INFOCUS

MACRO COMMENT

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Singapore's exchange rate and monetary policy

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A previous issue of *Infocus*, entitled 'Singapore's successful monetary policy turns 40'[1] (May 2021) reviewed the Monetary Authority of Singapore's (MAS) management of monetary policy. Unusually, the MAS manages policy via the exchange rate rather than the interest rate. In this follow-up edition of *Infocus*, EFG Chief Economist Stefan Gerlach looks at how the MAS adjusts the exchange rate in response to changes in macroeconomic conditions.

Most advanced small open economies manage monetary policy by varying a short-term policy interest rate in pursuit of a numerical objective for inflation, typically 2%. This approach, called inflation targeting, was first adopted by New Zealand and Canada in the late 1980s – and subsequently by the UK, Sweden, Australia and a little later by Norway and Iceland – and has led to much improved control of inflation.

In contrast, the Monetary Authority of Singapore (MAS) has forged its own path and conducts monetary policy by steering the exchange rate to achieve price stability, which it has not defined exactly. This is an unusual approach, but the MAS has employed it successfully since it was introduced in the early 1980s.

Why has the MAS chosen to focus on the exchange rate rather than an interest rate in its monetary policy strategy? One reason is that the Singaporean economy, with a trade-to-GDP ratio of 336% in 2022, is much more open than the inflation targeting economies. World Bank data show that the trade-to-GDP ratio is about 50% in the antipodes, 70% in Canada and the UK, and 90% in Scandinavia. The extreme openness of the Singaporean economy makes it essential to control the exchange rate since exchange rate changes have a profound impact on inflation.

The reason the MAS has left its inflation objective undefined appears to be that it was not specified when the strategy was adopted and by the time inflation targeting became common the MAS had a long and successful track record that mitigated the need for any adjustment to its policy framework. The inflation rate in Singapore has averaged almost exactly 2% between 1980 and 2023.

In studying monetary policy, it is often assumed that policymakers set an interest rate in relation to its own past value and measures of inflation pressures and economic activity in the economy. Analysts of Singaporean monetary policy have instead viewed the MAS as steering the change in the effective exchange rate in response to its past lagged value and measures of inflation and economic activity.

This approach is taken here too. As a preliminary step, it is important to be clear about what variable is viewed as the policy instrument.

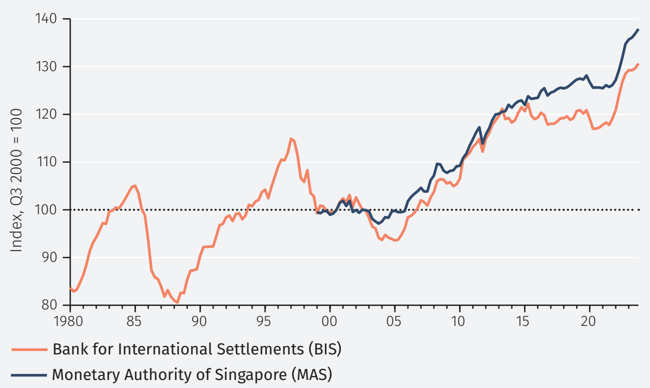
The NEER of the Singapore dollar

The MAS publishes a measure of the Nominal Effective Exchange Rate (NEER) – which is a trade-weighted average of the exchange rate of the Singapore dollar.

However, data on this exchange rate are only available since 1999. Since we wish to look at Singaporean exchange rate policy also in the 1980s and 90s, another measure of the NEER is required. We therefore use Bank for International Settlements (BIS) data on the NEER for Singapore, which is available for a much longer time period.

Figure 1 shows BIS data on the NEER from 1980 and MAS data from 1999. The two exchange rates evolve in broadly similar ways, although some differences are also apparent, which indicates that slightly different trade baskets have been used. However, the work below uses percent changes in the

1. Nominal effective exchange rates fo the Singapore dollar



Sources: MAS and BIS. Data as at 24 February 2024.

[1] See 'Singapore's successful monetary policy turns 40'.

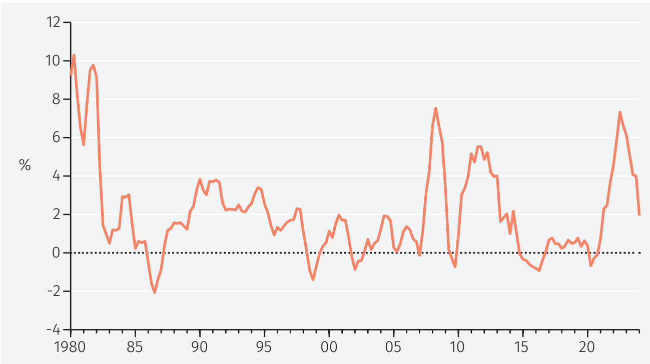
NEER. From that perspective these two measures of the NEER look broadly similar: the correlation of quarterly changes is 0.76. Since exploratory work indicated that the results are insensitive to the exact measure of the NEER employed, the BIS series is used above.

Macroeconomic conditions

The main objective of monetary policy in Singapore is to "maintain price stability conducive to sustainable growth of the economy" as stated in the MAS Act.

Given the importance of price stability for the MAS, one would expect policy to respond to offset movements in inflation. Figure 2 shows that inflation over the period 1980-2023 experienced occasional swings. It peaked in 2008Q3, that is, around the time of the collapse of Lehman Brothers and the start of the Global Financial Crisis. It also peaked at the end of 2022, following the Russian invasion of Ukraine. Overall, inflation averaged 2.1% in the period studied.

2. Singapore inflation



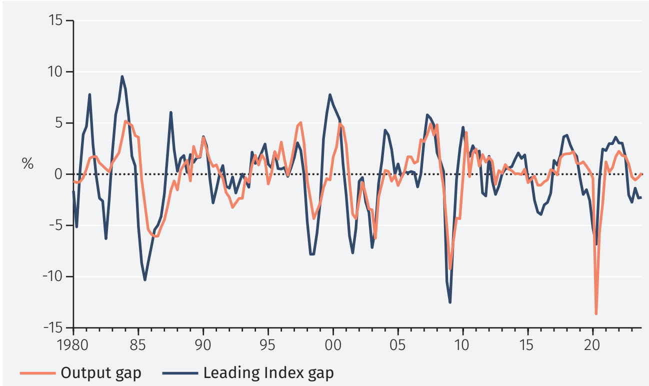
Source: Statistics Singapore. Data as at 24 February 2024.

Analysts focus on the output gap as a critical determinant of MAS monetary policy. Of course, the MAS presumably looks at a range of indicators of economic activity when determining policy. The question analysts face is which variable is most strongly correlated with the MAS's view of the state of the business cycle.

Since data on real GDP are reported with a long lag, are often revised and can be subject to idiosyncratic effects (e.g. from the weather), it is useful to use an alternative measure of economic activity such as the Quarterly Composite Leading Index. This is a subjective measure which is forward-looking. As such it may better capture the near-term growth outlook for the economy that the MAS is interested in.

Since both real GDP and the Leading Index rise over time, we compute an output and a leading indicator gap, which are shown in Figure 3.[2] These move strongly together, as evidenced by the correlation coefficient of 0.63. Since it is not clear which does a better job to capture MAS policy, we use both in the empirical work below and let the data decide.

3. Economic activity



Source: Statistics Singapore. Data as at 24 February 2024.

Analysis

Several analysts have studied the MAS's conduct of policy.[3] A common approach, followed here too, is to assume that the MAS sets the quarterly rate of change of the NEER depending on the rate of change of the exchange rate in the previous quarter, inflation pressures and economic activity. Since preliminary work indicated that the leading indicator gap was more significant than the output gap, it was used in the analysis.

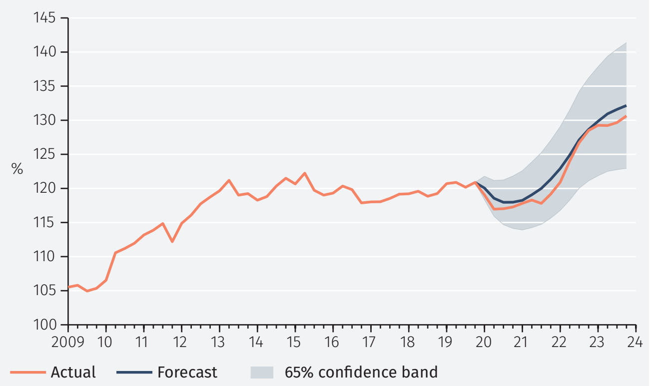
Relegating details to the *Appendix*, the results show that the MAS responds strongly to inflation and the leading indicator. The results also indicate that the responses are quick.[4]

Estimating the model on data over the period 1980Q3 to 2019Q4, the explanatory power can be assessed by comparing forecasts, and the actual evolution, of the exchange rate in the period 2020-2023. In doing so, the actual values of inflation and the Leading Index gap are used. If the actual exchange rate falls within the confidence band associated with the model, it can be said to explain the data well.

As shown in Figure 4, while the NEER had been held broadly constant for an extended period, from October 2021 onward

[2] We use the Hodrick-Prescott filter.
[3] The analysis here follows that of B. T. Macallum (2007), 'Monetary Policy in East Asia: The Case of Singapore', Bank of Japan, *Monetary and Economic Studies*, 25, 13-28.
[4] This follows from the fact that the parameter on the lagged change of the exchange rate is close to zero.

4. Out-of-sample forecast for NEER



Sources: EFG estimates on data from BIS, MAS and Statistics Singapore. Data as at 24 February 2024.

the MAS decided to tighten monetary policy to limit inflation pressures.[5] This led to a marked appreciation of the NEER. Nevertheless, the actual and forecasted exchange rates are strikingly similar.

Outlook for the exchange rate

At the time of its policy meeting in January, the MAS expected economic activity to strengthen in 2024 and inflation to remain elevated but decline during the year. It viewed its monetary policy stance, and the continued appreciation of the exchange rate, as appropriate and noted that the sustained appreciation of the exchange rate will continue to dampen imported inflation and domestic cost pressures. Barring further external shocks, a stronger Singapore dollar is to be expected.

APPENDIX

The model is estimated on data spanning Q3 1980 – Q4 2019. The estimates are tabulated below.

Variable	Coefficient	Std. Error	t-Statistic	P-value
Constant	-0.20	0.15	-1.32	0.19
Lagged dependent variable	0.14	0.08	1.81	0.07
Inflation	0.21	0.06	3.73	0.00
Leading Index gap	0.12	0.03	3.96	0.00
R-squared	0.26			

[5] See the speech on 'Inflation and Monetary Policy' by Mr Edward S. Robinson, Deputy Managing Director, MAS, 6 March 2024.

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