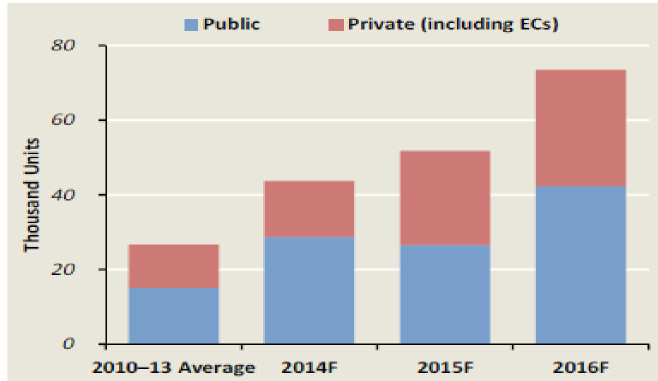
Meanwhile the inflation contribution of car prices and imputed rentals is expected to be negligible. While COE premium volatility is unlikely to subside in the near term as the market digests recent adjustments to the vehicle quota system, COE premiums could head slightly lower into 2H14 as higher COE de-registrations push COE quotas higher over 2014. Meanwhile housing rentals will suffer as foreign worker tightening constricts demand and more housing units come on-stream – the average 22,255 private residential units projected for completion in 2014 and 2015 are for example 76% higher than the average increases over the previous four years.

Figure 19. Number of Cars Aged 9–10 Years as of End of Period



Source: MAS Macroeconomic Review Apr 2014

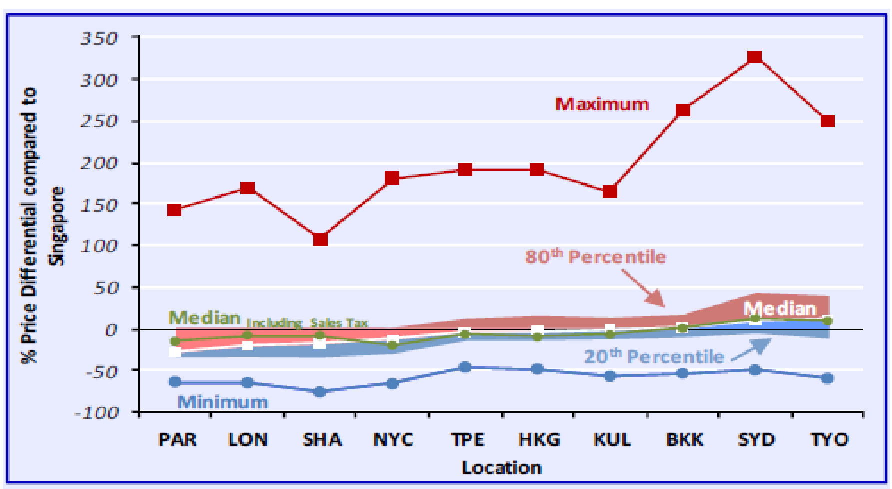
Figure 20. Expected Residential Dwellings Completion



Source: MAS Macroeconomic Review Apr 2014

Notably, the Macroeconomic Review contained a box item on consumer price differentials across geographical locations. The study concluded that while Singapore prices of the surveyed consumer goods are not the lowest, they are not the highest across the locations surveyed either – comparing Singapore to other cities, the median price differential is close to zero and the 20th-80th percentile lines are tightly bound between -14% and +17%. This paints a more balanced picture than the recent EIU survey showing Singapore to be the most expensive city in the world – as we had noted in our Singapore Macro View - MAS Preview: Standing Pat despite Disinflationary Undercurrents, such surveys measure price levels rather than inflation, but after nearly three years of high inflation, the public may be conflating the two. Moreover, these surveys measure costs faced by expatriates rather than locals, with more locally-consumed items such as bread or petrol not significantly more expensive than other global cities.

Figure 21. Distribution of Price Differentials in Each City Compared to Singapore



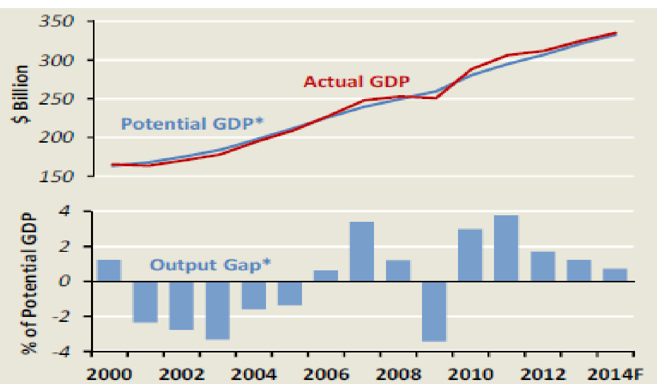
Source: MAS Macroeconomic Review Apr 2014

Overall, we did not sense any significant change in MAS's approach to monetary policy. We suspect MAS likely remains focused on the medium-term outlook rather than near-term risks, placing a greater weight on the "known" risks stemming from domestic cost pressures as opposed to "unknown" tail risks to growth – as before, there is likely room within the current policy stance to accommodate incremental deviations from the baseline scenario.

With supply constraints keeping the output gap positive, we suspect MAS sees the balance of risk as tilted towards inflation, with the risk that core inflation exceeds MAS's implicit tolerance levels (estimated at 2-2.5%). Despite headline disinflation, core remains more important for policy formulation, especially against the backdrop of a tight labour market. But in an (unlikely) tail risk scenario where a collapse in asset prices has knock on effects on the rest of the economy, this would fundamentally change the baseline scenario and by extension, the policy stance.

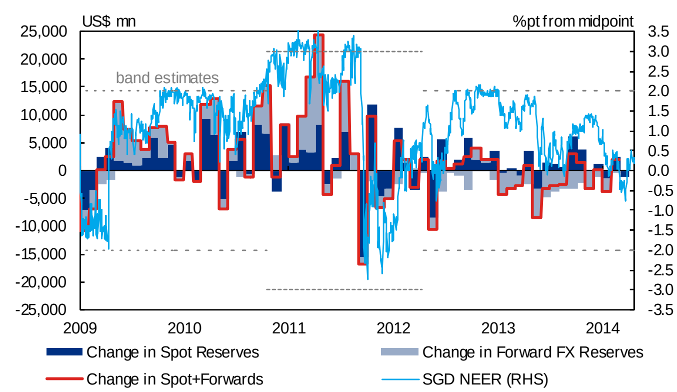
The hurdle to any changes in the monetary policy stance thus likely remains high though, within this, we still sense a slight hawkish bias. Rather than frequent adjustments to monetary policy, MAS likely prefers a stable policy stance correctly calibrated to the medium-term outlook which should result in a better inflation result. With respect to the odds of a tightening, we sense MAS is mindful not to overreact to inflation, as a somewhat higher level of inflation is to be expected as part of the unavoidable transition cost of economic restructuring, which may be entering an intermediate and advanced phase – tempering, not fully offsetting, inflation may be the aim here. Put another way, any excessive policy tightening that slows growth and incomes would ultimately hinder the goal of raising productivity and income levels. In particular, with cost pressures still the focus and a low probability of tail risks to growth materializing, the hurdle for a policy easing remains very high – given the risk of exceeding MAS inflation tolerance thresholds, there was little chance of an easing which would have fanned the turnaround in imported inflation.

Figure 22. Real GDP and the Output Gap



Source: MAS Macroeconomic Review Apr 2014

Figure 23. MAS lost US$1bn of spot FX reserves in Mar, confirming intervention to prevent excessive NEER weakness within the band



Source: Bloomberg, CEIC, Citi Research

MAS lost US$1bn of spot FX reserves in Mar, confirming intervention to prevent excessive NEER weakness within the band. This tactical "steering of the NEER" allows MAS flexibility to manage the exchange rate between policy meetings. We see the "crawl" of the mid-point as consistent with the MAS's baseline scenario for GDP, with the band width allowing for some FX fluctuations to accommodate deviation from this central scenario. Excessive volatility within the band – especially if accompanied by a strong directional momentum not consistent with MAS's assessment of the fundamentals – will likely be met with intervention. The tug-of-war between headline (dis)inflation and slight hawkish bias implies range trading in the NEER in the upper half of the band.

Appendix A-1

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