DEVELOPING THE FINANCIAL SERVICES INDUSTRY IN SINGAPORE

Abstract

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Along with manufacturing, the financial-business service sector drove Singapore's sustained, robust economic growth. The financial sector was first perceived as the necessary infrastructure to attract multinational corporations. Only in the 1980s was Singapore's potential as a financial center recognized. Development of the financial center followed an unconventional path shaped by particular economic circumstances, unique institutional arrangements, and macroeconomic policy objectives.

Since the early 1990s significant structural changes have taken place in Singapore's financial sector in such non-traditional activities as fund management, off-balance sheet corporate financing, derivatives trading, and foreign exchange hedging. The pace of change will quicken as Singapore pursues its goal of becoming the world's third financial center by the year 2000. Since late 1997 the Financial Sector Review Group has been charting the liberalization and deregulation of the financial system.

While other countries in East Asia suffer financial paralysis, Singapore's financial sector appears to have come through the currency turmoil relatively calm and stable. The immediate lesson that Singapore could learn from the financial turmoil is the need to be more transparent in disclosure standards and credit evaluations. Such transparency can only come about with greater financial sector competition and accountability through further liberalization, not tighter regulations or protection.

Capital accumulation and the financial system. Singapore financed its rapid GDP growth with significant foreign savings, mostly in the form of direct foreign investment. The financial system kept pace with the growth of the economy. Bank assets grew rapidly in the 1970s and slowed in the 1980s and 1990s along with the real sector. Deposits of non-bank customers slowed in the early 1990s as increasingly sophisticated households invested in real estate and financial assets. Commercial bank portfolios diversified into in securities and equities in the 1980s. The number of banks increased over four-fold from 1970 to 1994, with the largest increase in offshore banks. The existence of many offshore banks and foreign banks created the human and physical facilities required to undertake international banking business in Singapore.

Through Asian Currency Units (ACUs), which manage foreign currency-denominated funds of residents and non-residents, Singapore developed an active foreign exchange market. Most transactions in the Asian dollar market are among banks from other world financial centers. Singapore's separation of domestic and offshore financial markets contrasts with the approach of Thailand where the Bangkok International Banking Facility (BIBF) was seen as the means both to develop an international financial center and to ease the entry of foreign institutions into the domestic market.

Singapore encouraged the development of the securities market, supporting the unit trust industry through tax incentives for example. The Stock Exchange of Singapore (SES) uses a floorless, computerized trading system with scripless settlement; it supports round-the-clock trading and the common listing of Eurodollar and Asian dollar bonds. The Singapore International Monetary Exchange (SIMEX) operates a mutual offset system with the Chicago Mercantile Exchange through a computer linkup. The fund management industry has also been encouraged through tax incentives and regulations on placement of compulsory savings accounts.

Financial regulation and the role of the central bank. The Monetary Authority of Singapore (MAS) is, in effect, the central bank. It formulates and implements monetary policy and regulates financial institutions. The regulatory framework provides explicit walls between financial companies, commercial banks, and merchant banks through restrictions on the kinds of activities each can undertake. Operations of banks' ACUs are strictly demarcated from their domestic operations. Equity investments are segregated from banking operations. The SES is self-governing and permits financial institutions to fully own member companies; banks can therefore engage in stock brokering.

Regulation of capital flows has focused on the supervision of the financial institutions involved since 1978 when direct controls were lifted. The separate accounts maintained by banks' ACUs allow MAS to monitor the use of funds, especially the extent of lending to domestic operations. MAS's authority to approve credit uses has been a key to maintaining the offshore character of the Asian dollar market.

Strict supervision of financial institutions has obviated the need for detailed public financial disclosure. Through the imposition of regulations and provision of tax incentives MAS has access to an enormous amount of information regarding bank and financial institution operations. The professionalism cum conservatism of MAS staff plus its wide discretion within the regulatory framework constitute the basis for the soundness of the financial system.

Economic circumstances and macroeconomic policy. Three economic circumstances shape Singapore's macro-economic policy–it is a small, open economy engaged in international trade; it has highly open capital markets; and it is fiscally prudent. In a small open economy, the exchange rate is the nominal anchor for monetary policy and a strong exchange rate policy helps to negate imported inflation. Free convertibility of deposits between local and foreign currencies and swift capital mobility to exploit rate differentials mean that domestic interest rates are largely determined by rates abroad and by expectations on the future strength of the Singapore dollar. Consistent budget surpluses and compulsory savings contributions to the Central Provident Fund (CPF) create incipient currency appreciation and liquidity drains from the banking system.

Exchange rate policy objectives and monetary policy conduct. The objectives of exchange rate policy are to contain imported inflation, keep domestic price increases low, and ensure sufficient liquidity for sustained real economic growth. Another task is to regulate the economy when it overheats. Monetary policy in Singapore typically does not utilize such conventional instruments as open market operations through treasury bills, reserve requirements, or the discount window. Instead, MAS conducts foreign exchange, currency swaps, and direct money market deposits or withdrawals to regulate liquidity in the banking system and carry out the policy objectives. With Singapore's relatively flexible wage system and price determination process, there is limited scope for monetary policy and exchange rate policy may be able to exploit the trade-off between inflation and competitiveness only in the short-term.

Internationalization of the currency. The long-standing policy of non-internationalization of the currency was breached with a 1996 policy allowing Singapore-dollar listing of foreign companies on the SES. The change raised the issue of whether to pursue internationalization to encourage development of the external economy. The rapid growth of the Asian dollar market shows that intra-regional trade and investment funding can flourish without Singapore giving up control over its exchange rate. Policy simulations indicate that given the current size of the money supply, internationalizing the Singapore dollar would make it vulnerable to speculation and destabilize the economy. But, allowing Singapore-dollar listing of foreign companies is not tantamount to full internationalization; the criteria for the qualifying foreign stocks provide ample safeguards to limit the internationalization. Furthermore, greater participation of foreign companies in the SES and promotion of fund management will boost the economy, meaning a net gain.

Liberalization of the financial sector. The Financial Sector Review Group (FSRG) is designing a liberalization of the financial sector. The private sector is being given greater leeway in order to promote financial innovation and MAS's role is shifting from regulation to supervision. FSRG will propose a conceptual framework for more "international, competitive and robust" domestic capital markets; recommend a framework, regulations, and administrative guidelines for corporate debt markets in order to expand corporate fund-raising activity; and recommend changes in disclosure practices. Within the financial system, further liberalization will likely involve reducing segmentation, both among financial activities and between the financial and other sectors, and increasing internationalization of the industry.

Maintaining macroeconomic stability and ensuring the soundness of the financial system will become more difficult as the removal of controls reduces the amount of information available to monitor risk-taking. Reporting requirements may be maintained through moral suasion.

Financial liberalization in a regional context. Asia's ongoing currency crisis may influence the further liberalization of Singapore's financial sector. The extent of losses sustained by Singapore's financial institutions resulting from the depreciation of regional currencies is not yet known, but its banks are adequately capitalized and their solvency is not an issue. Nevertheless, these losses together with the imperatives of international competition raise the strong possibility of mergers for Singapore's banks.

With interest in short-term lending to Asia low, now might be an opportune time to relax restrictions on these flows. Financial reforms in Japan will probably not generate much flow of new resources into Southeast Asian financial markets. Because of the limited potential of inflows in the next year or so, relaxing the restriction on short term flows would have a muted destabilizing effect on currency appreciation and it could offset the current depreciation pressure. However, it is critical for Singapore to retain strong supervisory oversight along with liberalization in order to ensure that the resulting inflows are put to productive use.