

Why Singapore is

... and why – despite its healthier condition – the Republic s

By LINDA LIM and JAMES CHENG

ON Jan 13, independent economic analyst and "anti-bubble activist" Jesse Colombo posted a lengthy commentary on *www.Forbes.com* titled "Why Singapore's economy is heading for an Iceland-style meltdown". To date, this has garnered more than 770,000 page-views, including from Singapore-based investors.

Mr Colombo argues that ultra-low interest rates have fuelled a "dangerous credit bubble" in the housing sector, where "Singapore's ratio of household debt to gross domestic product recently hit approximately 75 per cent ... up from 55 per cent in 2010 ... household debt has risen by 41 per cent since 2010, while household income has increased by only 25 per cent and wages by a paltry 15 per cent". Because "Singaporeans are going into debt to invest in property or buy more expensive houses than they can afford ... Singapore's property prices have approximately doubled since 2004, and are up by 60 per cent since 2009".

Risks arise because "70 per cent ... of Singapore's mortgages have floating interest rates". Singapore's recent GDP growth, disproportionately driven by construction and financial services, is unsustainable and "Singapore's bubble will most likely pop when the bubbles in China and emerging markets pop and as global and local interest rates continue to rise".

MAS's response

The Monetary Authority of Singapore (MAS) responded with a statement that noted:

First, "decisive steps have been taken to cool property demand and prevent excessive leverage", and "the property market is now stabilising and new housing loans have also been declining" (falling by 35 per cent year-on-year in Q3 2013).

Second, "household balance sheets are on the whole strong and property asset values are significantly higher than the debts incurred", with an average housing loan-to-value ratio of "a healthy 47 per cent".

Third, a recent International Monetary Fund (IMF) assessment concluded that Singapore's financial system would remain sound even with a sharp increase in interest rates and steep decline in property prices.

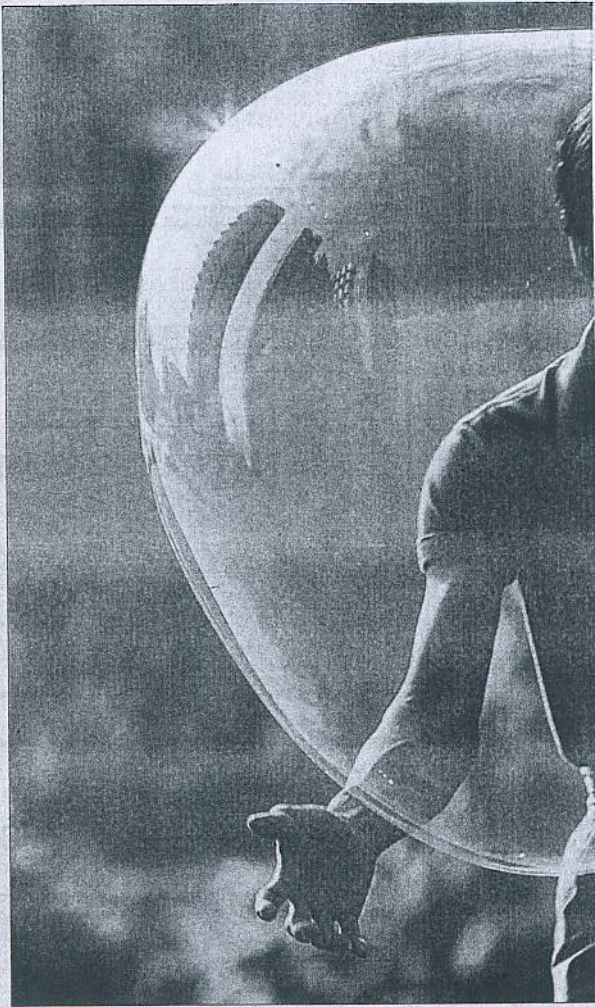
What happened globally?

Mr Colombo's overall thesis of a massive emerging market asset bubble fuelled by the US Federal Reserve and China's monetary stimulus following the 2008 global financial crisis is not new or original.

Economists understand that in a world of free capital flows, low interest rates in one country cause capital to move to other countries with higher interest rates, "chasing higher returns". The capital influx pushes up the currency of the recipient country, and lowers its real (after inflation) interest rate (because of the increase in money supply). This can fuel a domestic asset bubble (high, rapidly rising asset prices) especially in smaller economies where the flood of money has "not many places to go" and often ends up in real estate.

This happened in emerging markets like Brazil, Turkey and India, as well as Indonesia, the Philippines and Thailand, and in developed economies like Canada, Australia and New Zealand, all of whose floating currencies predictably soared.

A stronger currency helps to mitigate the inflation problem by lowering the cost of imports, but it also attracts even more capital inflow seeking to benefit from currency apprecia-



Beware the bubble bursting: Embracing a more neutral market-driven stance on appreciation expectations even when interest rates are low, and announc

tion even with low interest rates. This is the well-known "trilemma of international finance": a country cannot simultaneously have currency stability, capital mobility and monetary policy autonomy (independence in setting interest rates according to the condition of the domestic macro-economy).

What happened in Singapore?

In Singapore, MAS did the right thing in not raising interest rates (to cool off local inflation and deflate an incipient property bubble) because this would simply have attracted even more "hot money" inflows, further fuelling asset bubbles. It allowed the currency to rise, which helped to combat imported inflation, though this hurt export-oriented manufacturing and services like tourism and education.

But unlike emerging markets which limited capital inflows through (IMF-approved) taxes and other restrictions, Singapore could not do that as its very lifeblood is free capital flows, especially in and out of the financial services sector.

Instead, MAS has imposed domestic regulatory constraints such as loan restrictions on the banking, housing and automotive sectors. These are already having an impact, as seen in the Q3 2013 decline of car and private residential housing sales and prices, which should continue.

What happens now?

But the MAS measures' success also depends on what happens in source countries of the capital inflows. The Fed's 2013 announcement that it

would soon begin "tapering" its bond-buying or quantitative easing (QE) programme led capital to flow out of emerging markets, causing currency depreciation and interest rate increases in India, Indonesia, Brazil, Australia and other countries. This is a good thing, as it helps to deflate bubbles. But asset deflation also slows down economies through a "negative wealth effect" – as people's assets decrease in value, they feel poorer (or become bankrupt), so spend less.

The Fed is likely to taper very slowly, especially with Janet Yellen at the helm, so Singapore has time to let its asset bubbles deflate gradually, rather than crash suddenly. Interest rates should rise slowly, and the currency will depreciate gradually as the USD strengthens.

Singapore's "managed float" currency system and huge foreign exchange reserves (which can be used to purchase SGD to prop it up if necessary) protect it here: the SGD is not likely to drop by 15-20 per cent versus the USD in 2-3 months like the freely-floating AUD has. Singapore's financial sector is also pretty sound, given high domestic savings and deposit rates and generally conservative banking practices.

How did Colombo get it wrong?

Mr Colombo is correct on the market mechanism that leads to credit bubbles, but lacks knowledge of Singapore's policy and institutional environment. His statement that Singapore has a "25.38 average house

not Iceland . . .

till needs to be vigilant to keep its economy sound



ce on the SGD would discourage bubble-fuelling hot money inflows based on lower long-run GDP growth targets would 'reset expectations'. PHOTO: REUTERS

price-to-income ratio" probably results from dividing private housing price by average national income. But the private housing market involves only the top 15-20 per cent of income earners, while the majority 80-85 per cent of homeowners have access to much cheaper HDB housing (though this is still expensive by world standards as a multiple of average incomes).

The numbers Mr Colombo himself refers to suggest that the problem is nowhere as severe as he suggests: he says that "almost half" of banks' credit portfolios are in "property-related loans", with "residential mortgages accounting for nearly a third of their overall loan portfolios", and MAS estimates that around 10 per cent of borrowers "may have overextended themselves to buy property". So, 10 per cent of 30 per cent of banks' loan portfolios, or 3 per cent, are potentially at risk.

But not all of those "at risk" are going to default (especially if they are foreigners who bought the property with USD and can repay their loans with fewer USD as the SGD depreciates). MAS also has the means to contain the problem, including (if necessary) persuading banks to roll over loans, and providing partial bailouts of borrowers or lenders.

Singapore's government debt is also not the problem that Mr Colombo says it is, given the decades-long practice of running huge annual budget surpluses and accumulating massive reserves (both of which may be criticised for other reasons, but do provide large buffers against any sudden

credit implosion or capital flight).

So there's nothing to worry about?

Not quite. MAS's "average" housing loan-to-value (LTV) ratio of 47 per cent ignores the distribution of LTV. It is likely (given the booming property market of recent years) that a significant minority of mortgage-holders could have much higher LTVs, balanced by those (particularly wealthier, older mortgage holders) whose LTV is very low. Household balance sheets are also relatively illiquid, with 60 per cent of net worth derived from real estate and 17 per cent locked up in the Central Provident Fund (CPF).

How vulnerable a minority of households is to default depends on the (unpredictable) speed and size of interest rate increase and property value decline, which in turn negatively impact banks' loan portfolios. As the US subprime mortgage crisis showed, even a small minority of non-performing loans may be sufficient to trigger a broader financial crisis. Added to this, Singapore's economy now depends more heavily on the financial sector, which itself is now more open than during the Asian financial crisis of 1997.

What about China's influence?

Mr Colombo mentions China's reining-in of its credit bubble as another major risk for Singapore. The Chinese government is certainly serious about this, raising interest rates, restricting credit and allowing the yuan (CNY) to strengthen. But this process

will be gradual. The government has already "eased on tightening" when nervous about the political consequences, while local authorities, the shadow banking system and state-owned banks have been very creative in combating the credit crunch.

This may not bode well for China's efforts to quickly rebalance its economy, but it helps slow down the retreat of Chinese hot money flows, much of which is already outside China. China's economic slowdown will reduce Chinese tourism, including casino tourism, into Singapore, but this will be partially countered by the increased purchasing power of a stronger CNY and a weaker SGD. Of greater concern would be a "hard landing" in China adversely impacting our commodity-exporting neighbours, especially Indonesia.

What should be done in Singapore?

The Singapore authorities might emulate China's policies to achieve a "soft landing". Embracing a more neutral market-driven stance on the currency would discourage bubble-fuelling hot money inflows based on appreciation expectations even when interest rates are low. Announcing lower long-run GDP growth targets would "reset expectations" and discourage future speculative bubbles, as would reducing over-reliance (including by GLCs) on construction, real estate and leverage finance (property loans) for GDP growth.

Besides reducing risk and volatility of the economy as a whole, such moves would also contribute to Singapore's cost-competitiveness (by limiting asset and goods-and-services price inflation), housing affordability (including the aspirations of some citizens for private housing), and productivity goals (by diverting capital from rent-seeking to value-creating enterprises). If housing expenses claim a smaller share of the family budget, more could be spent on other goods and services, encouraging entrepreneurship and perhaps even that elusive second child.

The bottom line

Singapore's financial sector and economy are not at risk of an "Iceland-style meltdown", as Jesse Colombo claims. Still, the market mechanisms on which his analysis is based are standard features of global capital markets, and fragilities and excesses do exist in our financial system. Consumers and investors can keep our money and its purchasing power safe by understanding and acting on a few simple principles: low interest rates (and high and rising property prices) do not last forever; excessive leverage (indebtedness for speculative purposes), like gambling, puts one at risk of losing everything; the government cannot protect and rescue us from all our behavioural excesses (that is, market risks exist in Singapore investments just as they do in other places - to expect otherwise is to court "moral hazard"); and the most secure way to make more money is to increase productivity from which sustainable higher incomes and real wealth flow. As a mature, developed economy that is now one of the world's richest as well as most open, we can no longer rely on future rapid GDP growth for recovery from a potential financial crisis.

Linda Lim, a Singaporean economist, is professor of strategy at the Stephen M School of Business at the University of Michigan; and James Cheng, a Singaporean MBA graduate from the same university, served as lead portfolio manager/CEO of Morgan Stanley Investment Management Singapore from 2006-12 and as