BT Explains

How Singapore's monetary policy works

The Monetary Authority of Singapore's (MAS) goal is to ensure price stability as a basis for sustainable economic growth. When inflation is low and stable, there is less uncertainty about returns on long-term investments, and firms can plan further ahead. It also helps to ensure a competitive export industry.

Unlike most major economies, Singapore's central bank manages the exchange rate, rather than the interest rate, and has done so since 1981. A small and open economy, Singapore is highly dependent on trade. The Singapore dollar's strength relative to other currencies can thus influence prices significantly.

The exchange rate is also relatively easy for the central bank to control – by buying and selling Singapore dollars. By choosing to manage the exchange rate, MAS gives up control over domestic interest rates. As capital flows in and out freely, interest rates are largely determined by foreign interest rates and how investors expect the Singapore dollar to move. – ***Teh Shi Ning and Kelly Tay***

> *"Managing inflation expectations and preventing inflation from escalating will be the key challenge facing monetary policy during the transition to a productivity-based economy."*
>
> **– MAS managing director Ravi Menon, on securing price stability as Singapore restructures (2013)**

The 'BBC' system

BASKET

The Singapore dollar is managed against an undisclosed basket of currencies of Singapore's main trading partners and competitors. Each of these currencies is assigned a different degree of importance, or weight, depending on Singapore's trade exposure to that currency. This reduces volatility, compared to if the Singapore dollar were pegged to any single currency.

S$ BAND

This trade-weighted Singapore dollar (S$NEER: nominal effective exchange rate) is allowed to float within an undisclosed policy band, rather than kept to a fixed value. The band absorbs short-term market volatility and provides flexibility.

S$ CRAWL

The band is reviewed twice a year to ensure that the Singapore dollar is aligned with underlying economic fundamentals. By adjusting the slope, width and level of the band, the MAS allows the currency to 'crawl' higher or lower, rather than forcing it to move sharply. Businesses, institutions and traders can buy or sell the Singapore dollar to pay for goods and services, hedge against future movements, or trade in forex markets. But once the Singapore dollar trades outside of the S$NEER band, the MAS will step into the markets to buy or sell as much of the currency as is needed to keep it within the band.

How the exchange rate affects inflation

Directly: tempers imported foreign inflation

Foreign prices of imports, such as food, apparel and raw materials, can push consumer price inflation higher. With a stronger S$NEER, the foreign prices of imports convert into lower Singapore prices.

Stronger S$NEER → Lower import prices → **Lower inflation**

Indirectly: tempers demand for Singapore's exports

A stronger Singapore dollar makes exports less competitive, and export demand could fall. Lower demand for inputs such as manpower and capital leads to lower pressure on costs to rise, thus tempering inflation.

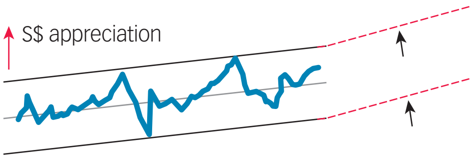
Stronger S$NEER → Lower demand for exports → Lower demand for inputs from Singapore firms → Lower cost pressures → Slower feed-through to prices → **Lower inflation**

Adjusting the S$NEER band

MAS assesses the balance of risks to Singapore's growth and inflation, particularly core inflation. Every April and October, it can decide to change none, one or more of these policy levers

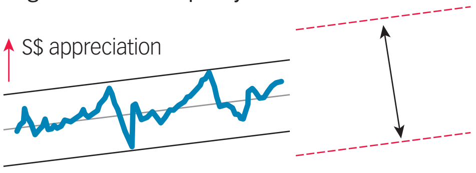
The slope of the policy band determines the pace of appreciation

- Usually done when MAS thinks that medium-term economic activity is changing gradually
- Eg. April 2010: slope made slightly steeper



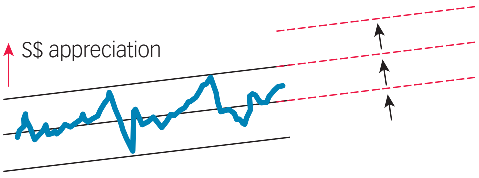
The width of the policy band determines how volatile movements can be

- Usually done when there is higher volatility in international financial markets (such as fears that Greece would exit the eurozone in 2010)
- Eg. October 2010: policy band widened

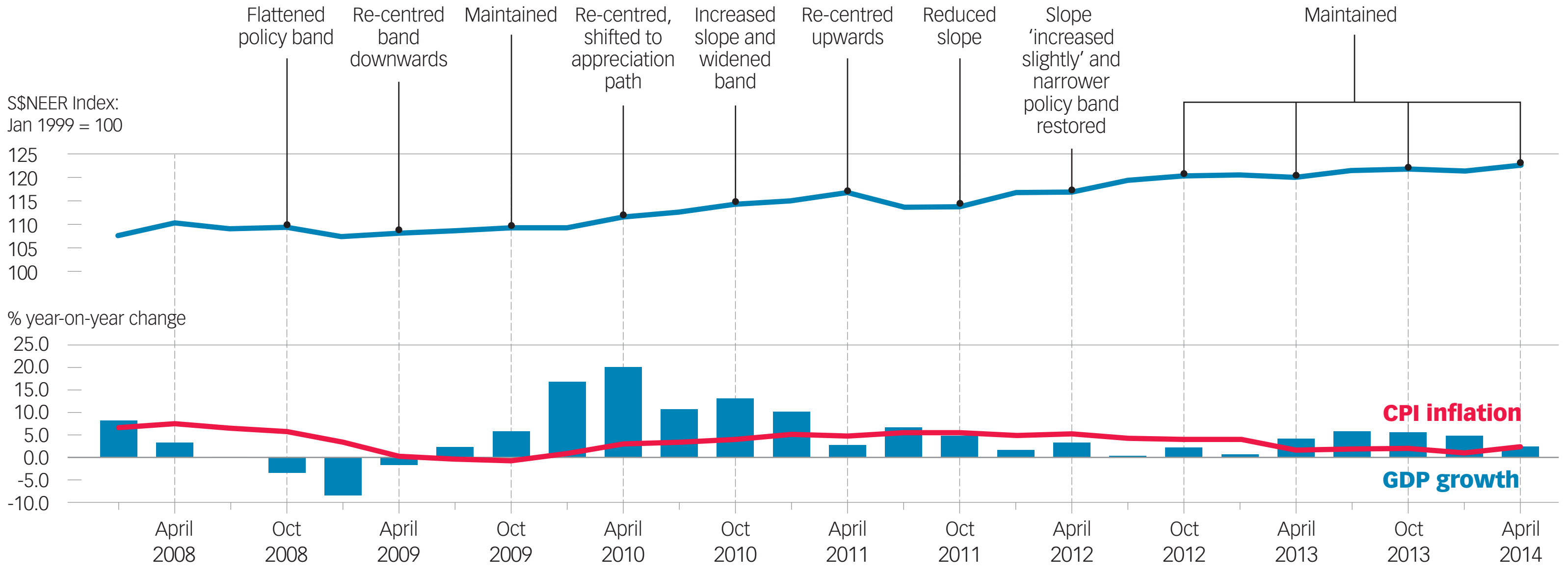


The level of the policy band reflects underlying economic fundamentals

- Usually done when the expected path of economic activity abruptly shifts the prevailing level of S$NEER
- Eg. April 2011: policy band shifted to align mid-point with prevailing S$NEER



How MAS managed the S$NEER policy in recent years



Boom:	**Great recession:**	**Recovery:**	**Restructuring:**
'Modest & gradual appreciation'	Neutral policy stance	'Modest & gradual appreciation'	Subdued to modest growth, rising domestic cost pressures

Source: MAS, Department of Statistics BT Graphics: Teh Shi Ning, Kelly Tay, Simon Ang, Noordin Ayob & Jonathan Goh