Embrace with Caution: Singapore's digital growth path and its central bank

MSc Local Economic Development student, Wingyan Yip, reviews Singapore's economic growth path away from trade to fintech and how the role played by its central bank differs from other investment-attracting state actors.

The Merlion seen from its back with a view at the three towers of the Marina Bay Sands. The Merlion is the official mascot of Singapore. Photo credit: fad3away.

Earlier this month, the Ministry of Trade and Industry in Singapore reported a GDP growth of 0.7% during 2019, the lowest since 2009. The country's export has borne the brunt of the US-China trade war and a downturn in the global electronics cycle, nearly sending the economy into a technical recession. In a trade climate still riddled with uncertainties, Singapore has turned to its domestic sector for growth catalysts. But Singapore has more ambitious growth catalysts than even a S$1 billion housing estate revamp project – it wants to lead Southeast Asia in digitising the economy. Singapore's path to digitisation is an endogenous growth model writ large: From the Economic Development Board (EDB)'s financial advice for tech start-ups, to the state-backed fund Temasek Holdings' investment in "aspiring unicorns", a network of state actors are working closely to incentivize innovation. Little has been discussed about their potential impacts on the Monetary Authority of Singapore (MAS), the country's central bank. What do these fintech developments mean to the factor markets and how has the central bank been addressing them? Two recent developments are in focus here: digital currencies and virtual banking.

Let's start by noting that Singapore follows a monetary policy that focuses more on price stabilisation than interest rate or capital flow which are difficult to control given the small and open economy of Singapore. The Singapore dollar effective exchange rate, or S$NEER, is allowed to appreciate within a policy band comprised of a basket of trade partner currencies. The central bank believes that by influencing the currency it can impact the level of imports and exports, which could in turn lessen inflation or stimulate domestic production. One way in which fintech developments might warrant MAS's intervention is if they influence the supply and demand of money significantly, as could be the cases of digital currencies and online banks.

Digital Currencies

Digital currencies could detach the link between MAS's currency intervention and inflation if it becomes a widely adopted payment instrument. Beyond Bitcoin and Ethereum, which are treated more as speculative assets, stablecoins like Facebook's Libra have the potential of becoming a legitimate medium of exchange.

Among the many problems discussed by the critics, one risk is particularly relevant to the function of the central bank: how likely is a private issuer like Facebook able to maintain the stability of a stablecoin? Libra pegs its value to a basket of low-risk assets – not unlike the Bretton Woods system of fixed exchange rates – but such low-risk assets are finite and liquidity could become a problem. The more Libra consumers demand, the less likely Facebook will be able to find enough safe assets to back its currency. The fear of everyone converting their dollars to gold was one reason why Nixon to pull the US from the Bretton Woods system in 1971.

MAS has been aware, of course, of the risk of Libra becoming a widely accepted medium of transaction. Any cryptocurrency aspiring to be used on a global scale will either have to be pegged to some asset values or be exposed to chronic speculation – neither safeguards price stability. Were cryptocurrencies to gain prominence over a national currency within the territory, central banks' intervention in the exchange rate would no longer influence price levels. Imagine crypto inflation where Facebook is unable to defend a speculative attack on Libra and consumers with Libra wallets see their purchasing power dwindled – do we then expect an IMF bailout?

As a regulator, MAS has so far been open to cryptocurrencies, though exercising with considerable caution. The use of cryptocurrencies is still confined to a small group of businesses and is not close to influencing price levels. New legislation such as the Payment Services Act, which comes into force this month, mainly addresses other risks such as money laundering and online transaction security. MAS also proposed to regulate crypto derivatives on approved exchanges. It remains to be seen how much the central bank would allow the spread of cryptocurrencies without eroding its monopoly over money issuance.

Virtual Banking

MAS announced in June that it would issue up to five digital bank licenses. Digital banks are banking entities that operate without physical branches. The five licenses are made up of two retail and three wholesale licenses which can only serve businesses. The ride-hailing app Grab and the mobile network Singtel have already applied for a retail banking license as a joint venture. Once granted the license, the Grab-Singtel venture can compete with traditional banks to offer interest on deposits and extend credit to individuals and businesses alike.

As digital banks compete to offer attractive returns to savers, the preference for savings over consumption will provide more funds for investment in the country. Though it is not the priority of MAS to manage liquidity, the central bank should be reasonably concerned if excess liquidity causes money supply to grow faster than real income. But given the reservations SMEs hold over export performance in 2020, it is hard to tell if investment will increase even with easy credit. There is no dire need for the country to increase savings either since it does not suffer from a balance of payment deficit.

On the other hand, the introduction of online-only banks might just be the healthy dose of cortisol traditional banks need to up their game for digital banking. Thomas Piketty wrote in *Capital in the Twenty-First Century* that Asian economies benefited more from the knowledge diffusion brought by open trade than the free flow of capital. The know-how these online banking players can add to the economy may as well be Singapore's to reap.

To moderate potential risks, Singapore is running this trial with two stages for the retail bank player. Entities will only be granted Digital Full Bank license when they have proved not to pose any significant risks and meet capital requirements. Hence, before reaching the full bank status, they will be restricted in terms of business operation, deposit and product offering.

Looking at China, one sees how the value-added fintech might just help shadow banking grow rapidly. The lesson is not lost on MAS, who has facilitated tech investments with cautious optimism as a central bank and financial regulator. In a trade climate that grew much fickler last year, Singapore is obviously banking on fintech as its next domain of competitiveness. The endogenous growth theory has technology at the heart of growth, but tech investments will only keep coming if macroeconomic fundamentals are reassuring. MAS knows its role in Singapore's digital growth path well.

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