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Economic Conditions in Singapore and Vietnam: A Monetary Policymaker's Report

Each year, the President of the San Francisco Fed joins the Federal Reserve Board Governor responsible for liaison with Asia on a "fact-finding" trip to the region. These trips advance the Bank's broad objectives of serving as a repository of expertise on economic, banking, and financial issues relating to the Pacific Basin and of building ties with policymakers and economic officials there. The knowledge gained and the contacts developed are valuable in understanding trends affecting the Twelfth District, in carrying out responsibilities in banking supervision, and in ensuring that policymakers have the understanding of global economic developments necessary to conduct policy and promote the stability of financial markets. This Economic Letter *summarizes President Yellen's report to the Head Office Board of Directors on her trip to Singapore and Vietnam in November 2007. (For a discussion of findings from the trip regarding the banking and financial sectors, please see the February 2008 issue of the Bank's publication,* Asia Focus, *http://www.frbsf.org/publications/banking/asiafocus/2008/Asia_Focus_Feb_08.pdf)*

Singapore

In 2007, we visited two Southeast Asian economies, the city-state of Singapore and the country of Vietnam. We began in Singapore because it serves as a major financial hub in Southeast Asia and is a logical destination for garnering information about the region as a whole. We also wanted to learn more about the investment strategies of sovereign wealth funds, and Singapore has two major ones: the Government Investment Corporation and Temasek, which jointly hold well over $200 billion in assets.

Although conditions cooled in the fourth quarter, Singapore's economy experienced robust growth in 2007. It is anticipated that GDP growth for the year was in the 7.5% to 8.0% range. Historically, Singapore has focused heavily on electronics. But, because of growing competition, the government has implemented industrial policies to diversify the economy, including a focus on tourism and on building a world-class educational system. Singapore also has made important gains in the health sector, especially pharmaceuticals and biotech research, bidding aggressively to attract renowned foreign scientists; indeed, a local company, ES Cell International, recently became the first firm to offer vials of stem cells over the Internet. Finally, it has focused on financial services, and, in particular, it has promoted itself as a center for private banking.

With Singapore's robust growth in 2007, unemployment has fallen to a nine-year low of 1.3% and inflation has risen, reaching close to 4% during the past year. Our discussions at the Monetary Authority of Singapore (MAS) focused in part on its approach to macroeconomic management. MAS implements policy largely via exchange rate adjustments, and it has been addressing rising inflationary pressures by allowing the currency to appreciate more rapidly against the U.S. dollar. This appreciation directly lowers import price inflation and curbs growth in net exports. The MAS anticipates that growth in 2008 will also be somewhat depressed due to spillovers from the U.S. subprime problem, which is expected to dampen U.S. consumption and imports from the region.

Decoupling? This brings me to one of the most important topics of conversation on our trip, namely, how developments in the United States are likely to affect Singapore, Vietnam, and other Asian economies. As much as we tried to keep our discussions focused on Asia, our contacts wanted to talk about U.S. developments. Once upon a time it was said that when the U.S. sneezes, the global economy catches cold. But recently, some observers have argued that the Asian and U.S. economies have become "decoupled"—that a downturn in the United States will produce very few spillovers for the Asian economies. The general consensus among the market participants we met is that the decoupling view is not correct—that the U.S. and Asian economies are strongly enough linked that there will be significant spillovers. This is particularly true for Singapore, which has a very open economy. But even though such negative spillovers seem likely to dampen growth somewhat from an exceptionally high level, officials in both countries still anticipate that growth will remain solid. The optimism partly reflects China's growing role as a generator of demand for the region's products as well as the benefits that Asian economies are realizing from market interest rate reductions (or delayed increases, in the case of Europe and Japan) worldwide.

Singapore continues to run a trade surplus. An indicator of Singapore's openness is that exports plus imports as a share of GDP—a common measure of openness—stands at almost 300%. Due to its location, excellent port facilities, and liberal re-exporting tax policies, Singapore has long served as an entrepôt for the region. So, almost half of Singapore's exports are re-exports.

The country runs a very sizeable current account surplus—over 25% of GDP in 2007—which has been rising over time. A country's current account surplus is equivalent to its flow of foreign lending. Like many other East Asian economies, Singapore suffers from a so-called saving glut, in the sense that domestic saving greatly exceeds the domestic demand for funds to finance capital formation, and the gap has been rising over time.

These huge current account surpluses have allowed Singapore to accumulate a large stock of foreign assets, controlled by the government in several forms. Reserves held at the MAS have grown from $75 billion in 2001 to $136 billion in 2006.

Singapore's sovereign wealth funds. The Singapore government also has two large investment funds, often called sovereign wealth funds (SWFs), to manage the government's assets: Temasek and the Government Investment Corporation (GIC).

SWFs have recently become very large, very visible, and very controversial. The controversy arises because most are not terribly transparent about either the size of their holdings or their investment strategies and because of concerns that their investments may be dictated not just by profit-maximizing intentions, but also by geopolitical strategies. (For more on Asia's SWFs, see Aizenman and Glick 2007.) In Singapore, we visited with senior officials of the GIC and Temasek. These firms have been in the headlines for their recent investments in Merrill Lynch and UBS. Both funds have faced increased international pressure to become more transparent in order to improve their accountability to domestic shareholders, reduce risks to the international financial system, and address the risk of growing financial protectionism.

The GIC was established in 1981 to manage Singapore's foreign exchange reserves. It does not publish financial results but is believed to manage more than $100 billion in assets through a network of international offices, making it one of the largest SWFs in the world. Its portfolio includes equity, fixed income, foreign exchange, money markets, real estate, and private equity. The GIC also makes direct investments in Asian companies, focusing on China, Japan, India, South Korea, Australia, and Southeast Asia.

Temasek is funded from dividends from Singapore's state-owned enterprises (SOEs) as well as proceeds from the sale of shares of SOEs. Its portfolio reached $108 billion as of March 2007. Temasek has expanded aggressively and since 2002 has focused on direct investment opportunities in Asia, which now account for 40% of its portfolio.

Temasek has been more actively engaged in its investments than the GIC. It doesn't seek to manage companies, but it may exert influence on or sit on the boards of some institutions.

Vietnam

Our visit to Vietnam was the first by Federal Reserve officials since the normalization of bilateral relations in 1995. My instant impression was one of a widespread entrepreneurial spirit and an openness to new and practical ideas. The streets are crowded with motor scooters and economic activity, round-the-clock construction activity, and urban centers that already mirror those in far more developed economies. The sense of optimism and excitement is palpable. And the economy is booming: With growth close to 8% per year since 2001, it is considered by many a new "Asian miracle." This growth has been accompanied by very significant reductions in poverty.

Government policies have been a huge impetus to growth. They have aimed to transition Vietnam rapidly to a market-oriented economy. The private economy is flourishing, and formal official recognition of Vietnam's private sector expanded with the passage in 2005 of a Unified Enterprise Law and a Common Investment Law. These laws are designed to boost private investment by reducing administrative barriers to business development. They also aim to improve corporate governance in SOEs and to create a level playing field for state, private domestic, and foreign firms.

In Hanoi, we met with top governmental officials involved in economic policy. We were quite impressed with the clear commitment by senior party leaders to continued reform. Vietnam's accession to the World Trade Organization (WTO) in January 2007 reinforces the irreversibility of these reforms.

The country is viewed as highly hospitable to foreign investment, which has grown rapidly and is fueling a vibrant export sector. Since its accession to the WTO, Vietnam has been freed of quota restrictions on its textile exports, and these have grown very rapidly. Vietnam has a large pool of unskilled workers currently earning very low wages. Half the population is below the age of 25, and 90% is literate.

One consequence of Vietnam's strong economic growth has been increased inflationary pressure, which reached 10% this year. We discussed this situation with our counterparts at the State Bank of Vietnam (SBV). The problem the government faces is a classic one, where a monetary authority's exchange rate goal is inconsistent with its desire for price stability. The SBV is not yet independent, and its policies reflect the high priority that the government attaches to very rapid export growth. The SBV is therefore resisting the upward pressure on its currency caused by its large trade surpluses and large capital inflows into its booming equity market.

Vietnam's equitization of SOEs. Like many formerly nonmarket economies including China, Vietnam faces the issue of how to deal with its SOEs. We met with officials of the State Capital Investment Corporation (SCIC) to discuss issues relating to privatization—or equitization as it is called in Vietnam. Equitization has been proceeding rapidly, and the number of SOEs has fallen from about 12,000 to 2,500. The process involves converting an SOE to a joint stock company with some shares retained by the government, some allocated to employees on the basis of tenure with the company, and the remaining shares sold in the market on public exchanges. The state's retained interest is determined by the strategic nature of the company and managed by the SCIC. The economic problems associated with privatizing SOEs—layoffs and unemployment—have been much less severe in Vietnam than in many other transition economies. Most of Vietnam's privatized SOEs have been profitable and have expanded.

The sheer number of equitizations has helped fuel the stock exchanges. We met with the president of the Ho Chi Minh City Stock Exchange and visited the trading floor. New IPOs, plus the rising values of shares of equitized firms, have contributed to a 30-fold increase in market capitalization. Market capitalization has reached 38% of GDP, and government officials expect this to double again in another year. According to the president, the exchange itself would be equitized in 2009.

Challenges to growth. The dominant sense in Vietnam is one of excitement about the economic progress that has been made and enthusiasm about the economy's future. We sought, however, to catalog some of the challenges that remain and possible obstacles to continued success.

One obstacle relates to technological progress. Some studies suggest that the booming growth experienced over the past decade has largely been driven by capital accumulation rather than improvements in technology. There are exceptions. In Hanoi, we met with Western-trained venture capitalists who were nurturing indigenous startup technology companies and grooming them for IPOs, in one case, with a planned NASDAQ listing. But an expedition to a factory on the outskirts of Ho Chi Minh City reminded us that the level of technology in much of the manufacturing sector is still quite rudimentary—"shovel level." The fear is that if Vietnam is unable to upgrade its technology substantially, sustained growth beyond the level of a newly emerging economy will be impossible. More than one market participant we met suggested that Vietnam's fate might be to catch up to Thai levels of development, at which point reduced cost advantages would halt its rapid growth. Still, catching up to Thailand would represent no small achievement, as GDP per capita in Vietnam stood at less than a quarter of Thai levels in 2005.

There are also structural impediments to continued strong growth. One is an inadequate education system. Although literacy is high, many market participants expressed concern about the quality of education and a shortage of skilled labor, particularly labor with management skills. Infrastructure is a further barrier to growth.

These challenges notwithstanding, our visit to Vietnam made clear that the nation has already traveled far along the road of transition to an emerging market economy.

Janet L. Yellen
President and Chief Executive Officer

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