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SINGAPORE: CYCLICAL UPTICK BUT STRUCTURAL CHALLENGES REMAIN

Singapore has received some much-needed good economic news of late, with economic growth and exports surprising to the upside. However, the external environment could grow more challenging if protectionism and populism do take root in key markets. Two major policy initiatives by the government have been released recently – the report of the Committee for the Future Economy (CFE) and the budget statement. We provide our take on the economic prospects and whether the policy responses will suffice for Singapore.

The economy is turning around – upside surprises likely

Singapore's economy enjoyed its fastest growth in about two years, expanding 2.9% y/y in the fourth quarter last year, surging from 1.2% in 3Q16 as the rebound in external demand boosted manufacturing activity.

- **Manufacturing jumped 11.5% y/y in 4Q16**, up from 1.8% in 3Q16 as the turnaround in global demand powered Singapore's electronics and biomedical manufacturing clusters. In fact, the acceleration in exports in January tells us that the trade-led cyclical recovery has legs – exports grew by 11.1% in Jan 17, up from 9.2% in Dec 16. Encouragingly, this export bounce is broadly based and boosting export-facilitating activities such as transport and storage.

- **Near term outlook looks good, for now**: Singapore's composite lead indicator has been rising in recent quarters, suggesting continued overall economic growth. The forward-looking indicators for global demand such as the OECD lead indicator and new orders in purchasing manager surveys provide strong evidence that the export rebound will be sustained. Interestingly, the latest data from the Eurozone shows the economy accelerating nicely, giving global demand more legs to depend on than just the US.

- **But some sectors continue to languish**: The construction sector actually contracted 2.8% y/y in 4Q16, worsening from a fall of 2.2% in 3Q16 as private construction activity withered. Overall, the services sector (two-thirds of the economy) disappointed, barely eking out growth in 4Q16 of 1.0%. Financial and business services are struggling, offset by sectors such as social services which are benefiting from ramped up government expenditures on eldercare and healthcare.

In short, the economy has a dualistic nature, with the export-oriented segments enjoying a near term bounce from rising global demand but other segments being weighed down by a number of structural factors. Overall, since external demand is about two-thirds of total demand in value-added terms, the global upswing helps us overcome the domestic headwinds, at least for now.

This has two important implications for policy.

First, with growth surprising to the upside and tepid non-tradeable inflation telling us that there is considerable slack in the economy that will limit upside to overall inflation, there is no reason for the Monetary Authority of Singapore to further ease exchange rate policy as some have speculated.

Second, the improvement in the economy buys Singapore more time to address the other challenges in the economy, some of which are structural in nature. With monetary policy having accomplished what it can, further demand management policy has to be oriented towards fiscal policy to support the weaker segments of the economy – which is unfortunately where the bulk of Singaporeans earn their income. Next, structural challenges need to be addressed as well. This is where we need to assess the latest budget as well as the report of the Committee for the Future Economy (CFE) come in.

Budget 2017: expansionary budget with sector specific measures

We see four broad themes underpinning this budget.

- **Net stimulatory impact**: On our measure of fiscal spending, and assuming that the budget balance turns out as estimated, fiscal policy is expansionary compared to the contractionary effect in 2016. However, budget surpluses tend to be bigger than the government initial estimates, so the actual fiscal outcome could well be less than intended. Still, it is helpful that SGD700mn worth of public sector construction projects will be brought forward to this year and next, providing a well-needed boost. Sector-specific measures will also be rolled out to aid some sectors experiencing cyclical headwinds. Rebates to both the corporate and personal incomes taxes, as well as the GST Voucher handouts will provide (small) fillips to the private consumption level.

- **Preparing the economy for the future**: The Budget also fleshed out a number of recommendations laid out by the CFE, including help for Singaporean firms to scale up and internationalise as well as Singaporean workers to equip themselves with skills which are relevant and valuable in new and rising industries.

- **Growing emphasis on increasing revenues**: Finance Minister Heng spoke about the need to broaden the tax base and control expenditures. Budget caps on government ministries will be reduced by a further two-percentage points to improve spending disciplines.

- **But the move towards an inclusive and caring society continued**: As Singapore ages and families become smaller, the government seeks to catalyse community efforts to help the needy. The budget increases funding of charities and voluntary welfare organisations and expanded support for the disabled and those with mental health conditions.

Tackling structural challenges – the CFE Report

The CFE laid out seven major clusters of recommendations to gear Singapore to face the challenging environment it finds itself in. The CFE's aim is to empower Singaporeans to be "pioneers of the next generation", leading to an average annual growth rate of 2-3% and culminating in good jobs and meaningful careers for all Singaporeans while also ensuring that manufacturing continues to play a large role in its economy.

The seven broad and "mutually-reinforcing" strategies suggested by the CFE focused on (a) Deepening and diversifying international connections; (b) Acquiring and utilising deep skills; (c) Strengthening enterprise capabilities to innovate and scale up; (d) Building strong digital capabilities; (e) Developing a vibrant and connected city of opportunity; (f) Developing and implementing Industry Transformation Maps (ITMs); and (g) Partnering each other to enable innovation and growth.

Two key questions are raised - what specific policy changes might emerge out of the CFE report and whether the CFE's modest goals be achieved.

Cautious policy approach that emphasised ongoing initiatives

The CFE report carefully adhered to existing policy approaches, with few ground-breaking new initiatives. The emphasis was on expanding implementation of ongoing strategies, on the view that the highly complex and unpredictable world limited policy options to building capacities and improving the enabling environment instead of picking winners or being more targeted or more specific:

- **No change to key growth sectors**: The Government will take on a more active role to support growth and innovation in sectors such as finance, hub services, logistics, urban solutions, healthcare, the digital economy and advanced manufacturing.

- **Retaining a large manufacturing base,** of around 20% of total economic output. The core of the CFE's strategy here is the Industry Transformation Maps (ITMs) that were announced last year. These are industry-specific platforms to integrate planning and implementation in 23 industries and about 80% of the economy. Six have been launched to date.

- **No change to economic openness**: Singapore will focus on progressing negotiations for the Regional Comprehensive Economic Partnership (RCEP). No new initiatives for regional integration appear to have been contemplated nor was there an indication of what Singapore would do now that the Trans-Pacific Partnership initiative has floundered.

- **The most substantive measures in the CFE report related to deregulation to spur innovation, digitisation and entrepreneurship**: First, the government will re-design the regulatory environment to be more supportive of innovation and risk-taking, such as through regulatory sandboxes and by issuing "no action" letters assuring disrupting companies that they would not be penalised if in pushing the envelope with new ideas they brush up against Singapore's infamously rigid regulations. Second, the government also committed to act as a source of "lead demand" for up-and-coming industries,

particularly those which intersect which strategic national needs. Third, government will simplify the regulatory framework for venture capitalists and encourage the entry of private equity firms to provide smart and patient growth capital. Fourth, it will also set up a Global Innovation Alliance to link Singapore's institutes of higher learning and companies with overseas partners in major innovation hubs and key demand markets.

- **Scaling up and internationalising**: Government to support the scaling up of high-growth local enterprises as well as the commercialisation of research findings and intellectual property of research institutions. The government will make a big push for agglomeration gains through enhanced international connectivity as well as by developing districts such as Jurong and Punggol into synergistic and vibrant clusters.

Can the objectives outlined by the CFE be achieved?

Much has been written about the CFE report so our comments are confined to two big issues.

First, Singapore faces overarching challenges requiring a more fundamental re-think of Singapore's economic model if the CFE's goals are to be attained.

The average annual 2-3% growth target is a marked downshift from the 3-5% range posited by the 2009 Economic Strategies Committee. It is difficult to see Singapore hitting the 2-3% growth target given that:

- **Long-term economic growth constrained**: Growth is a function of productivity growth and labour force growth but productivity performance has been lacklustre and the demographic headwinds can only grow as the population ages.

- **Moreover, a more hostile global trading environment beckons**: US President Trump is following through with his protectionist bent while Congress is contemplating a border adjustment tax that would hurt imports into the US and potentially spark off a trade war.

- **Singapore's status as the premier regional hub challenged**. Bangkok is emerging as rivals to hub services which Singapore has focused on as a high-growth industry while Hong Kong is widening its lead in many areas. Some elements of the regional hub are already at risk. The local stock market's turnover volumes have plummeted since 2013 with average daily trading volumes declining while those on other regional exchanges have grown. A lack of liquidity and weak valuations are deterring regional and local firms from listing in Singapore. Yet, it is the stock market that provides growth companies with viable exit strategies and without that, the government's pursuit of smart and patient capital from venture capital and private equity will struggle.

- **High cost structure inhibiting entrepreneurship and growth of SMEs**: Costs in terms of rents, wages and compliance have mounted resulting in a loss of cost competitiveness. High costs are also stifling entrepreneurial spirit and inhibiting the growth of local start-ups.

Second, the push for a large manufacturing base needs better under-girders.

Several advanced economies such as Germany, Japan and South Korea have remained production powerhouses, showing that maintaining a robust manufacturing base in a mature economy is feasible and rewarding. But Singapore's manufacturing share of GDP has been on a downtrend, from 26% in 2000 to 19% in 2015 while Germany and South Korea's have remained largely unchanged and Japan's has ticked down only slightly from 23% to 20% over the same period. The reason is that Germany can count on its world-class *Mittelstand* group of small and medium enterprises while Japan and South Korea have strong national champions to undergird their respective manufacturing bases. However, Singapore has an unhealthy reliance on MNC-led growth and foreign direct investment and has not been making great inroads at nurturing a strong core of SMEs.

A big worry is that in the pursuit of this 20% target, the government will ramp up its big-ticket giveaways and sweeteners to entice MNCs to remain in or come to Singapore. This would mean more investment incentives and tax breaks pointing to a higher cost of attracting foreign investment and potentially skewing the cost-benefit analysis against Singapore's favour.

The bottom line: The economic cycle is turning around, giving Singapore breathing space to address the larger structural challenges we face. The latter is an evolving process which the CFE has helped to accelerate. Hopefully, over time, the government will feel its way to a pragmatic mix of policies that comprehensively addresses long term challenges.