

ASIAN WEEKLY ECONOMIC INSIGHTS



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Asian Economic Perspectives

Local Bonds Benefit as Singapore Acts to Curb Inflationary Pressure

The Singapore economy has grown rapidly this year, reviving the risk of inflation and prompting the city state's central bank—the Monetary Authority of Singapore—to announce a slight tightening of its policy. As we explain in more detail below, we regard this as a positive development for holders of Singapore-dollar bonds.

Real GDP growth topped 9.4% year on year in the quarter just ended—the strongest growth rate since first-quarter 2006—which suggests that the economy is expanding at a rate higher than its potential 6% to 7%. The GDP gap—the actual growth rate minus the potential growth rate—has widened, pointing to a build-up of underlying inflationary pressures. These can be seen in a tightening of the labour market and a rise in unit labour and general business costs.

Inflation Takes Over Growth as Policy Target

While Singapore has experienced disinflation over the past year, the two percentage-point hike in goods and services tax implemented in July gave a one-off push to headline inflation (**Display 1**). Consumer price inflation (CPI)—arguably the trigger for the MAS's policy tightening—has jumped close to 3% year on year over the past three months, from below 1% year on year in first-half 2007. With the tax-induced cost pressure expected to fade during 2008, however, the real inflation worry, in our view, is not so much the CPI as asset prices. Singapore's residential property market—having lagged behind the rally seen in some of its regional counterparts such as China, Hong Kong and South Korea—has made a major comeback this year. Private residential property prices surged about 27% year on year in the third quarter following modest annual increases of 7% in 2006 and 3% in 2005. While the linkage between

residential property prices and general inflation may not be direct, the government will focus on sector-specific supply-side measures—by, for example, making more land available as a result of extended reclamation programmes—in an effort to moderate rising prices.

A Steeper SG\$ Appreciation Path

In its October 10 semi-annual monetary policy review, the MAS said it would “increase slightly” the slope of the Singapore-dollar appreciation band as a foil to inflationary pressures. This means that the authority will intensify its traditional strong exchange-rate policy, arguably an effective measure against inflation for the past decade, during which CPI has stayed below 2%. As a small open economy, driven by exports and highly dependent on imports, Singapore targets exchange rates rather than interest rates to manage inflation. We expect the MAS will now allow a 2.5% annual appreciation of the trade-weighted currency basket (or the Singapore-dollar nominal effective exchange rate, SG\$-NEER) compared to around 2% previously. According to our estimates, the SG\$-NEER has already jumped to the upper edge of the currency band since the MAS's announcement: Previously, it was slightly above the centre (**Display 2**). History suggests that SG\$-NEER tracks the band's upper edge—as it did during most of 2006, for example—for as long as the MAS targets a firmer exchange rate.

Benign Domestic Interest Rates

Using interest-rate parity theory as a guide,¹ it is reasonable to assume that the expectation of a higher rate of currency appreciation will help keep Singapore's domestic interest rates benign, so as to preserve a broad equilibrium of interest-rate

¹ The expected return on Singapore dollars (i.e. domestic interest rates plus expected changes in exchange rate) should track the return of holding US dollars (i.e. US interest rates)

differential between the Singapore dollar and the major currencies in its trade-weighted basket. For instance, three-month SIBOR is 2.3% while three-month US\$ LIBOR is around 4.9%—an interest-rate differential of some 260 basis points. Indeed, Singapore’s domestic short-term interest rates have since April stayed below the implied short-term rates suggested by our equilibrium interest-parity modelling (**Display 3**). We suspect that this reflects a deliberate strategy by the MAS to maintain enough liquidity in the local system to keep domestic interest rates low and shield the Singapore dollar from becoming a target currency for the yen carry trade.

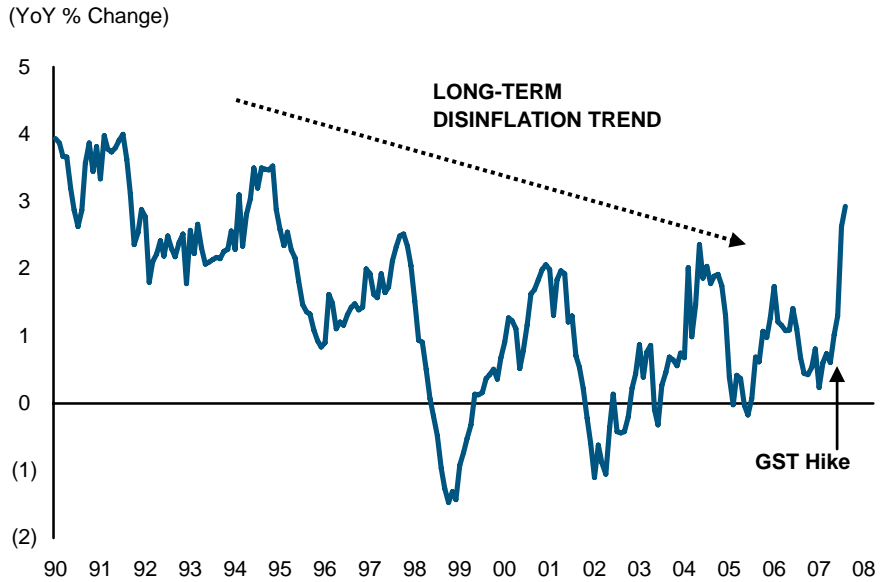
Investment Implications

A firmer Singapore-dollar exchange rate and low domestic interest rates are positive for local-currency bonds. From an exchange-rate perspective, we expect that the currency’s steeper appreciation path will be effective in slowing CPI to around 1.5% in 2008. If inflation surprises on the upside,

we expect the MAS will consider re-centring the currency band at a higher level and so further increase the currency’s appreciation. Given the weakness in the US dollar and the expected strength in the euro and major Asian currencies (all of which are in the Singapore-dollar trade-weighted basket), the policy of SG\$-NEER appreciation implies potentially stronger appreciation of the Singapore dollar against the US dollar, which would be particularly favourable to a US dollar-based portfolio. From an interest-rate perspective, Singapore is in the best position among Asian economies to follow fully any potential future US Fed Fund rate cuts. Falling domestic short-term rates will continue to keep local bond yields at current low levels. We expect the 10-year yield, currently 2.72%, to stay below 3% during the next six months.

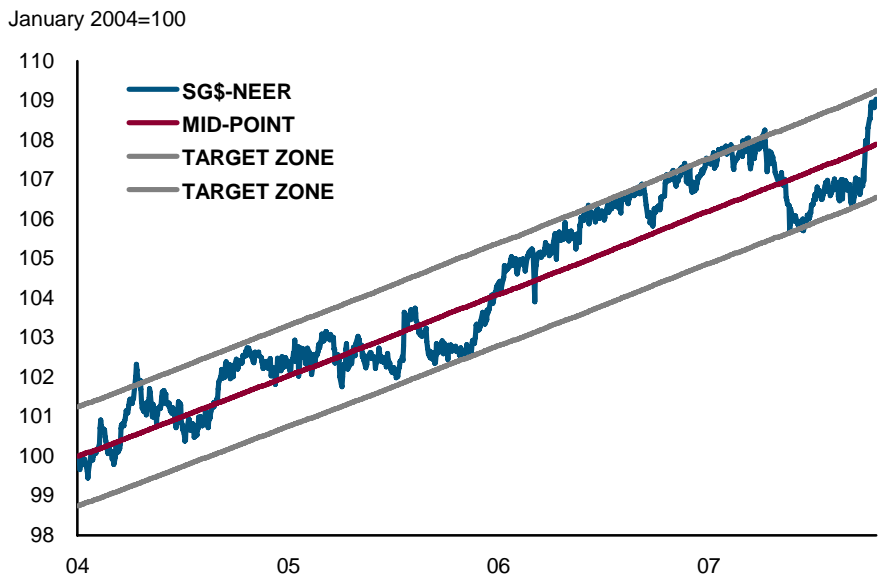
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Display 1: Inflation Spikes on Goods and Services Tax (GST) Hike Consumer Price Inflation



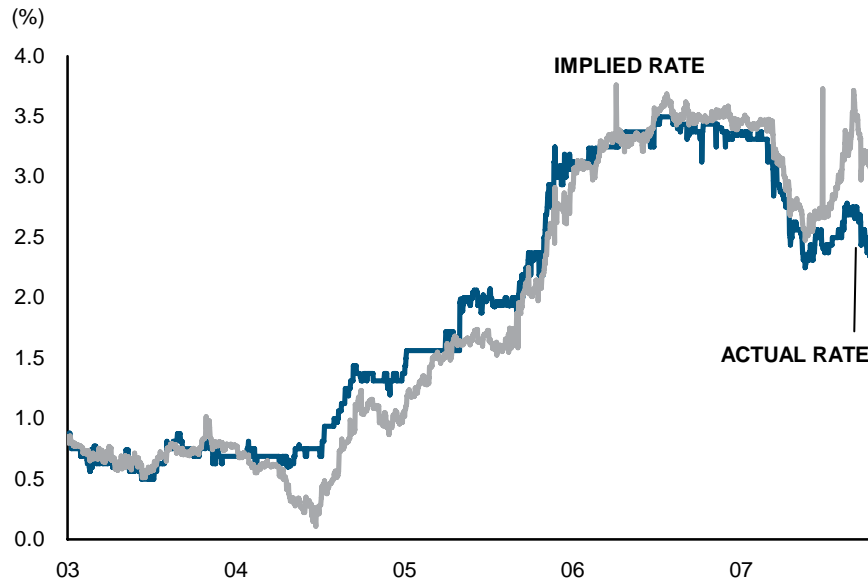
Source: CEIC Data and AllianceBernstein estimates

Display 2: Currency Appreciation Gathers Steam SG\$-Nominal Effective Exchange Rate (NEER) and Target Zones



Source: Bloomberg, CEIC Data and AllianceBernstein estimates

Display 3: Short Interest Rate Stays Below Equilibrium Level Three-Month SIBOR, Actual vs. Implied Rate Suggested by Interest-Parity Model



Source: Bloomberg, CEIC Data and AllianceBernstein estimates