

- (b) Discuss whether the liquidity preference theory provides an adequate explanation of the level of interest rates in your country. [15]

[To answer the above essay question, answer the following short questions step by step.]

- (i) Do Singaporeans generally hold active balances or idle balances?

The idea of LP is related to  $i/r$  makes sense only if it is SENSITIVE to  $i/r$ . This in turn implies that a large part of it should be held for SPECULATIVE purpose (Idle balances) i.e. to invest in bonds (since transactions and precautionary demand for money = active balances is perfectly interest inelastic).

If LP is largely for transactions and precautionary [as is the case for Singapore] then it would be relatively more INTEREST-INELASTIC/INSENSITIVE. Graphically, this means the LP function would be vertical or very steep in Singapore's case since the speculative demand or demand for idle balances is unimportant.

- (ii) Does Singapore have the necessary institution and culture to trade in bonds?

Singapore has no active SECONDARY bond market that trades in existing bond issues. Unlike the USA, our bond market is largely for new issues. Holders of bonds are mainly institutions whose intention in holding them isn't speculative in nature e.g. CPF; POSB Insurance companies, etc.

Note: The government-run pension fund, the Central Provident Fund (CPF) is the single largest holder of a special kind of government bonds. They are specially-issued, non-tradable, long-term government bonds which are held by the CPF until maturity. In 2000, it held some S\$60 billion of such bonds. Most of the proceeds from such bonds are probably channeled to the Government of Singapore Investment Corporation (GSIC) for investment in foreign assets.

#### Obstacles in Developing the Debt Markets:

##### Low Supply (Low Issuance of Bond)

- Government and many large companies in Singapore do not need to borrow as they are cash-rich.
- The small domestic market of Singapore severely limits the amount of funds its government and local corporations would need.
- Singapore's sophisticated bank lending network makes it easy for statutory boards and corporations to obtain credit.
- Issuing of bonds is more troublesome and time-consuming
- The debt market in Singapore is more of a 'captive' market – high proportion of the SGS is held by banks and finance companies to fulfill the minimum liquidity asset requirement and thus there is little trading of these securities in the secondary bond market.

Note: The government does not need to run a fiscal deficit to develop treasury bills and bonds. In fact, a government running budget surpluses has a relatively easier task raising funds through issuing government securities. This is because investors might have greater confidence in holding the bonds of such a government and would probably be willing to accept a lower yield.

##### Low Demand

- Singapore's investors still prefer equities and properties over bonds as they do not have to pay tax on capital gains obtained from investing in equities and properties while yield from bonds are low and unattractive. As a result, bond investors tend to buy and hold their bonds rather than trade actively.

Note:

Before 1998, the main obstacle to foreign participation in the Singapore debt market was the MAS's policy of discouraging the internationalization of the Singapore dollar which restricted

offshore borrowings denominated in SGD 5 million and prohibited Singapore-based financial institutions from trading Singapore Dollar derivatives.

This policy has been progressively liberalized. We do not have any restriction on Singapore-based financial institutions trading with non-financial institutions. However, two restrictions remain – lending to non-residents financial institutions is still capped at SGD 5 million per institution and non-resident financial institutions can raise any amount of Singapore dollars through the debt issuance, provided that the proceeds are swapped into foreign currency before the funds repatriated.

Many other initiatives have been taken by MAS to develop Singapore's bond market that enabled it to grow substantially in size, depth and liquidity. This has resulted in Singapore Government Securities (SGS) being included in JP Morgan's World Government Bond Index. In January 2005, Singapore became the first Asian nation outside of Japan to enter the widely-followed Citigroup World Government Bond Index, signaling the suitability of SGS for global investors. Among all the ASEAN countries, Singapore is ranked the second highest, behind Indonesia, in terms of the share of public debt to GDP. In 2000, the ratio for Indonesia and Singapore was 102 percent and 84.5 percent respectively.

Refer to the Appendix for more details on the development of the bond market in Singapore

- (iii) Is there active regulation of the money supply by the MAS as compared to that of the Federal Reserve in the US (FED) and Bank of England (BOE) and why?

The Central Bank in USA/UK actively carries out MONETARY POLICY i.e. regulate the money supply and hence determine the position of the  $M_s$  function. But, unlike the US Fed Reserve or the BOE [Bank of England], the MAS [Monetary Authority of Singapore] does not carry out active monetary policy and it is concerned about maintaining price stability: Singapore dollar is 100% backed by gold and reserves and credit creation of banks is monitored closely - evidence: no bankruptcy of banks.

Singapore's monetary policy is basically passive. The MAS targets or manages the exchange rates.

- (iv) Can Singapore set our own interest rate and why? [Hint: Think in terms of the smallness and openness of the economy.]

Singapore cannot afford to set our own  $i/r$  because of the openness of our economy to international capital flows. Funds can move freely in and out of the country. There is no capital controls. Any misalignment of  $i/r$  with international trends will cause outflow of capital [if it is below global  $i/r$ ] or inflow of capital [if it is above global  $i/r$ ]. This will disrupt the stability and bring about volatility to our exchange rates. This volatility of exchange rate in turn would adversely affect our trade and investment flow. Since the Singapore economy is highly dependent on foreign trade and investment, this vulnerability explains why Singapore does not have a free hand in setting our own  $i/r$ .

- (v) Is the liquidity preference theory applicable to Singapore?

The LP theory seems to be inapplicable in explaining the level/movement of  $i/r$  in Singapore. This is due largely to the fact that our economy is very open and small and the speculative demand for money in the local context has no strong influence on  $i/r$ .