SPEECH BY MR THARMAN SHANMUGARATNAM, MINISTER FOR FINANCE, AT THE ASSOCIATION OF THE BANKS IN SINGAPORE ANNUAL GENERAL MEETING, AT 8.30PM ON FRIDAY, 27 JUNE 2008, SHANGRILA HOTEL, SINGAPORE

Mr David Connor, Chairman, ABS
Council Members of ABS
Ladies and gentlemen

1. I am glad to be here tonight. The Association of Banks' Annual Dinner is always a good opportunity for Singapore's financial services community to catch up, explore issues that concern all of us, and look ahead. This year, it comes at a time of considerable challenge in the global economy, with inflation on the rise around the world while growth slows.

2. As a matter of pure coincidence, the ABS was formed at the onset of the first oil crisis 35 years ago. The years that followed were marked by high inflation and a global recession. It defined the 70s as a period of global stagflation. Can we now avoid a new period of stagflation?

Avoiding Stagflation

3. Until recently, the last two decades had been exceptionally positive for the world economy. Since the early 90s, growth had been strong while inflation had come down and stayed low over a long period. Volatility in both growth and inflation had also declined, especially in the developed countries. It led observers to call this period of exceptional macroeconomic stability "The Great Moderation".

4. There were several reasons for this, including improvements in the effectiveness of monetary policy in avoiding economic overheating and keeping prices stable. But a major reason also was the entry of China and other low-cost producers into world markets. These large new entrants helped to keep costs and prices down, even as the world economy grew rapidly.

5. However, the long period of macroeconomic stability also led to heightened risk taking behaviour. Leverage reached unprecedented levels in global finance. Credit spreads on risky assets fell to exceptionally low levels. Financial engineering and the search for higher yields led to an explosion of credit derivatives, CDOs and other complex financial instruments. High yielding securities backed by subprime mortgages in the US found their way to the books to financial institutions in other parts of the world, especially in Europe.

6. As we all know, the credit bubble has burst, precipitated by a sharp decline in the US housing market. Risk aversion has come back in a big way, and deleveraging is occuring across the financial system. Problems in the US subprime market have spread to other segments of the credit market.

7. Fears of implosion in the global financial system have receded following the US Fed's intervention in Bear Sterns. But vulnerabilities remain. With US consumer confidence and the housing market continuing to decline, no serious observer believes that the major financial institutions are out of the woods yet.

8. Together with the credit crunch, we are seeing a rise in inflationary pressures, all over the world. The causes are still being debated, but the fundamental reasons are clear enough.

9. First, the demand and supply of commodities have diverged. Prices of food and fuel have increased because of growing demand, especially from the rapidly-growing emerging economies, while global supply of these commodities has been stagnant or inelastic. These underlying trends have been accentuated by more recent developments. In the oil market, supply disruptions contributed to a large decline in stocks since the middle of last year and hence sharply higher prices. Food prices have been inflated by the diversion of food supplies into production of bio-fuels. There are also questions over whether speculation and the shift of financial investments into commodity futures have led to higher commodity prices, but the evidence for this remains tentative to date.

10. The second fundamental has to do with monetary policy. It is now recognised that monetary policy globally has been too loose in recent years. Combined with increased leverage in financial markets, it has led a build up of excess liquidity and inflationary pressures. This showed up first in the asset markets, several of which in both developed and emerging economies experienced bubbles which have since been burst. But lax monetary conditions have also boosted aggregate demand, now showing up in commodity prices.

11. We have therefore entered a new phase in the globalised world economy, with heightened risks to growth co-existing with increased inflationary pressures. The dividends to the world economy arising from the entry of large new producing regions, in the form of low global inflation despite rapid growth, have run their course. Productivity gains globally are also slowing down, while resource utilization rates are at a high level. The Great Moderation is over.

12. Policy-makers everywhere face a growing trade-off between inflation and growth. Managing this trade-off will be the key challenge for economic policy.

13. However, stagflation is not a foregone conclusion. How policies respond will determine if we enter a period of stagflation, with inflation rising or persisting at high levels while growth weakens.

14. In the US and Europe, both the Fed and ECB have recently signalled that risks of higher inflation are now dominant, even as their economies face a slowdown in growth. They aim to prevent inflationary expectations from becoming entrenched. It is not too early to do so. In the US, the latest University of Michigan survey of consumers indicated a pick-up in expectations of future inflation to its highest levels since 1982. However, some observers also expect the softening of the employment market to reduce the likelihood of a wage-price spiral, which is what happened in the 70s.

Managing the Growth-Inflation Trade-off in Asia

15. The Asian economies now face the same challenge of managing the trade-off between growth and inflation. They are still growing well. Although they will feel the effects of the US housing contraction and consumer spending slowdown, China is still expected to grow at 9-10% this year; India at 7-8%, and the ASEAN economies at 5-6%. It is too early to say if the Asian economies have 'decoupled' from the US. A severe US recession, especially in the manufacturing and technology sectors as happened in 2001, will likely have much greater impact on Asia.

16. Further, 'decoupling' has certainly not taken place in global inflation. Developing Asia in fact faces the same inflationary pressures as the US or Europe,

plus more. Asian countries have been harder hit by the rise in prices of food, which takes up a much larger share of household expenditures (30% or more, which is roughly double what it is in the US and Europe), as well as by the oil price increase. CPI inflation in developing Asia is now running at around 8% on average, although the figures probably understate inflationary pressures in economies with price controls on various commodities. Some Asian economies are seeing much higher inflation rates.

17. The key challenge in the Asian economies is to prevent a second round of inflation following the current increase in inflation due to fuel and food prices. Addressing this challenge will require clear resolve in monetary policy to control second-round inflation, and accept a trade-off in aggregate demand and growth. It also calls for creative use of fiscal policy to help segments of the population which are most hurt by rising inflation.

18. To put the matter pointedly, a rapidly growing Asia cannot continue to import US monetary policy if it is to check inflationary pressures. The US Fed's drastic loosening of monetary policy since the onset of the sub-prime crisis, justified by the risk of financial market collapse, has been largely accommodated by Asia. With limited flexibility of Asian exchange rates, the US Fed's easing has to varying degrees translated into lax monetary conditions in Asia at a time of rising inflation and still healthy economic growth.

19. It has to be said that there was some reason for caution in Asia in tightening monetary policy too rapidly over the last year, given the considerable uncertainties that prevailed in global markets and the very real risk that the world economy would go into a tailspin. Going forward too, there is reason why many Asian economies want to avoid dramatic action to raise interest rates or engineer a sharp appreciation of their currencies. Many lack liquid derivative markets in which businesses and banks can hedge risks, or modern systems of risk management. Sudden, large moves in monetary policy pose real risks of financial instability, and if subsequently reversed, will lead to a loss of credibility for central banks.

20. Most Asian countries have begun tightening monetary policies, with greater boldness in some instances like in India, where inflation has also risen rapidly. Overall, however, there is at this stage a need for greater recognition that inflation poses a more potent economic risk than a slowdown in growth, and a clearer resolve towards tightening monetary policy, either through interest rates of exchange rates .

21. The lessons of the 70s are relevant. We know the US Fed made the error then of allowing inflationary expectations and a spiral of wages and prices to set in, before it finally recognized the severity of the problem and tightened policy. It took Paul Volcker to raise interest rates to double digit levels and bring about a deep recession before the Fed succeeded in reversing the psychology of inflation. The lesson central banks have learnt is that monetary policy has to be tightened well before inflationary expectations develop, and bearing in mind that the full impact of monetary policy on inflation has a significant lag. When monetary policy falls behind the curve, it means having to make more painful choices further down the road.

Letting Oil Prices Pass Through

22. The second challenge around the region is in cutting back on fiscal subsidies, especially on consumption of fuel. Several countries are already reducing

subsidies, taking the political costs of doing so. But removing subsidies is the right approach not only because it to avoids increasing the strain on fiscal resources, but because it allows consumers and businesses to adjust to the new reality of high oil prices. There is paradoxically a cost in higher inflation immediately. But there is also benefit in reduced expectations of future inflation - because everyone knows that the fiscal subsidies that cap local prices are not sustainable when global prices have moved up for the long term.

Singapore's Monetary and Fiscal Policy Response

23. Singapore's challenges mirror those faced elsewhere in Asia, but are in some ways more pronounced. We are a price taker in the true sense, given our small size and the openness of our economy and financial markets. We cannot insulate ourselves from global prices of food or fuel, or anything else.

24. Our inflation rate this year is now expected to average 5-6%, with a higher rate in the first half of the year being balanced by a slowing of inflation towards the end of the year. However, the strong run-up in global oil prices means that there is more risk of inflation on the upside.

25. MAS's consistent policy objective has been to moderate inflation over the medium term. It began tightening monetary policy, which in Singapore's case is implemented through exchange rate policy, well before the recent increase in global inflation. Since April 2004, the Singapore dollar has appreciated by 12% against its trade-weighted basket of currencies (S$NEER) - or by 23% against the US dollar. The MAS' policy of gradual S$ appreciation, carefully calibrated, is succeeding in mitigating inflationary pressures. For eg, it has helped achieve lower food price inflation than amongst our principal trading partners.

26. This steady approach to exchange rate policy, focussed on the medium term and with shifts in policy taken in time and not left till problems become severe, has given MAS credibility. It also means that the responsibility rests on fiscal policy to respond to short term problems, where feasible to do so on the budget. This is in fact the approach we have taken this year.

27. The various measures taken in the Budget over the last two years - last year to offset the effects of the GST increase and this year to share surpluses with the population - will provide significant help to the segments of the population who are most adversely affected by inflation. Low-income households will receive benefits this year that exceed the increases they face in their cost of living. Most middle-income families too will get benefits that at least meet the increased costs of the household budget.

28. Our ability to use fiscal policy to help people adjust to immediate changes in the inflation environment, however, depends on the state of the budget. We will not be able to provide offsets for the population each time inflation picks up.

29. But it also underlines the importance of prudence and disclipline in fiscal policy, maintained consistently through the years. It is only through prudent fiscal policies that we afford a buffer that enables us to respond to short term difficulties in the way we have done this year, and that we allow monetary policy to stay focused on the medium term.