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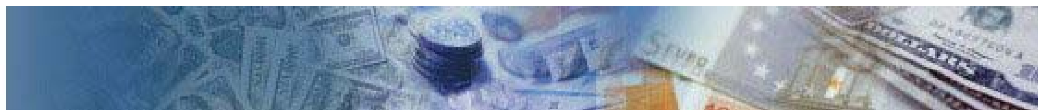


Policy Brief No. 1 /2011

Evolution of the Financial Sector and Financial Regulation in Singapore

In discussions of the appropriate systems of financial regulation in late-industrialising developing countries, Singapore is often presented as an example. Its experience is seen as illustrating the advantages of, and the best way to establish, a modern and "efficient" financial system along the lines of the Anglo-Saxon model. With the sector competing with Hong Kong as a local financial hub, it has managed to grow significantly in size. As a result, the financial sector in the country is seen as being less important as a supportive infrastructural facility for the real economy, than as a sector in its own right, contributing to GDP generation and growth in output and employment. The financial structure and the regulatory framework it includes have also proven to be robust, even when buffeted by regional financial crises (as in 1997) or global crises (as in 2008). This makes Singapore an instance of a country that is home to an open and globally integrated financial sector, without being afflicted by the instability that is seen to arise when countries are open to cross-border flows and to the operations of international financial firms of various kinds.

This policy brief focuses on certain distinctive features of the financial sector of Singapore and the regulatory policies that underlie its functioning. It also identifies the circumstances and policies that endowed the financial system in Singapore with the relative stability it displays.

Financial Sector Evolution

Many of the policies that influenced the evolution of Singapore's financial structure to its current form were introduced after August 1965, when it became a sovereign state after separating from Malaysia. Given the inadequate development of manufacturing in the city-state and the shortage of natural resources and energy assets, the government was initially focused on developing the country as a trading hub and using

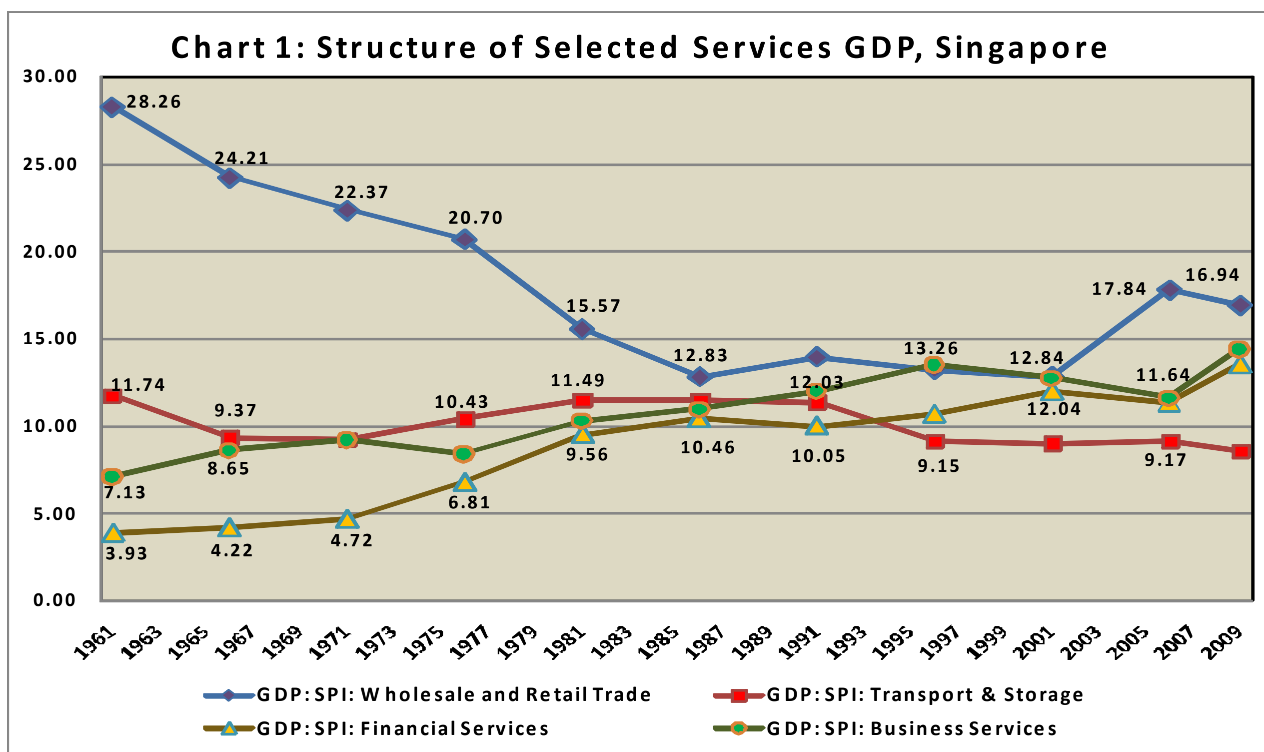


Chart 1: Structure of Selected Services GDP, Singapore

the reduced trading costs that would entail to attract relocative investments in manufacturing. It helped that Singapore had developed capabilities in the provision of a range of services associated with transportation and transshipment since its operation as a free port under the British. To this was added, after independence, the policy of attracting investment into manufacturing for export. Within this framework, the initial development of Singapore's financial market was geared to meet the financing needs associated with these activities.

The main function of the financial sector at the domestic level in the late 1960s was to support manufacturing activity and in the early 1970s it also effectively catered to the financing requirements of the public housing policy. Bank loans and advances to manufacturing increased from 12.8 per cent of the total in 1962 to 27.6 per cent in 1973 and those for housing from 2.6 per cent in 1962 to 14.2 in 1973. Much of this increase was at the expense of the share of bank loans devoted to sustaining foreign and domestic trade, whose share in total advances fell from 51.6 per cent in 1962 to 30.1 per cent in 1973. Over the following decade, till 1982, while the decline in the share of trade continued, manufacturing was losing out, while the share of housing in advances appeared to have reached its limits. Increasingly, it was the non-bank financial sector that seemed to be absorbing a rising share of bank credit.

Table 1: Bank Credit to Non-bank Customers by Industry

INDUSTRY	1962	1967	1973	1976	1979	1982
General Commerce (imports, exports, wholesale and retail trade)	51.6	44.6	30.1	37.5	41.5	25.2
Manufacturing	12.8	21.4	27.6	26.7	23.4	18.2
Building and Construction and Housing loans	2.6	10.8	14.2	12.8	9.1	15.6
Transport, storage and communication	-	1.0	4.6	3.1	4.5	7.8
Financial Institutions	-	3.0	6.5	8.5	9.9	15.4
Professional and private individuals	-	12.0	11.6	6.9	5.6	10.2
Agriculture, Mining and Quarrying	5.3	1.9	0.6	0.8	0.5	0.1
Others	-	5.0	4.8	3.8	5.5	7.0

Source: Adapted from Blanc (2008)

From the late 1960s, a combination of special international circumstances and conscious state policy was defining a new role for Singapore's financial sector.

The increasing expenditure incurred by the US during the Vietnam War tightened credit availability and led to widening interest rate spreads in the Euro-dollar and US markets. This encouraged international banks to look for ways to channelise and benefit from the dollar reserves in the Asia-Pacific region. This required presence in the Asian region. Although Hong Kong was preferred as a location, the unwillingness of the authorities to do away with the 15% tax on interest income from foreign currency deposits made Singapore a competitive alternative to house the Asian Dollar Market (ADM).

The subsequent growth of the ADM was facilitated by numerous decisive measures designed and implemented by the government of Singapore1. Over time the government's success in attracting foreign financial firms to establish operations in Singapore and in inducing them to use their presence there as a base for their regional operations, legitimised the objective of seeking to make Singapore a regional financial hub. This required a considerable degree of liberalisation of policy with regard to both entry and operations.

Seen in this light, three sets of objectives can be seen to have determined Singapore's financial policies over time, though each set would have been emphasised to differing degrees at each point in time. The first of these objectives would have been to ensure the emergence of a financial sector most suitable for supporting Singapore's role as a trade and transshipment hub and as a hub for an export-reprocessing industry based on foreign, multinational investment.

The second would have been to promote financial sector growth of a kind that will allow the sector to be not just a supportive complement to the goods producing sectors, but an "industry" in its own right, undertaking activities not necessarily related to Singapore's own non-financial sector development trajectory. Finally, at some point, Singapore must have opted to push this development of the financial sector beyond normal limits, to emerge as a regional financial centre, by introducing policies reflecting its bid to be such a centre.

Table 2: Growth of the Singapore Asian Dollar Market

Year	No. of participating banks	Gross of ACU assets (US$mn)	Growth rate (%)
1968	1	30.5	
1969	9	123	303
1970	14	389.8	217
1971	19	1062.8	173
1972	25	2976.1	180
1973	46	6277.2	111
1974	56	10357.3	65
1975	66	12597.4	22
1976	-	17354.1	38

Source: Wong (1976)

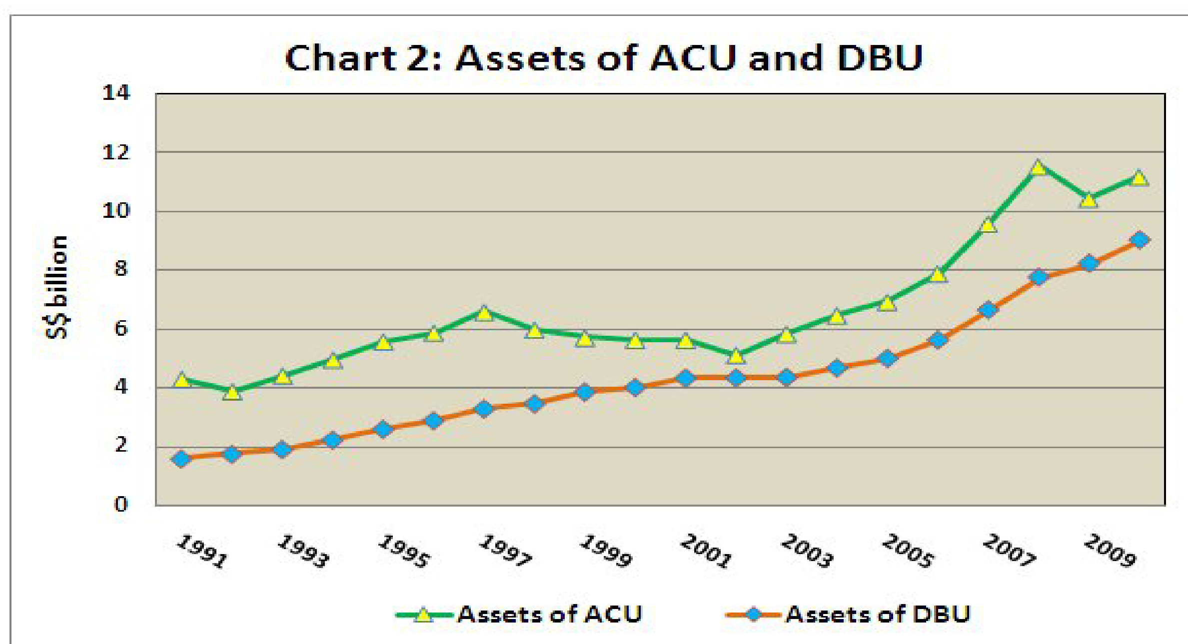
The financial deregulation at the domestic level was initiated in 1975, when the cartel system for fixation of interest rates was abolished. This was followed by capital account liberalisation in 1978 when exchange controls were lifted completely. From the late 1970s, the government promoted the internationalisation of financial services by allowing the entry of more foreign banks. These reforms at the local and institutional level oriented the domestic financial institutions to adapt to the greater liberalisation package that followed in later years. In addition, the government, through a series of measures, sought to privilege the financial firms engaged in foreign transactions to attract them to Singapore (Wong, 1976).

A consequence of these and other measures was the rapid growth of the Asian Dollar market after 1968. This success facilitated the government's effort to use the financial structure created in the initial years to take the financial sector forward. The financial services sector also became diversified, with banking accounting for just less than 50 per cent of the nominal valued added, while securities dealing and fund management activities contributed 13.2 per cent, Insurance 16.1 per cent and other financial services 22.3 per cent.

Evolution of Financial Regulatory Policies

Liberalisation of the financial sector was a sequenced process and the government was conscious of the dangers of subjecting the domestic financial sector and economy to the volatilities that characterise international financial markets. It therefore sought ways of ring-fencing the domestic sector and protecting it at least partially from such volatility. An important objective here was to prevent the internationalisation of the Singapore dollar and to limit the operations of foreign banks.

The presence of foreign banks could result in flows of capital into and out of the country, which could destabilise credit and currency markets and precipitate crises that could damage the domestic economy. The strength of Singapore's financial policy lies in the fact that, it recognised these possibilities and designed innovative means to address them.



An important element of the policy was not merely to adopt the practice (popularised by the Glass-Stegall Act) of creating Chinese Walls separating the banking, securities trading, insurance and other segments of the financial sector, but to extend this in its own special context to separate to some degree the domestic and international operations of the banking sector. The principal instrument used for this purpose was the provision of differentiated licenses, defining the area of operation of an entity, to individual banks.

Foreign banks with restricted licenses increased in number from 6 in 1971 to 14 in 1994 and 50 in 2011. This combination of a dominant presence of foreign banks and a high proportion of them with restricted licenses is seen as a conscious policy to exploit the benefits of foreign bank presence, while insulating the economy from the instability that may arise due to that dominance.

Another potential source of instability was the rapid growth of the Asian Dollar Market (ADM). This necessitated greater monitoring and the government recognised the need to separate it from the Domestic Banking Units (DBUs). Giap and Kang (2000)2, provide an exhaustive description of the dichotomised management of the financial sector adopted by Singapore. Both DBUs and Asian Currency Units (ACUs) are financial entities registered, established and operating under the supervision of the Monetary Authority of Singapore. But, DBUs can deal only in the Singapore dollar while ACUs are free to deal in any currency other than the Singapore dollar.

ACUs are specially licensed units of commercial and merchant banks that can accept time and demand deposits in foreign currency and can grant credit in foreign currency to both residents and non-residents. The Domestic Banking Units are subject to stricter regulatory requirements than Asian Currency Units.

Chart 2 shows the growth of DBUs and ACUs since 1990. As can be seen from the graph, the assets of ACUs have consistently exceeded that of DBUs since the early 1990s.

Another growing concern of the central bank was to find ways to compensate for the inefficiency of traditional monetary policy measures (due to the country's openness to international prices and exchange rates) to control prices and output. Hence the central bank shifted its attention to exchange rate policy, which was the only instrument available for effective macroeconomic management. The central bank advocated the non-internationalisation of the Singapore dollar to maintain the efficacy of exchange rate policy. Under this policy, the central bank signaled its strong disapproval of any form of speculation in the Singapore dollar (SGD) by restricting the selling of SGD to non-residents and the trading of inter-bank SGD derivatives, which could be used for leveraging and hedging SGD positions.

The twin strategies: (1) dichotomisation of the financial sector; and (2) non-internationalisation of the Singapore dollar can thus be viewed as the key financial management policies that enabled Singapore to promote itself as an international financial centre while retaining the autonomy to efficiently manage the economy by means of exchange control policy. These measures were combined with enhanced prudential regulation in the wake of the liberalisation of the late 1990s.

The regulatory challenge before Singapore is unique, similar to the economic and financial environment of the city state. The emerging challenge before the country is to incorporate dynamic regulatory strategies to retain the control of the domestic financial sector even while opening up to foreign competition and ensuring that destabilising influences such as those that afflicted Iceland, for example, do not overcome its financial sector.

[1] Wong (1976) details the different decisive measures taken by the Singapore government to develop the Asian dollar market.

[2] Giap Khee.T., Kang.C. (2000), "Singapore's Dichotomised Financial System", in *Rising to the Challenge in Asia: A study of financial markets, Vol: 3, Sound Practices*, Asian Development Bank.