# 3.1 External Outlook

## G3 Economies to Lead Global Growth in 2014

**The upturn in the G3 is more assured, while Asia ex-Japan's prospects are somewhat less certain.**

Since the last *Review*, the divergence in growth prospects between the G3 and emerging Asian economies has grown starker. Although GDP growth on a trade-weighted basis in Singapore's major trading partners is projected to rise from 3.8% in 2013 to 4.2% this year, this improvement will be mainly due to a stronger performance by the advanced economies. (Table 3.1) Downside risks to growth in these countries have diminished, alongside greater policy certainty. In the US, consumer demand and business spending are expected to pick up, underpinned by a strengthening labour market and higher capacity utilisation. As for the Eurozone, the recent decline in credit risk premia has allowed larger firms to access financing by issuing debt at a lower cost, even as bank lending contracted. In Japan, domestic demand will be supported by fiscal measures to offset the consumption tax hike. Overall, growth in the G3 economies is expected to nearly double to 1.9% this year, from 1.0% last year.

The rebound in G3 growth augurs well for Asia ex-Japan, with the NIEs benefiting the most, given their higher direct export exposure to the advanced markets and the global electronics industry. Nevertheless, the growth outlook for emerging Asia is clouded by downside risks on several fronts. First, political uncertainty has risen in several countries, with elections taking place in India and Indonesia starting from April. In addition, the political impasse in Thailand continues to dampen confidence and domestic demand. Second, the risk of a marked slowdown in China cannot be discounted, as policy-makers chart a course in economic restructuring and debt deleveraging. Third, the build-up of corporate debt in emerging Asia in recent years has left the region vulnerable to further increases in funding costs as monetary conditions normalise worldwide. (Chart 3.1) Debt servicing and repayment abilities could be further compromised if softer economic growth erodes corporate profits. On balance, the Asia ex-Japan region is likely to grow only slightly faster at 5.2% in 2014, compared to 5.0% last year.

**Table 3.1**
**GDP Growth Forecasts**

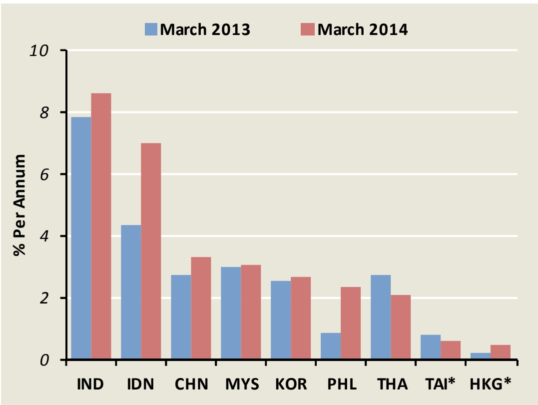
(%)

| | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Total*** | **3.8** | **4.2** | **4.4** |
| **G3*** | **1.0** | **1.9** | **2.1** |
| US | 1.9 | 2.7 | 3.0 |
| Eurozone | −0.4 | 1.2 | 1.5 |
| Japan | 1.5 | 1.3 | 1.3 |
| **Asia ex-Japan*** | **5.0** | **5.2** | **5.4** |
| **NIE-3*** | **2.7** | **3.4** | **3.6** |
| Hong Kong | 2.9 | 3.4 | 3.5 |
| Korea | 3.0 | 3.5 | 3.7 |
| Taiwan | 2.1 | 3.3 | 3.6 |
| **ASEAN-4*** | **4.9** | **4.9** | **5.3** |
| Indonesia | 5.8 | 5.4 | 5.8 |
| Malaysia | 4.7 | 5.1 | 5.0 |
| Thailand | 2.9 | 2.5 | 4.2 |
| Philippines | 7.2 | 6.4 | 6.3 |
| China | 7.7 | 7.3 | 7.2 |
| India** | 4.7[e] | 5.4 | 6.0 |

Source: CEIC, Consensus Economics Inc. and EPG, MAS estimates

* Weighted by shares in Singapore's NODX.
** Refers to fiscal year ending March.
[e] Consensus estimates.

**Chart 3.1**
**One-year Government Bond Yields in Asia ex-Japan**




Source: Bloomberg
* Two-year government bond yield.

**Reduced policy uncertainty will reinforce a long-awaited pickup in US investment.**

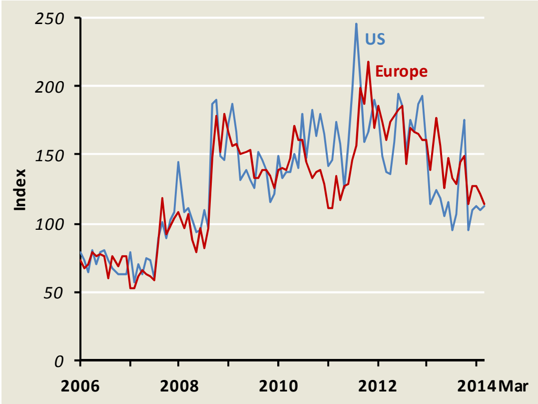
In the US, an unusually severe winter weighed on economic activity early this year, causing production chain disruptions and delivery delays. However, the economy is expected to stage a stronger recovery for the rest of this year as capital spending gathers pace alongside a steady rise in capacity utilisation. The latest National Association for Business Economics survey found that the majority of firms had plans to ramp up capital expenditure in the next six months. Industrial production and real retail sales also started to grow again in February, after contracting in the previous month. Correspondingly, US PMIs, which deteriorated in the early months of Q1, have improved—the manufacturing PMI picked up half a point to 53.7 in March from the month before, while the services PMI rose from 51.6 in February to 53.1 in March.

The tapering of quantitative easing by the Federal Reserve is expected to continue at a measured pace, while Congress' approval of a new budget in late 2013 will keep the government funded for the next two years. Reflecting these developments, an index of economic policy uncertainty for the US compiled by academic researchers has been broadly trending down. (Chart 3.2) This index has been shown to presage GDP and employment movements. Recent labour market conditions confirm that economic activity is on the mend—payroll growth increased to 192,000 in March, close to the 197,000 in the previous month. Concurrently, the labour force participation rate appears to be recovering from its secular decline since 2009, as discouraged workers return to the workforce. (Chart 3.3) Accordingly, the US economy is expected to grow by 2.7% in 2014 and 3.0% in 2015, up from 1.9% last year.

**The Eurozone recovery is gaining momentum as improved business conditions spur growth.**

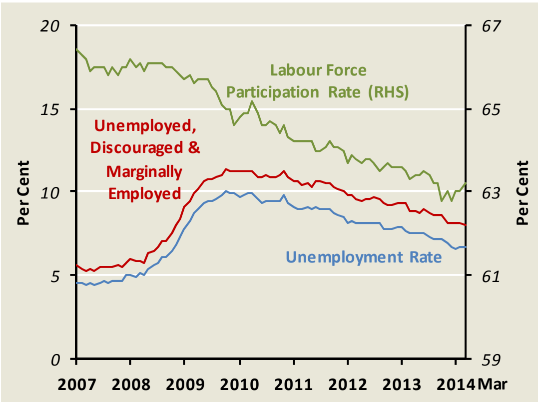
The Eurozone is set to experience moderate growth over the next few quarters, as the ongoing cyclical upturn gains traction. Impediments to growth are gradually being lifted. For instance, the tightening of bank lending standards has abated, while the pace of fiscal adjustment at the Eurozone-wide level is projected to slow. In the periphery, Ireland officially exited its sovereign bailout programme last year and Spain concluded its bank recapitalisation programme.

**Chart 3.2**
**US and European**
**Economic Policy Uncertainty Indices**




Source: www.policyuncertainty.com

**Chart 3.3**
**US Labour Market Indicators**

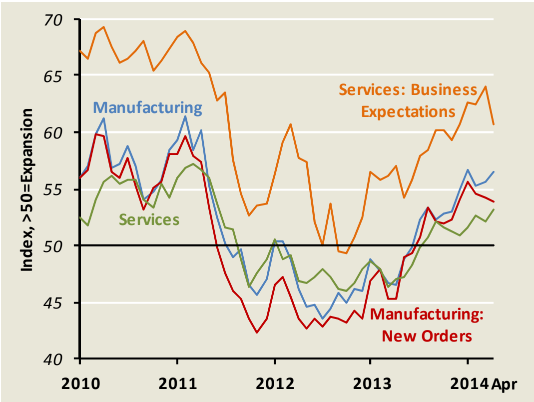



Source: CEIC

The resumption of economic growth and steadfast implementation of reforms in these countries have stabilised the public debt ratio and restored a measure of investor confidence. Consequently, borrowing costs have fallen, allowing sovereigns to seek fresh funding from the private sector.

As in the US, economic uncertainty in the Eurozone has been declining steadily since 2012, and is now at the level before the Greek debt crisis broke out in 2010. (Chart 3.2) Consequently, consumption indicators, such as retail sales and new car registrations, have picked up since late 2013. Forward-looking PMI surveys also indicate that business conditions will continue to improve. In Q1 2014, the new orders sub-index of the Eurozone's manufacturing PMI picked up to 54.8 and the business expectations sub-index of the services PMI rose to 63.0, its highest reading since H1 2011. (Chart 3.4) With dissipating uncertainty and improving sentiment creating a virtuous circle, growth in the Eurozone is forecast to come in at 1.2% in 2014, before rising further to 1.5% in 2015.

**Chart 3.4**
**Eurozone PMIs**



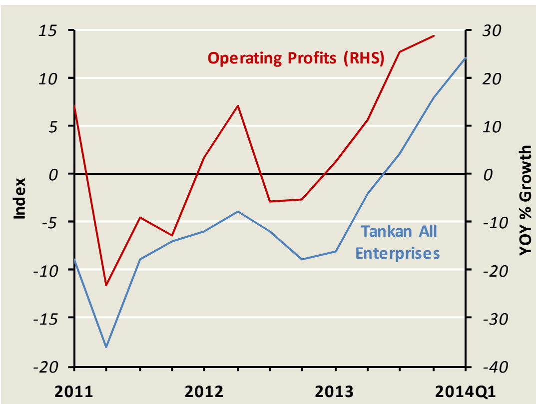

Source: Markit

## Downside risks from Japan's consumption tax hike will be capped by fiscal support.

Japan's economic performance is expected to be uneven in the first half of the year. The frontloading of consumption expenditure, which was already discernible in Q4 last year, is likely to have intensified in Q1 2014, ahead of the consumption tax increase. Thereafter, a pullback in private spending is projected and an output contraction in Q2 cannot be ruled out. However, the dampening effect of the tax hike will be cushioned by offsetting fiscal measures, including tax cuts for enterprises and support for households.

Economic activity in H2 2014 will also be bolstered by developments on the corporate front. The BOJ Tankan survey showed a further increase in the proportion of firms reporting favourable business conditions in Q1 2014, alongside buoyant growth in operating profits. (Chart 3.5) Moreover, some companies are distributing a part of the profits to workers, having agreed at the spring 2014 wage negotiations to increase base wages for the first time in five years. While the investment outlook is not as sanguine, given the uncertainty surrounding the tax rate hike, some pickup in capital expenditure is expected in tandem with improving exports as the global economy recovers. Consequently, Japan's GDP growth is projected to ease only marginally to 1.3% this year.

**Chart 3.5**
**Japan Tankan Survey and Firms' Operating Profits**



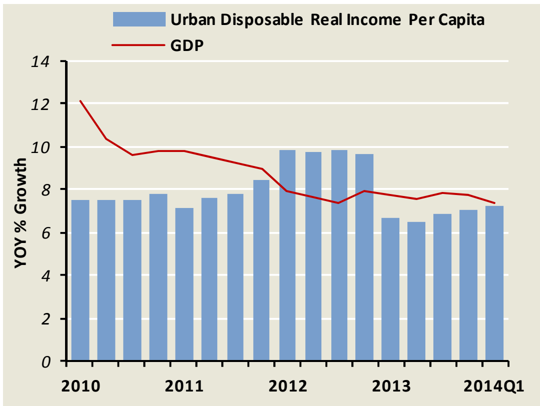

Source: BOJ, MOF

### Economic restructuring and deleveraging are weighing on China's near-term growth …

Following growth of 7.7% last year, the Chinese economy is likely to expand at a slightly slower pace in 2014, as it faces domestic headwinds. Intensifying government initiatives to restructure the economy following the Third Plenum in November 2013, while beneficial in the longer term, will weigh on industrial output in the coming quarters. Further, liquidity tightening by the central bank and measures to temper credit growth will curtail business expansion. In addition, substantial over-supply in some heavy industries and measures to clamp down on polluting industries are having a dampening effect on investment.

Indeed, China's growth momentum slowed markedly in Q1 2014, amid a deceleration in industrial output and fixed investment. Overall GDP rose by 1.4% q-o-q SA, compared with 1.7% in the previous quarter. In year-on-year terms, growth softened to 7.4% in Q1, down from 7.7% in the preceding quarter. Despite the slowdown in GDP growth, however, resilient private consumption should help to moderate the expected decline in domestic demand in the coming quarters, as disposable income growth in urban areas has remained firm. (Chart 3.6) In April, the Chinese authorities also announced modest fiscal measures to arrest the economic weakness. Tax breaks for small businesses will be extended, while the construction of social housing and railways will be accelerated. These measures have been deliberately restrained, as forceful pump-priming or monetary easing would detract from China's ongoing efforts at rebalancing and deleveraging. Nonetheless, further fine-tuning measures may be introduced if the pace of economic activity falters again, providing a floor to GDP growth. At this juncture, the Chinese economy is projected to expand by 7.3% this year and 7.2% in 2015.

**Chart 3.6**
**China's GDP and Disposable Real Income Per Capita**




Source: CEIC and EPG, MAS estimates

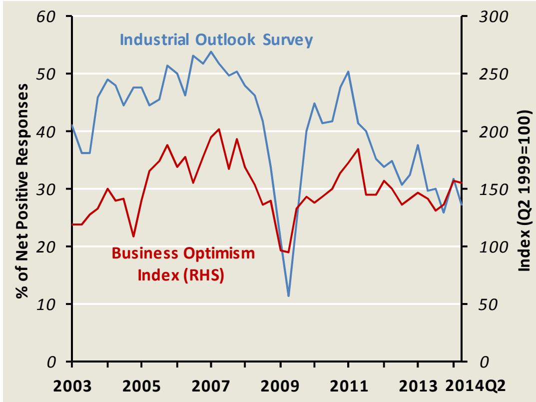
### … while political uncertainty clouds India's prospects.

In India, a raft of investment-friendly reforms announced in late 2012 have had limited impact on GDP growth thus far. Despite moves to streamline project approvals and liberalise FDI, realised investment has remained tepid. Although business optimism has recovered from the four-year low seen in

Q3 2013 amid effective measures to stabilise the rupee, it has slumped again lately. The recent decline could be attributed, in part, to heightened policy uncertainty in the run-up to India's national elections in May. (Chart 3.7) However, a conclusive electoral outcome could swing business sentiment around and catalyse new investment.

In the meantime, India's main growth driver, private consumption spending, will continue to be sluggish, as elevated inflation continues to erode real disposable incomes. In addition, public spending will be restrained by the need to curb further fiscal slippage in FY2014, given that the fiscal deficit is likely to have exceeded the government's target in the last financial year. Consequently, the country's economic performance is likely to remain muted in the near term. GDP growth is currently projected at 4.7% in FY2013, but the pace of expansion is expected to improve slightly to 5.4% in the next fiscal year as business and consumer confidence strengthens after the elections.

**Chart 3.7**
**India's Industrial Outlook Survey and Business Optimism Index**

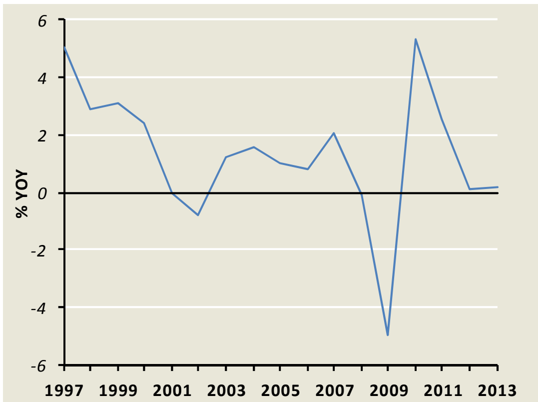



Source: CEIC

**The global tech upturn will cushion the impact of China's slowdown on the NIEs.**

The trade-dependent NIEs are expected to build further on the economic momentum gained in late 2013 and grow at a faster pace in 2014. Improving demand for electronics, spurred by the corporate IT replacement cycle in the advanced economies, should support industrial production in the NIEs and offset the impact of slowing demand from China. However, persistently elevated household debt in Korea and stagnating wage growth in Taiwan will continue to weigh on consumer spending. (Chart 3.8) Meanwhile, Hong Kong's economic recovery should make further progress, barring a disorderly correction in its property market. All in, GDP growth in the NIEs as a whole is envisaged to rise to 3.4% in 2014, from 2.7% last year.

**Chart 3.8**
**Taiwan's Wage Growth**



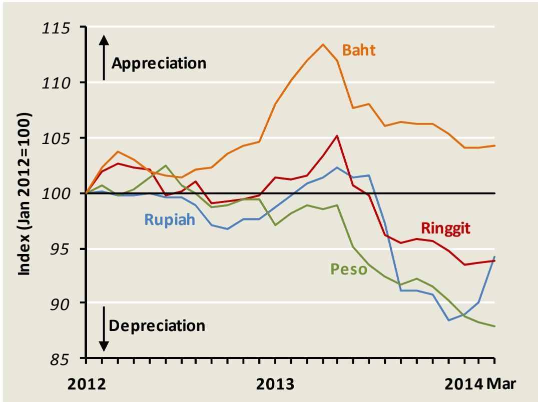

Source: CEIC and EPG, MAS estimates

**Real exchange rate depreciation will provide some support for ASEAN-4 exports.**

Alongside the anticipated recovery in the G3 economies, an increase in ASEAN-4 exports is expected to broadly counterbalance a retraction in domestic demand in these economies. As a result, GDP growth in the region is projected to be stable at 4.9% in 2014, unchanged from last year. While borrowing costs have risen and dampened both consumption and investment, a significant depreciation of these countries' real effective exchange rates since mid-2013 provided a countervailing boost to their short-term global export competitiveness. (Chart 3.9) The rotation from domestic to external demand will, in turn, underpin a further improvement in the aggregate current account balance, which reverted to a surplus of 1.7% of GDP in Q4 2013. With external balances improving, the region should be better able to weather intermittent volatility that may arise from further QE tapering.

However, downside risks have not receded entirely. The tentative recovery in ASEAN-4 exports thus far remains vulnerable to renewed stresses in the global economy and political developments. In particular, Indonesia and Malaysia, the commodity exporters in the region, will be adversely affected should growth in China slow more sharply than expected. In Thailand, ongoing political tension will hold back spending and cast further uncertainty on the growth outlook. In Indonesia, the extent to which structural reforms will be implemented in the post-election period will depend critically on whether a dominant party emerges from the elections.

**Chart 3.9**
**Real Effective Exchange Rates in the ASEAN-4**

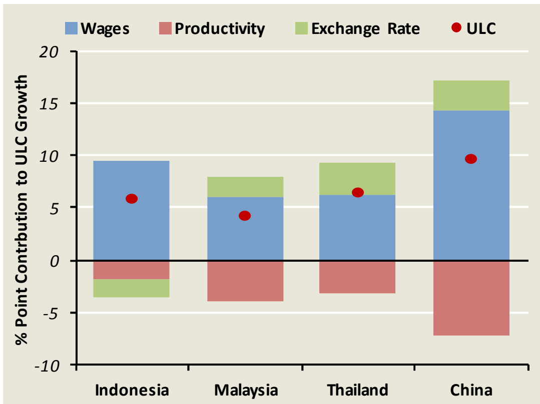



Source: JP Morgan and EPG, MAS estimates

## ASEAN's draw as an FDI destination has risen, amid changes in the region's competitive landscape.

Turning to the longer term, the prospects for FDI in the ASEAN-4 economies have revived recently, alongside an evolution of the regional economies' comparative advantage.[1] Within developing Asia, China is currently the largest recipient of FDI inflows, accounting for almost a third of the total.[2] There are, however, several push and pull factors that are increasing ASEAN's attractiveness as an investment location *vis-à-vis* China. A key push factor is rising labour costs in the latter. China is facing a shrinking working-age population, which has precipitated sharp wage hikes in recent years. While there have been accompanying gains in productivity, the pace of wage increases has outstripped productivity improvements by a greater margin, resulting in sharper increases in Unit Labour Cost (ULC) compared with the rest of the region. (Chart 3.10) In contrast, most of the ASEAN economies continue to enjoy demographic dividends, with a labour

**Chart 3.10**
**Breakdown of Unit Labour Cost in Selected Asian Economies, 2004–13**




Source: CEIC and EPG, MAS estimates

Note: Productivity growth has the opposite sign due to its dampening effect on ULC.

1 Estimates of FDI vary. To ensure consistency across countries, we have used UNCTAD data where possible, as it is largely based on the BOP concept of FDI inflows.

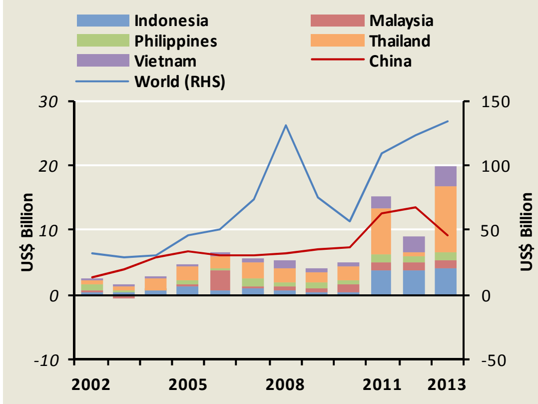
2 Hong Kong accounts for approximately half of the FDI flows received by China (IMF CDIS). While Hong Kong is a substantial "conduit" for foreign investors wishing to invest in China, the data may include some "round-tripping" of domestic investment being rechanneled into China via Hong Kong.

force that is still projected to grow, at least into the next decade. These factors, combined with heightened Sino-Japanese tensions, appear to have diverted some Japanese investment from China to ASEAN. (Chart 3.11)

Across the ASEAN region, FDI prospects differ, depending on the relative strength of pull factors, such as the availability of labour, infrastructure support, political stability and domestic market access. In recent years, Indonesia has gained prominence as an FDI destination, as improving political stability prompted foreign companies to invest in the country to gain access to its growing consumer market and leverage off its relatively cheap labour and abundant natural resources. (Chart 3.12) In Vietnam, the strong FDI flows can be explained by its proximity to China, which facilitates access to the latter's existing production networks and huge market. Malaysia has thus far also been an attractive location for MNCs. However, with wage costs rising alongside industrial development, there is a need to progressively move into higher value-added activities. In response, the government has introduced a series of initiatives, including the Economic Transformation Program, which is beginning to bear fruit.

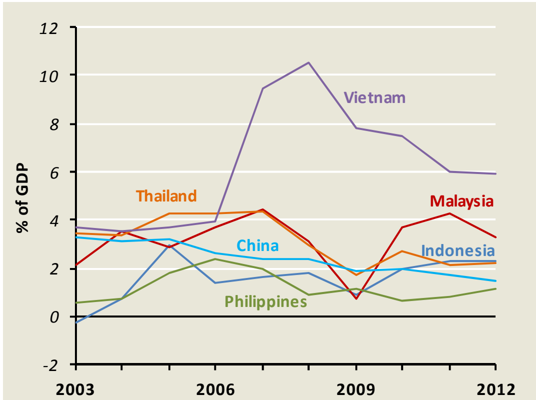
In comparison, Thailand and the Philippines have underperformed relative to regional competitors in attracting foreign investment. FDI flows into Thailand as a share of GDP has trended down since 2008, in part reflecting rising labour costs due to less favourable demographics, as well as the impact of the 2011 floods. Over the longer term, the resolution of long-standing political problems is critical, with important implications for infrastructure development, policy effectiveness, and the overall investment climate. The Philippines' lagging FDI performance, particularly in manufacturing, may be partly attributed to its poor transport network and protectionist policies. (Chart 3.13) While not faring worse than Vietnam in these areas, it does not enjoy the same proximity to China which would compensate for these deficiencies. The smaller amounts of FDI received by the Philippines may also reflect the country's comparative advantage in the business services sector, which tends to be less capital-intensive.

**Chart 3.11**
**Japan's Outward FDI Flows**



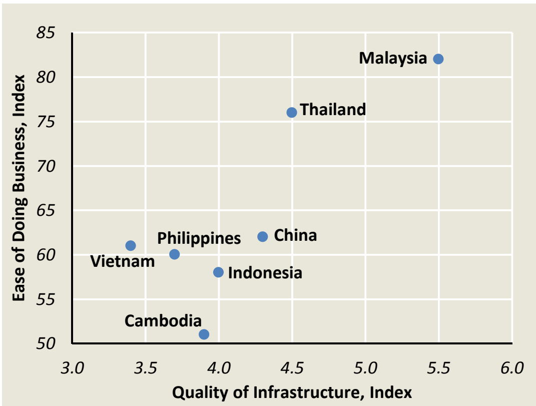

Source: JETRO

**Chart 3.12**
**FDI Flows into Selected Asian Economies**




Source: UNCTAD

**Chart 3.13**
**Ease of Doing Business and Quality of Infrastructure in Selected Asian Economies**

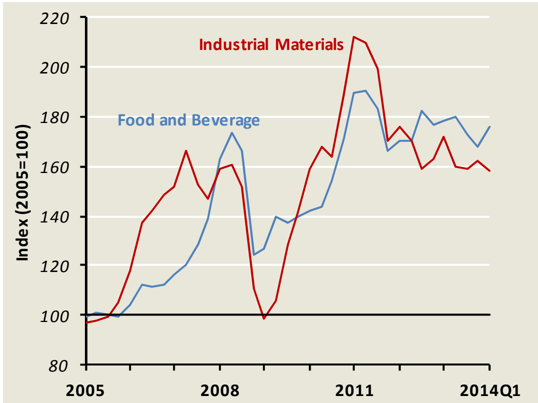



Source: World Bank

**Global inflationary pressures are likely to remain moderate.**

For the rest of this year, global inflation is expected to be contained, as prices of industrial commodities are weighed down by slower growth in China. (Chart 3.14) Nonetheless, food commodity prices could face some upward pressures, with the anticipated onset of El Niño weather patterns later this year. In the G3 economies, inflationary pressures are expected to remain subdued. The Eurozone is set for an extended period of low inflation as wage growth is held down by high unemployment and a negative output gap. Meanwhile, the consumption tax hike will lift headline inflation in Japan. On the whole, inflation in the G3 economies is projected to rise mildly from 1.3% in 2013 to 1.5% this year. In Asia ex-Japan, the outlook for consumer price inflation is mixed. While China's headline figure will likely be weighed down by excess capacity in the industrial sector, inflation in the ASEAN-4 is set to creep up slightly, mainly due to cost-push pressures from subsidy rationalisation and the pass-through from currency depreciation. Overall, consumer prices in Asia ex-Japan are forecast to rise by 3.9% this year, down slightly from the 4.0% increase in 2013.

**Chart 3.14**
**IMF Global Commodity Price Indices**




Source: IMF

# 3.2 Outlook for the Singapore Economy

## An Interplay between Cyclical and Structural Forces

**Restructuring will continue into 2014.**

In the first chapter of this *Review*, the cyclical and structural interactions that affected Singapore's economic growth profile in 2013 were highlighted. Some of these trends are expected to continue throughout 2014. On the cyclical front, the external headwinds that have confronted the domestic economy over the last few years should gradually recede over the course of the year. However, the ongoing restructuring towards productivity-led growth will generate further transitional frictions, notably in the form of higher labour costs through the tightening of foreign labour inflows. This, in turn, will continue to weigh on GDP growth.

Concomitantly, other important adjustments are taking place in the economy. One persistent trend has been the rise of services. Over the last few years, various issues of the *Review* have discussed the increasing prominence of services, particularly modern services. The impact of global secular trends on domestic services industries will be discussed in the latter part of this section. Central to this theme is how the global IT industry is shifting towards services and gradually transforming the landscape of the domestic IT-related industries.

## Cyclical Rebound Alongside Margin Pressures

**The growth trajectory of the Singapore economy hinges on the global recovery profile.**

The global economy as a whole is expected to show continued improvement for the rest of the year, anchored by better prospects in the G3. Domestic demand in the ASEAN economies will remain soft, although exports are likely to pick up. China is expected to see slower growth this year amid ongoing structural reforms.

This somewhat differentiated growth profile will have a bearing on the performance of the Singapore economy this year. The last *Review* highlighted that domestic demand in the G3 economies continues to provide the greatest support for Singapore's GDP growth, although domestic demand from the region also rose considerably through the 2000s.

Among the G3 economies, the US is expected to be the most important driver of growth. Thus far, the recovery in the US has been supported by firm private consumption, which will remain a key pillar this year. Nevertheless, investment will play a more prominent role than it had in earlier years, although a strong rebound is unlikely at this stage.

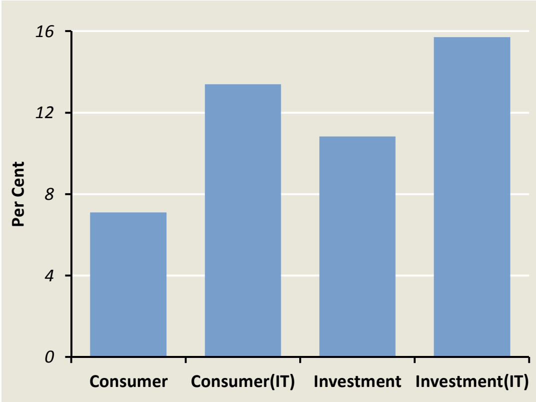
This shift in the mix of US growth drivers will have important implications for the rest of the world. Broadly, an improvement in US investment should translate into greater US import demand compared to the earlier consumption-led recovery. Chart 3.15 shows that the import intensity of capital goods in the US exceeds that of consumption. In fact, more recent data seems to suggest that demand for consumption goods is increasingly met by domestic producers. (Chart 3.16) In comparison, imports of capital goods have generally risen in tandem with investment.

**A recovery in G3 corporate demand bodes well for the IT exporting economies.**

A similar pattern is likewise observed in the US IT industry. The import intensity for US corporate IT products, comprising mainly office equipment (including PCs) is higher than that for consumer electronics. (Chart 3.15) Consequently, any pickup in US IT investment demand bodes well for global electronics exporters.

More recently, the recovery in the US electronics capex cycle appears to be gaining some traction, as shown by the 7.2% q-o-q SA expansion in private IT fixed asset investments during Q4 2013, following a flat outturn in the preceding quarter. Forward-looking indicators point to a continued pickup in the quarters ahead. Following the weather-induced slump in activity over Jan–Feb this year, the Empire State Manufacturing Future Technology Spending and Future Capital Expenditure indices recorded a turnaround in March. (Chart 3.17)

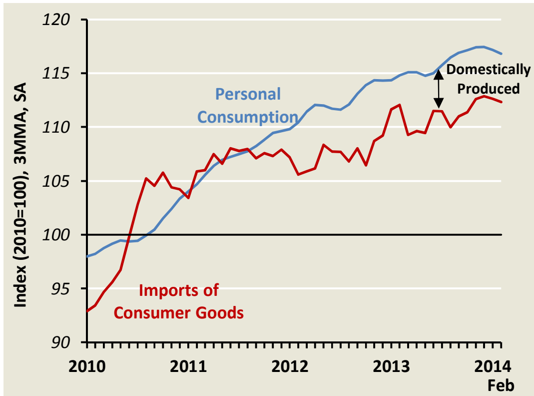
**Chart 3.15**
**US Import Intensity by Product Type**




Source: Bureau of Economic Analysis and EPG, MAS estimates

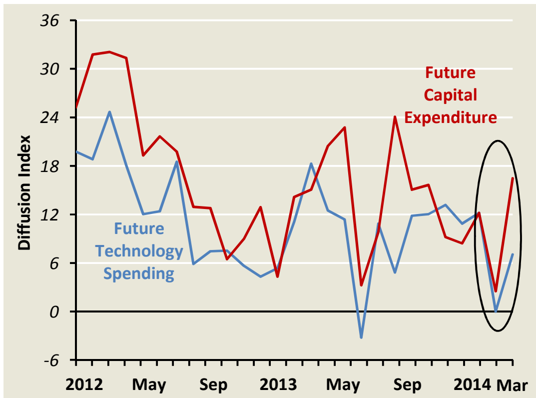
Note: Import intensity is defined as the share of imports as a percentage of output.

**Chart 3.16**
**US Personal Consumption and Imports of Consumer Goods**




Source: CEIC and EPG, MAS estimates

**Chart 3.17**
**US Technology Indicators**

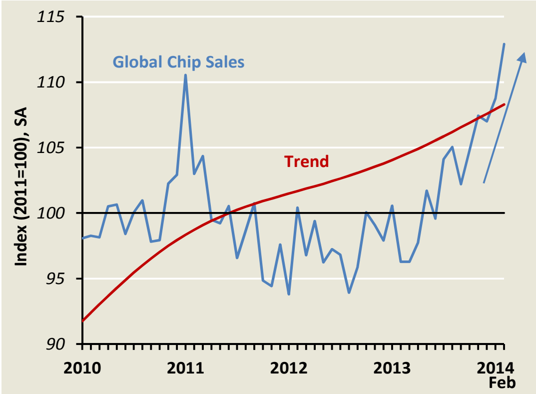



Source: CEIC and EPG, MAS estimates

The uptick in corporate demand, coupled with firm consumer spending, has galvanised further expansion in the worldwide semiconductor industry. Notably, in 2013, global chip sales emerged from a soft patch, after a bout of weakness which occurred in the aftermath of the post-GFC rebound. For the first time since mid-2011, the increase in revenue, depicted by the blue arrow, surpassed its trend. (Chart 3.18) Following three consecutive quarters of expansion in 2013, worldwide semiconductor sales rose further by 4.1% during Jan–Feb this year, as compared to Q4 2013.

Notwithstanding the cyclical boost, the rebound in the global IT industry is unlikely to be of similar magnitude to those in the past. For the year as a whole, the global semiconductor industry is expected to grow by slightly over 5%, only marginally better than the 4.8% in 2013. Apart from cyclical factors, there are also some structural changes that underpin this more modest projection which will be discussed further in the second half of this section.

**Chart 3.18**
**Global Chip Sales**




Source: Semiconductor Industry Association and EPG, MAS estimates

### Trade-related industries should benefit from the cyclical uplift.

The more favourable external environment, including the mild improvement in the global IT industry, should provide support to Singapore's external-oriented industries as a whole. In 2013, these industries accounted for about half of GDP growth and are projected to contribute more to growth in 2014, with the trade-related industries (manufacturing, wholesale trade and transport & storage) accounting for the bulk of the improvement.

In comparison, the financial services sector is likely to see slower growth, following the exceptional performance last year. While the upturn in global economic activity could impart some upside to Singapore's GDP growth, this will be capped by lingering concern over the impact of the downshift in the credit cycle on the emerging economies. Indeed, equity and bond funds domiciled in Singapore continued to see an outflow in Q1 2014 as investor confidence in the region remains subdued.

### Construction to augment infrastructure will help the domestic-oriented industries.

The domestic-oriented industries have been a key pillar of support over the last few years. Since 2010, they have accounted for about half of GDP growth, on average. While this is expected to fall slightly in 2014, these industries should stay resilient, underpinned by investment in transportation, housing and social infrastructure.

The construction sector, in particular, should expand further, buoyed by a strong pipeline of residential and non-residential projects. Around 48,000 residential units are due for completion annually over 2014–15, and another 74,000 units are projected to be built in 2016, significantly higher than the annual average of 24,000 units over the period 2010–13. (Chart 3.19) Concomitantly, more than 40% of the seven million square metres of space designated specifically for industrial use over the next three years will be completed in 2014. (Chart 3.20)

Investment spending aimed at expanding Singapore's infrastructure capacity has also been increasing. The amount of contracts awarded could reach an all-time high of $38 billion in 2014, driven by public investment in residential and non-residential projects. In particular, civil engineering work will gather pace with the commencement of large-scale projects, such as Project Jewel, Terminal 4 of Changi Airport, and the Thomson MRT line.

The enhanced infrastructure should, in turn, generate new downstream activities. For instance, the Sports Hub, which is scheduled for completion in Q2 2014, will augment Singapore's capacity to host sports and entertainment events, paving the way for greater visitor inflows. Additionally, new hospitals at Jurong Lakeside District will be completed this year, keeping pace with increased spending on healthcare services.

## Firms could see continued margin pressures in 2014.

Despite the expected improvement in external conditions this year, firms will be confronted with continued margin pressures. Specifically, the higher wage costs arising from the tightening of foreign labour inflows will further weigh on firms' profits.

However, the impact will be uneven. The effects of the tight labour market will be felt more acutely by firms with greater reliance on labour input. Chart 3.21 plots the share of remuneration in operating expenditure of the different sectors. Consumer- facing sectors, such as accommodation & food services and recreational,

**Chart 3.19**
**Expected Residential Dwellings Completion**

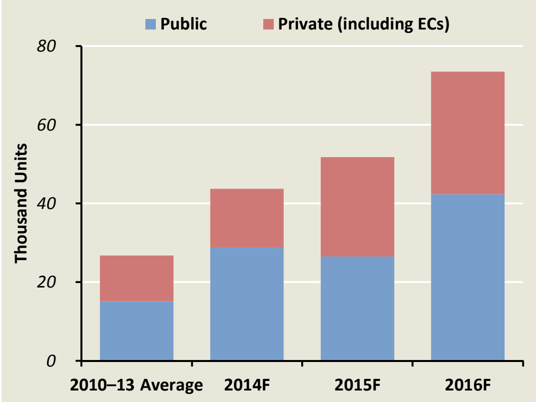



**Chart 3.20**
**Expected Completions of Non-residential Projects**

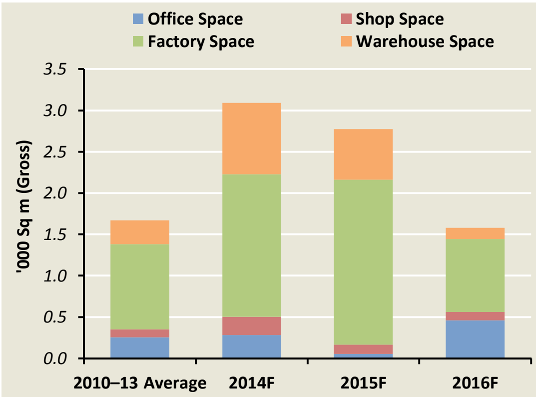
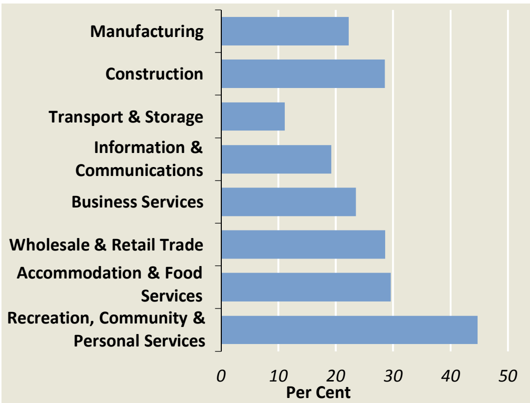



**Chart 3.21**
**Share of Remuneration in Operating Expenditure, 2011**




Source: EPG, MAS estimates

community & personal services, as well as the construction sector, have higher wage shares compared to the transport & storage and manufacturing sectors. Moreover, in manufacturing, the wage bill for smaller firms is significantly higher than that of larger firms. (Chart 3.22)

While some firms will be able to pass on the increases in costs to their customers, others that have been experiencing product price declines in recent years, such as transport & storage and selected segments within the manufacturing sector, could find it difficult to do so. (Chart 3.23) More specifically, in the logistics and shipping industries, global overcapacity and depressed freight rates may weigh on their bottom lines in 2014. Even firms that catered to strong domestic construction demand were unable to command higher product prices over the last three years due to keen competition. Indeed, some of the industries cited above, including transport & storage, and construction, have already seen a steady slide in their profit margins over time. (Chart 3.24) As of end 2013, the margins of the listed companies in these sectors were less than half of those in early 2010.

In the April 2012 issue of the *Review*, EPG charted the different phases of adjustment arising from a tighter labour market. Three years on from the start of the economic restructuring initiative, the domestic economy appears to be entering a consolidation phase, characterised by compressed profit margins and slower growth. Supply-side constraints will continue to weigh on growth this year. The outcome for firms will therefore depend on how efficiently they undertake the necessary investment, improve work processes, and augment the skill sets of their workers.

**On balance, the Singapore economy is likely to expand by 2–4% in 2014.**

Barring any unforeseen circumstances, the cyclical recovery in the Singapore economy is expected to continue, supported by strengthening corporate demand from the G3 economies and steady expansions in the domestic-oriented industries. Nonetheless, supply-side constraints due to higher labour costs and tighter profit margins could continue to weigh on growth this year. On balance, GDP is expected to rise by 2–4% in 2014.

**Chart 3.22**
**Manufacturing Sector Remuneration**

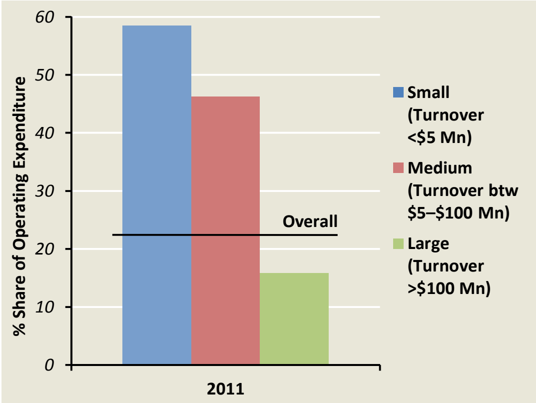



**Chart 3.23**
**Average Change in Product Prices 2011–13**

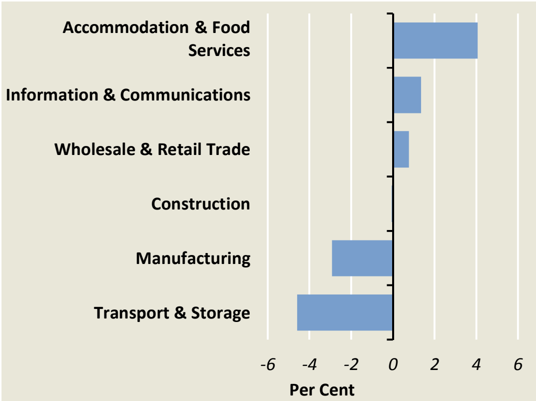
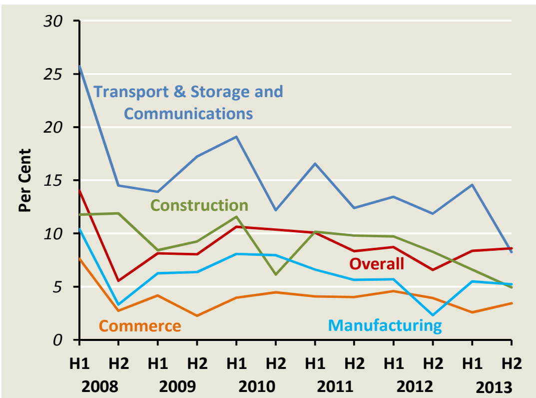



**Chart 3.24**
**Median Profit Margin of Listed Companies in Singapore (by Sector)**




Source: Thomson Reuters and EPG, MAS estimates

Note: Profit margin is defined as earnings before interest and taxes as a percentage of revenues.

# The Opportunities in Services

**There has been an increase in services activities in the Singapore economy …**

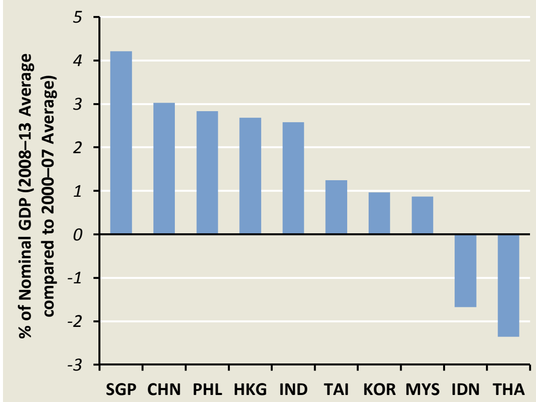
Global secular forces, coupled with the reconfiguration of the domestic manufacturing industry, are gradually changing the profile of economic activities in Singapore. One such shift is the rising importance of the services industry.

The gradual deepening of knowledge-based services expertise, a more highly educated workforce, as well as increasing fragmentation and digitisation has resulted in the increasing centrality of the services sector. Notably, over the 2008–13 period, most Asian economies have seen rising GDP shares for their services sectors, as compared to the pre-GFC period (2000–07). (Chart 3.25)

In Singapore, the economy has seen a trend increase in services over the past decade, with the sector accounting for over two-thirds of total output in 2013. (Chart 3.26) The shift in the Singapore economy towards services-oriented activities is also evident in trade. A decomposition of Singapore's trade data shows that over the past decade, services exports nearly quadrupled, buoyed by demand for financial services, business services, and tourism. From a broader perspective, a comparison with regional competitors indicates that Singapore's revealed comparative advantage[3] over the past decade resided in the provision of modern services. (Chart 3.27)

The acceleration of net investment commitments and foreign direct investment in Singapore's services sector further emphasises the rising importance of these activities within the domestic economy. Over the 2007–13 period, investment commitments in services surged by 28% per annum on average.

**Chart 3.25**
**GDP Share of Services in Asia**




Source: CEIC and EPG, MAS estimates

**Chart 3.26**
**Share of Services Versus Manufacturing in Singapore**

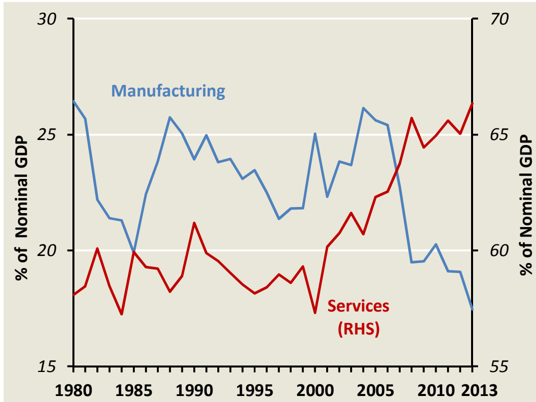
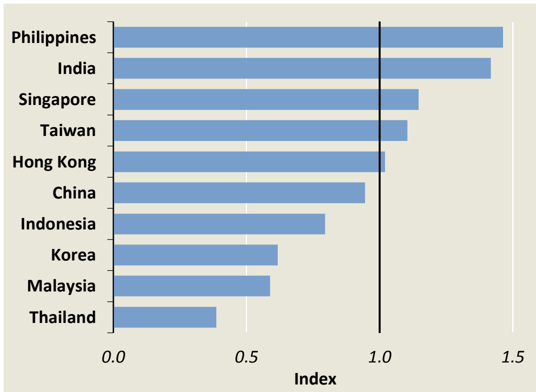



**Chart 3.27**
**Revealed Comparative Advantage in Modern Services*, 2011**




Source: WTO and EPG, MAS estimates

* Modern services refers to Financial, Telecoms, Computer & Information and Other Business Services.

3 The Revealed Comparative Advantage (RCA) Index shows the degree of trade specialisation of an economy. It is equal to the percentage of a country's exports of a specific good or service in its total export basket, divided by the equivalent percentage for a reference set of countries. Here, the reference group comprises Singapore, ASEAN-4, NIEs, China and India. An economy has a comparative advantage compared to its trading partners if its RCA is greater than 1.

### ... led by financial and business services.

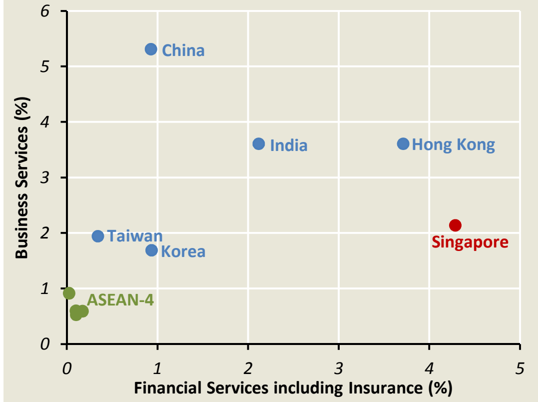
Among the regional economies, Singapore is one of the most orientated towards global demand for financial and business services. Using the share of global exports of financial and business services, Singapore ranks first and fourth, respectively. (Chart 3.28)

Further, a comparison with its regional neighbours shows that Singapore's revealed comparative advantages does lie in these sectors. (Chart 3.29) Singapore's competitiveness in business services stems largely from its attractiveness as a location for regional headquarters, while the financial services sector is anchored by many globally competitive clusters, including the fund management industry. Together, the domestic asset management and private banking segments recorded a stellar performance in 2013, expanding by 23.5% y-o-y and outpacing gains in the overall financial services industry. Rising affluence in the region continues to present opportunities for Singapore's fund management cluster. According to industry estimates, Asia Pacific is poised to be the world's largest market for high net worth individuals by 2015.[4] As a key financial services hub, Singapore will be able to capitalise on the growing appetite for wealth management services.

### Servicisation can also be seen within manufacturing.

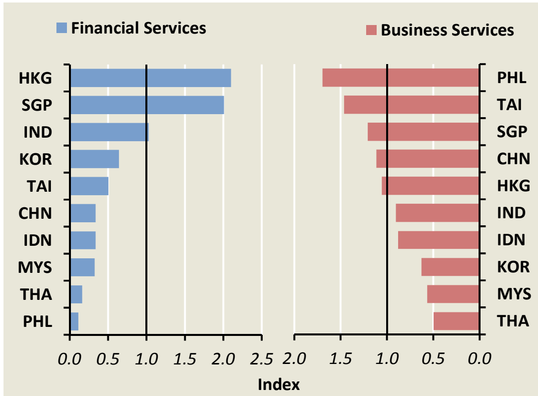
Not only are services sectors gaining greater importance as engines of economic growth, within manufacturing, multinational companies are also realigning their business operations to focus on delivering services complementary to the goods they produce. In fact, the shift towards a more services-based manufacturing sector is likely to accelerate in the coming years due to the higher profit potential of such activities. According to the *Global Service and Parts Management Benchmark Survey* by Deloitte Research, which polled more than 120 global manufacturers across the world, services accounted for almost half of their profits despite only accounting for a quarter of total revenues. (Chart 3.30)

**Chart 3.28**
**Share of Global Financial and Business Services Exports, 2011**



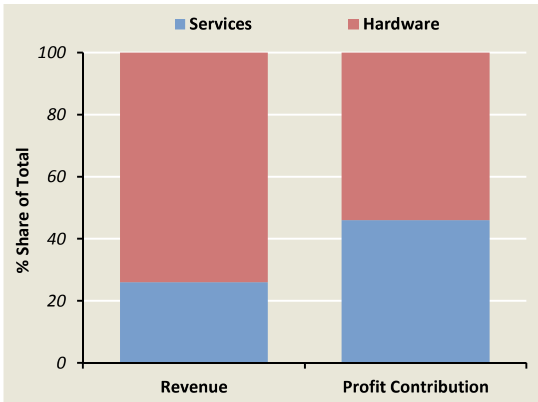

Source: WTO and EPG, MAS estimates

**Chart 3.29**
**Revealed Comparative Advantage in Financial Services and Business Services, 2011**




Source: WTO and EPG, MAS estimates

**Chart 3.30**
**Revenues and Profits of Global Manufacturers**




Source: Deloitte Research

4 Capgemini and RBC Wealth Management (2013), *World Wealth Report*.

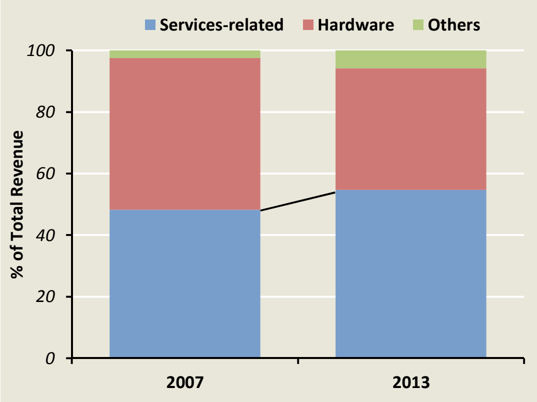
The global trend of servicisation has impacted manufacturing companies located in Singapore, especially IT-related producers. A breakdown of global revenues by the largest electronics firms in Singapore reveals that the share of total revenues accounted for by services-related activities rose from 48% in 2007 to 55% in 2013. (Chart 3.31)

**Servicisation within the global electronics industry is shifting the IT landscape.**

The increasing prevalence of services within the business models of IT companies is reshaping the global IT value chain. Upstream in the semiconductor segment, many US multinationals have adopted a fabless[5] business model focused on "design-only". Downstream in the consumer electronics segment, companies are increasingly generating revenue from software sales that are tied to the consumer electronics devices they produce. Traditional powerhouses in the PC industry, like IBM, have also relinquished their dominance in the hardware segment. Instead, they have turned towards services-related activities, such as Big Data and other types of analytics. In the data storage segment, the growing reliance on cloud-based applications by both consumers and corporates has also accelerated the pace of servicisation within the IT industry.

While a wider array of IT services portends new opportunities for the future development of the global IT industry, the lower hardware requirements of these new IT products has led to a slowdown in the growth of global chip sales. The average growth rate of global semiconductor sales volumes following the GFC was around a third of that before the crisis. (Chart 3.32) Contributing to this was the increasing centralisation of data storage, as cloud computing results in a slowdown in consumer and corporate demand for hardware, and the proliferation of smartphones and tablets with less hardware content and lower computing requirements. (Chart 3.33)

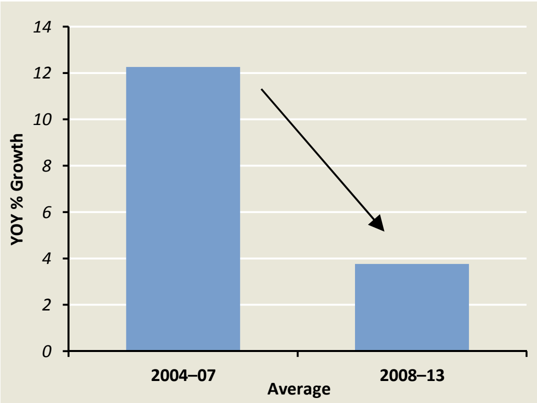
**Chart 3.31**
**Decomposition of Global Revenues of Largest Singapore-based IT firms**




Source: Company reports and EPG, MAS estimates

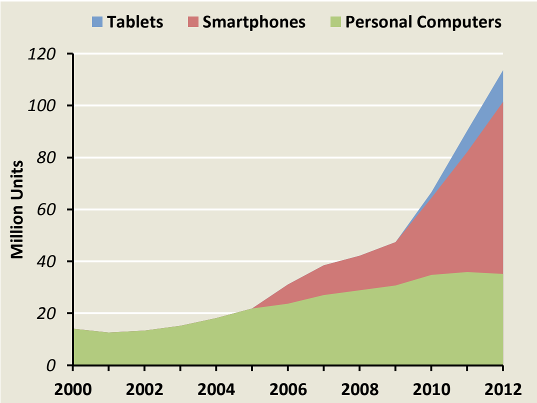
Note: The largest IT firms account for over 60% of domestic electronics output in 2012, according to DP Information Group Top 1000 Database.

**Chart 3.32**
**Volume of Global Chip Sales**




Source: WSTS and EPG, MAS estimates

**Chart 3.33**
**Global Shipments of IT Devices (by Type)**



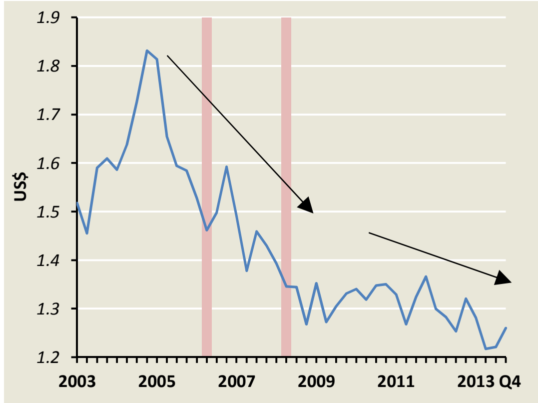

Source: Gartner, IDC, Strategy Analytics, company filings, BI Intelligence estimates

5 Fabless manufacturing refers to some semiconductor firms' business model of focusing on the design and sale of semiconductor chips, while the fabrication process of the manufacturing value chain is outsourced to specialised foundries.

Indeed, the decline in the prices of chips, reflecting technology improvements, as predicted by Moore's Law[6], has discernibly moderated in recent years. (Chart 3.34) A test for the presence of structural breaks suggests that there was a break in the trend decline of prices in Q2 2008, which coincided with the rise of smartphones and the demand for chips with lower computing power.[7]

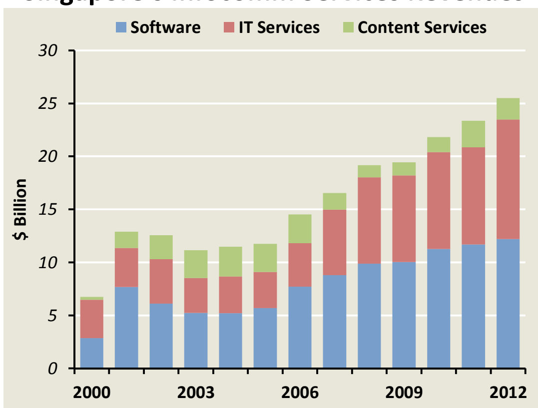
Nevertheless, over the longer term, the possible mass adoption of leading edge technologies—such as 3D printing, robotics and driverless cars—could give impetus to another wave of high growth in the IT sector. A more pervasive spread of these "killer applications" will come about as a result of Moore's Law applied across a broader range of processors, memory and sensors. Indeed, some commentators believe that when the exponential trend of computing power reaches the steepest part of the curve, the pace of innovation will be rapid and the impact on economic growth precipitous.[8]

**Chart 3.34**
**Average Selling Price of Integrated Circuits**




Source: Semiconductor Industry Association and EPG, MAS estimates

**Chart 3.35**
**Singapore's Infocomm Services Revenues**




**Singapore's IT and infocomm sectors are at the forefront of new demand for IT services.**

On the domestic front, the increasing commoditisation of IT hardware manufacturing could accelerate the servicisation of Singapore's IT sector in the near term. Cloud-based applications that extend the exportability of these services is expected to intensify in the coming years, and further increase demand for Singapore's infocomm services after a growth spurt in the second half of the 2000s. (Chart 3.35) In particular, firms which cater to data storage and management are likely to benefit the most. Providers of internet infrastructure and data storage based in Singapore currently meet more than 50% of the demand for data centre space in Southeast Asia.

6 According to Moore's Law, the amount of integrated circuit computing power that can be purchased for the same cost doubles every one to two years.

7 A Bai-Perron test was conducted to detect the presence of structural breaks over the period Q1 2003 – Q4 2013. The results rejected the null hypothesis of no structural breaks at the 5% significance level, with Q1 2006 and Q2 2008 as two possible break points. The Q1 2006 break point could have been due to supply-side expansions especially in China, which was fast becoming the dominant regional assembly hub for semiconductors.

8 Brynjolfsson, E and McAfee, A (2014), *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies*, W. W. Norton & Company.

**Trade liberalisation will stimulate growth in demand for Singapore's services exports.**

Imports of services globally increased from US$1.6 trillion in 2002 to US$4.3 trillion in 2012, recording an average annual growth rate of 10.5%. This not only reflected lower barriers in services trade with digitisation and information technology advancements, but concerted government efforts to improve cross-border flows. Since signing the Free Trade Agreement (FTA) in 1993 with ASEAN, Singapore's FTA network has expanded to over 20 regional and bilateral FTAs with 31 trading partners. With the conclusion of the latest FTA between Singapore and the European Union, Singapore now has FTAs with most of its major trading partners, thus providing companies with improved market access for services and government procurement opportunities, as well as enhanced investment protection. Such liberalisation of services trade has enhanced the prospects for Singapore's services by increasing the cross-border flow of trade and investment. This complements the trend of servicisation within Singapore's manufacturing sector by giving the sector's services exports greater market access. Together with innovation and investment within the sector, these developments will facilitate the continual transformation of the manufacturing sector so that it remains a key growth driver for the Singapore economy.

# 3.3 Labour Market

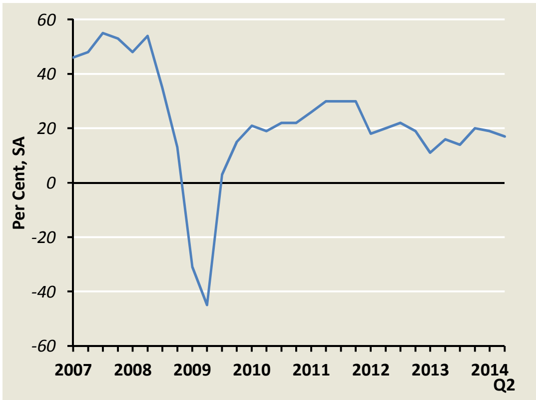
## Sustained Wage Increases amid Tight Labour Market

Robust demand for workers will continue to come up against tight labour supply, thereby exerting further upward pressures on wage growth. At the same time, productivity gains will be modest, reflecting in part the limited cyclical uplift expected this year, and will provide only a small offset to wage increases.

**Hiring intentions remain strong …**

Labour demand is expected to be firm, as the economic environment stays generally favourable. According to the latest ManpowerGroup Employment Outlook survey, hiring expectations for Q2 2014 improved in the external-oriented services sectors while remaining strong in the domestic-oriented sectors. Hiring sentiment, however, continued to be weak in the electronics industry amid the ongoing restructuring. Overall, the net employment outlook for Q2 2014 came in at 17%, slightly lower than in the previous two quarters but higher than the average of 15% for 2013 as a whole. (Chart 3.36)

**Chart 3.36**
**Net Employment Outlook**




Source: ManpowerGroup

**… in the domestic-oriented sectors and are improving in the external-facing services segments.**

External-oriented sectors, such as financial & insurance, wholesale trade and transportation & storage, are expected to increase headcount in tandem with an improvement in the economic environment. Job creation will also be boosted by capacity expansions of local shipyards.

Nevertheless, the domestic-oriented sectors will continue to underpin the bulk of employment gains. For example, the addition of 45 childcare centres and the completion of the Ng Teng Fong General Hospital this year will support hiring in the health & social services segment. At the same time, ongoing work at the Downtown MRT Line and Changi Airport Terminal 4, together with public housing projects and commercial developments such as South Beach, will boost demand for workers in the construction sector. The expected launch of Seletar Mall towards end-2014 will also increase employment opportunities in retail trade.

### However, tight labour supply will constrain employment growth ...

Despite strong hiring intentions, a large number of industries may continue to experience difficulties in filling positions due to the tight labour market. Indeed, the seasonally adjusted ratio of job vacancies per unemployed person reached an eight-year high of 1.44 in Q4 2013. Job vacancy rates rose in every sector in H2 last year, and all the services sectors, except Community, Social and Personal Services, recorded a larger proportion of vacancies left unfilled for at least six months. (Charts 3.37 and 3.38) Labour constraints could have become more pressing in the services sectors following the cut in the services Dependency Ratio Ceiling (DRC) from 45% to 40% and the services sub-DRC from 20% to 15% in July 2013.

This year, the inflow of foreign workers will be further tightened as more measures come into effect. In January 2014, the Q1 qualifying monthly salary for new employment pass applicants was raised from \$3,000 to \$3,300.[9] In addition, the grace period for the first round of DRC cuts introduced in July 2012 will expire in July 2014, so firms that exceed the lower DRCs will no longer be able to keep some of their existing foreign workers.[10] Foreign worker levies will also be increased across all sectors from July this year.

At the same time, the expansion in the resident labour force is likely to moderate given the record high labour force participation rate of 66.7% in 2013.

In sum, while companies have strong intentions to hire, the demand for workers will run up against a limited pool of labour, resulting in more moderate employment gains and stronger wage pressures in 2014.

### … and resident wage growth could face further upward pressures.

Overall resident wage growth rose considerably to 4.3% in 2013, from 2.3% in 2012. However, wage increments in the external-facing sectors, such as wholesale trade and financial & insurance, remained below their

**Chart 3.37**
**Job Vacancy Rates by Sector**

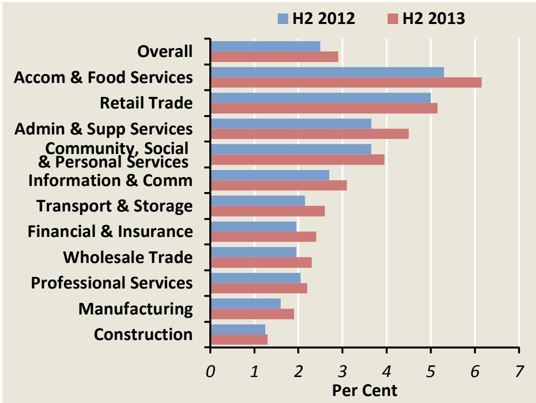
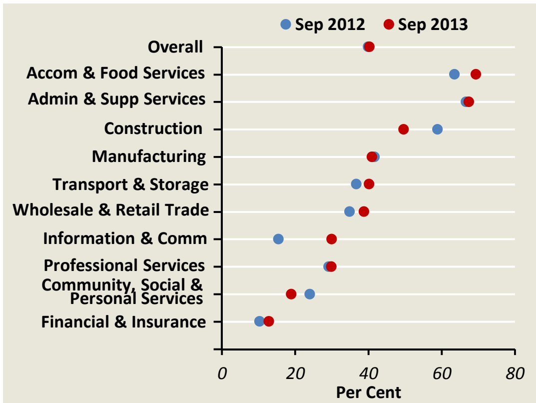



**Chart 3.38**
**Percentage of Vacancies Unfilled for At Least Six Months by Sector**




9 Older applicants will have to command higher salaries to qualify, commensurate with work experience.

10 The first round of DRC cuts was announced in Budget 2012 and came into effect from July 2012. The services sector saw a reduction in DRC from 50% to 45%, while the manufacturing sector DRC was cut from 65% to 60%. At the same time, the S Pass sub-DRC for all sectors was lowered from 25% to 20%.

respective historical averages, due to the sluggish external environment.

For the rest of this year, as labour supply constraints become increasingly binding and economic sentiment picks up in the external-oriented sectors, resident wage growth could see further upward pressures.

Meanwhile, productivity performance will be modest, given the expected moderation in GDP growth compared to 2013 as a whole, and the persistent weakness in trend productivity in the construction and services sectors. Coupled with the hikes in foreign worker levies, Unit Labour Cost will rise further in the near term, although government subsidies such as the Wage Credit Scheme will continue to provide some offset.

**Output growth has been driven by employment gains in the past decade ...**

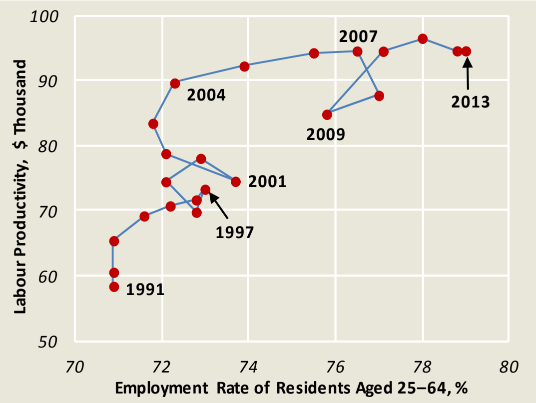
In the last few years, GDP growth has been led mainly by employment gains, especially for residents, as productivity growth was muted. Chart 3.39 shows the evolution of labour productivity levels and the employment rate (or employment-to-population ratio) of residents aged 25–64 over time.

In the 1990s, the upgrading of Singapore's industrial capacity resulted in significant improvements in productivity, but the resident employment rate did not go beyond 73%. In comparison, from 2004 to 2013, Singapore's resident employment rate rose by an unprecedented 6.7% points, alongside relatively small gains in productivity. While job creation was strong during this period, the employability of the resident workforce also improved, given the rise in the number of tertiary educated workers and the introduction of government measures, such as the Jobs Credit Scheme and the Special Employment Credit. (Chart 3.40)

**... but will have to be led by productivity growth in future.**

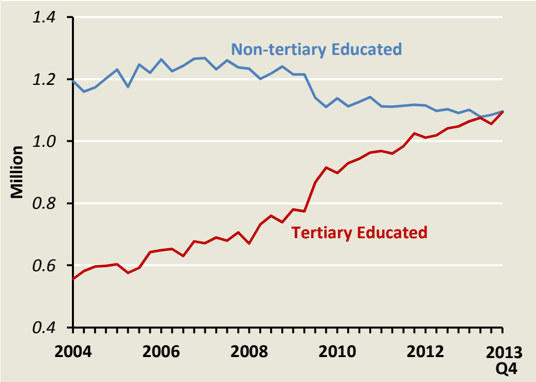
Going forward, the resident employment rate is unlikely to grow at the same pace as the last few years. Singapore's male employment rate is already higher than that of the OECD countries, with the exception of Switzerland. (Chart 3.41) Singapore's female employment rate is relatively low and has some scope to rise. (Chart 3.42) However, the increase will likely

**Chart 3.39**
**Labour Productivity and Resident Employment Rate**



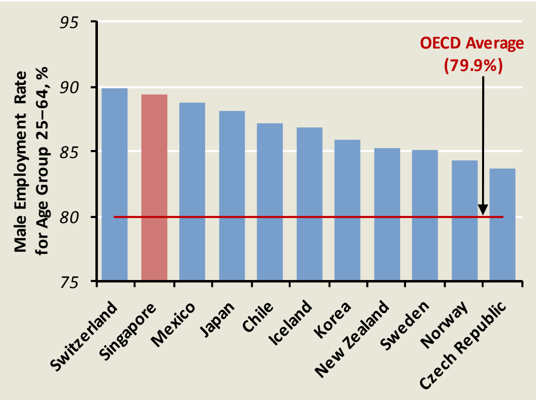

Source: EPG, MAS estimates

**Chart 3.40**
**Resident Labour Force by Educational Attainment**




Source: EPG, MAS estimates

**Chart 3.41**
**Male Employment Rates in Singapore and Top 10 OECD Countries**

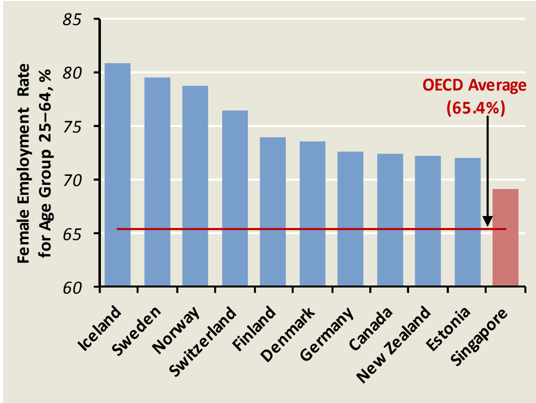



Source: OECD

be moderate, given the experience of other OECD countries. Chart 3.43 plots the average trajectory of the female employment rate in OECD countries that are ranked higher than Singapore in this indicator. Time *T* denotes the year just before these countries' female employment rates exceeded the latest reading of 69.2% for Singapore. The data shows that in the initial years before *T*, the female employment rate in the OECD countries rose sharply due to large numbers of women entering the labour force, typically in tandem with an increase in part-time and flexible work arrangements, and a change in their traditional role as homemakers. However, the female employment rate subsequently increased at a slower pace and even declined after reaching about 70%, as the marginal effect of the initial factors diminished.

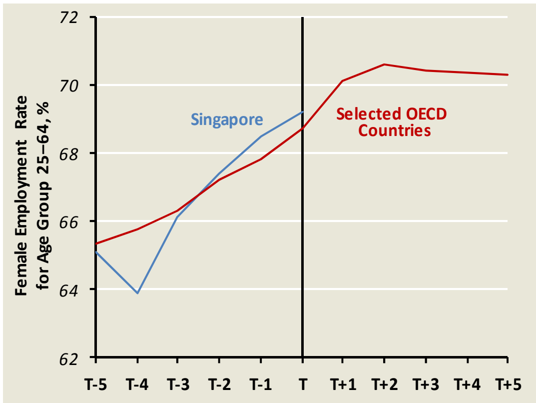
With the expected slowdown in the increase in the resident employment rate and the continued tightening of foreign worker inflows, growth of the Singapore economy will increasingly have to be met by productivity gains. Accordingly, the future trajectory of the labour productivity-resident employment line presented in Chart 3.39 could be towards the northeastern direction.

**Chart 3.42**
**Female Employment Rates in Singapore and Top 10 OECD Countries**




Source: OECD

**Chart 3.43**
**Female Employment Rate Trend**



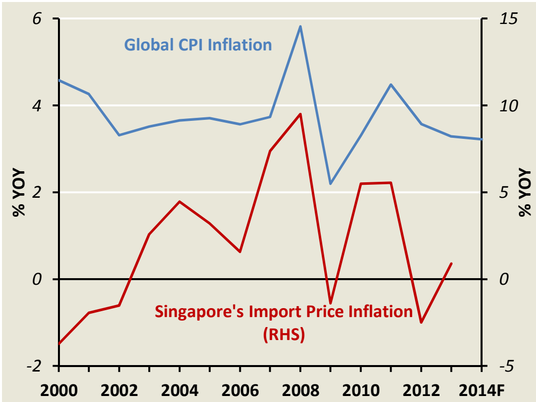

Source: OECD and EPG, MAS estimates

# 3.4 Inflation

## Domestic Cost Pressures Will Continue to be the Key Source of Inflation

EPG's overall assessment of underlying price dynamics in the economy remains broadly unchanged from the October 2013 policy review. Domestic business cost pressures are expected to persist and firms are likely to pass on accumulated costs, leading to broad-based price increases across the economy. While imported inflation has turned around, it is unlikely to add substantially to consumer prices.

**Chart 3.44**
**Global CPI Inflation and Singapore's Import Price Inflation**

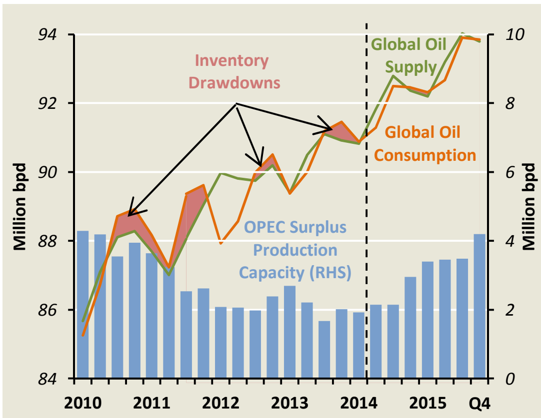



Source: IMF, DOS

### Price developments in most of Singapore's major trading partners will be benign.

On the external front, pockets of price pressures have emerged recently, partly reflecting the rationalisation of government subsidies in some neighbouring economies. However, inflation in other major trading partners is expected to remain generally subdued, given near-term growth uncertainties in the emerging economies and persistent labour market slack in the developed economies. Hence, overall imported inflation should remain modest. (Chart 3.44)

**Chart 3.45**
**Global Oil Consumption, Global Oil Supply and OPEC Surplus Production Capacity**




Source: EIA

Note: EIA defines OPEC surplus production capacity as the volume of production that can be brought on within 30 days and sustained for at least 90 days.

### Global oil prices are expected to decline slightly in 2014 …

In the commodity space, global oil prices are projected to edge down slightly in 2014, barring a severe deterioration in the geopolitical situation in the Middle East-North African (MENA) region and Ukraine.

Demand and supply in the oil market are likely to become more balanced as production recovers from the outages over the past year and North American oil production growth remains robust. (Chart 3.45) At the same time, the projected rise in OPEC's surplus production capacity in the coming quarters should provide the necessary buffer against any unexpected pickup in demand.

For 2014, the US Energy Information Administration (EIA) expects the West Texas Intermediate (WTI) benchmark oil price to average US$96 per barrel, down slightly from US$98 last year. Consequently, oil-related items are not expected to add to domestic inflation this year.

## … but global food prices could face some upward pressures.

In the food commodity segment, there are increasing signs that an El Niño weather phenomenon will occur in the second half of this year. El Niño is often associated with below-normal rainfall in Southeast Asia, Australia, India and West Africa, which would raise the prices of grains, including wheat, corn and rice, as well as oilseeds, such as soybean.

Nonetheless, sufficient supply buffers should cap the impact on global food commodity prices. The current stocks-to-use ratios for most food commodities are higher than those prevailing before the last El Niño episode in 2007–08, following the build-up in inventories over the past few years. (Chart 3.46) In particular, the price of rice, an important staple in the region, will come under downward pressure in the next few quarters as Thailand is expected to release a large portion of its stockpile onto the market. Hence, the impact of El Niño on domestic food prices is likely to be more modest this time round.

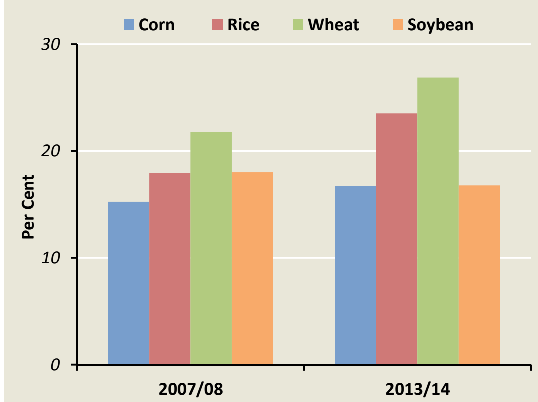
At the same time, further rationalisation of government subsidies in Malaysia and Indonesia could result in higher import prices of selected food items, such as live animals, cereal products, vegetables and beverage products & spices, given Singapore's dependence on these two import sources. (Table 3.2)

Taking these factors into account, domestic non-cooked food prices could rise at a slightly stronger pace in H2 2014 compared to the same period in the last two years. Meanwhile, cooked food prices will continue to be driven by domestic cost increases. For 2014 as a whole, domestic food inflation is expected to come in slightly above the 2.5% average over the last three years.

## Domestic business cost pressures will continue to build and pass through more strongly into consumer prices.

Given sustained labour demand in the domestic-oriented sectors and more binding constraints in hiring foreign workers, resident wage growth should remain firm this year. With productivity growth likely to provide only a modest offset, the Unit Labour Cost is expected to rise by another 3% in 2014. (Chart 3.47)

**Chart 3.46**
**Stocks-to-use Ratios for Major Food Commodities in the Year Before the Onset of El Niño**



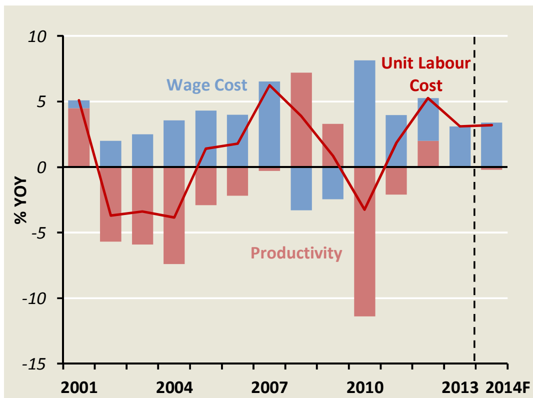

Source: US Department of Agriculture

**Table 3.2**
**Ranking of Malaysia and Indonesia in Singapore's Food Import Sources, 2010–12**

| | Food Import Source Ranking (Import Share) | |
|---|---|---|
| | Malaysia | Indonesia |
| Live animals | 1 (78%) | 2 (12%) |
| Cereal products | 1 (19%) | 9 (2.1%) |
| Seafood | 1 (14%) | 2 (14%) |
| Vegetables | 2 (19%) | 4 (10%) |
| Beverages & spices | 2 (16%) | 1 (20%) |
| Dairy products | 3 (16%) | 12 (1.1%) |

Source: UN Comtrade

**Chart 3.47**
**Contribution to Changes in Unit Labour Cost***




* Productivity growth has the opposite sign due to its dampening effect on ULC.

Businesses, in turn, are likely to pass on some of the accumulated increase in ULC to consumers amid generally supportive economic conditions. Indeed, cost pass-through will be even stronger if not for government measures such as the Wage Credit Scheme and Productivity & Innovation Credit (PIC), as well as other cash grants and tax rebates, which help to offset firms' operating and development expenditures. Based on EPG's simulations, these fiscal measures collectively lowered the CPI by 0.05% in 2011–12 and 0.13% in 2013. The restraining effect in 2014–16 is estimated to be slightly larger than that in 2013, given the enhancement to these assistance schemes in the recent Budget.

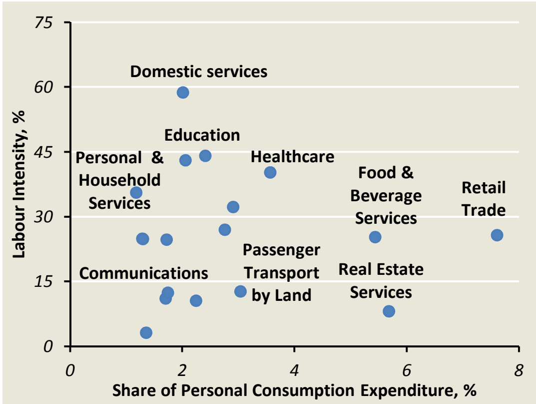
As mentioned in Section 3.2, consumer-facing services sectors are generally more sensitive to a change in labour cost, given their greater reliance on manpower. Chart 3.48 shows the labour intensities of the consumer-facing services sectors at a more disaggregated level, using detailed data from the 2007 Input-Output Tables, as well as their respective shares in households' consumption expenditures. Notably, price increases, led by higher labour cost, in the food & beverages and retail trade segments, will impact consumers more, given their relatively high weights in household consumption expenditure.

This year, overall services inflation is expected to come in at around 2.5%, comparable to that in 2013, as government administrative measures raised selected services fees last year but are expected to lower other services costs in 2014.[11] (Chart 3.49) Underlying services cost inflation, abstracting from the influence of government measures, would be around 0.5% point higher in 2014 compared to 2013.

### Notwithstanding near-term volatility, car prices are expected to add negligibly to inflation in 2014 …

COE premiums could remain volatile in the coming months as the market continues to adjust to changes in the vehicle quota system, including the re-categorisation of COEs and the shorter recycling

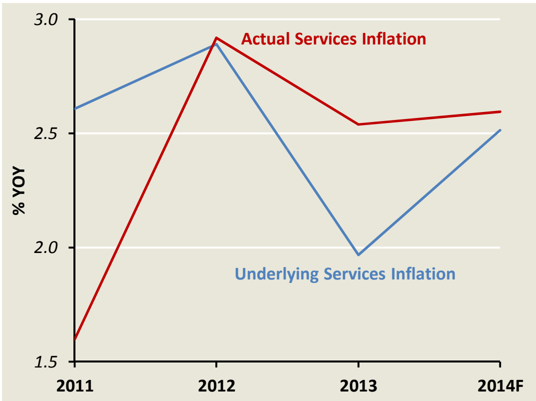
**Chart 3.48**
**Labour Intensity* and Share in Personal Consumption Expenditure**




Source: 2007 Input-Output Tables, DOS

* Labour intensity is computed as labour cost as a per cent of total output value for the sector.

**Chart 3.49**
**Actual and Underlying Services Inflation**




Source: EPG, MAS estimates

11 In 2013, a mandatory weekly rest day for foreign domestic workers resulted in an increase in the cost of household services, while medical insurance premiums rose after MediShield coverage was enhanced. In 2014, there are several enhancements to government subsidies for independent school education, kindergarten education and specialist outpatient treatment under the Pioneer Generation Package.

period.[12] Meanwhile, COE quotas are expected to increase over 2014 on account of higher de-registrations as a larger number of cars approach the end of their 10-year COE period.[13] (Chart 3.50)

On balance, COE premiums are expected to be slightly lower in the second half of the year. Based on this, the contribution of car prices to overall inflation will be minimal in 2014.

**… while housing rentals will continue to soften.**

Residential property rentals should continue to moderate, given weaker demand arising from slower inflows of foreign workers and a significant supply of newly completed housing units coming on-stream. For example, an average of 22,255 private residential units is expected to be completed in 2014 and 2015, which is 76% higher than the average annual increase in the preceding four years. In the HDB segment, the pace of flat completions will also accelerate, easing the latent demand for rental units.

Imputed rentals on owner-occupied accommodation are now expected to stabilise in 2014 and add negligibly to overall inflation, following the 0.8% point contribution in 2013.

**Pressures on core inflation will be stronger than those on overall CPI inflation in the next few quarters.**

For the rest of the year, underlying inflation will remain firm with sequential core price increases expected to stay slightly above its historical average. (Chart 3.51) On a year ago basis, core inflation could rise to around 2.5% in H2 2014. (Chart 3.52)

In comparison, the rise in the overall CPI will be more moderate, dragged down by the weakness in COE premiums and housing rentals. On a sequential basis, CPI-All Items inflation will likely come in lower than the 10-year average of 0.7%. On a y-o-y basis, CPI-All Items inflation will be volatile. After averaging 1.0% in Q1 this year, it could surge to 2.5–3% in Q2 due to the exceptionally low base a year ago when COE premiums corrected, before easing to below 2% in Q4.

**Chart 3.50**
**Number of Cars Aged 9–10 Years as of End of Period**

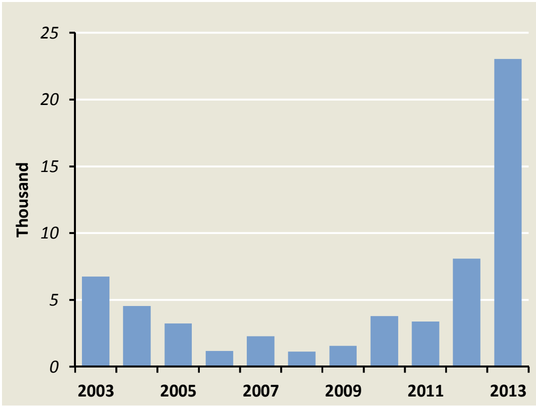



**Chart 3.51**
**Sequential Q-O-Q CPI Inflation Forecasts**

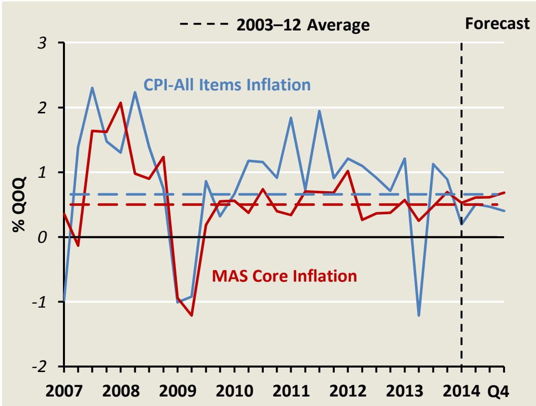
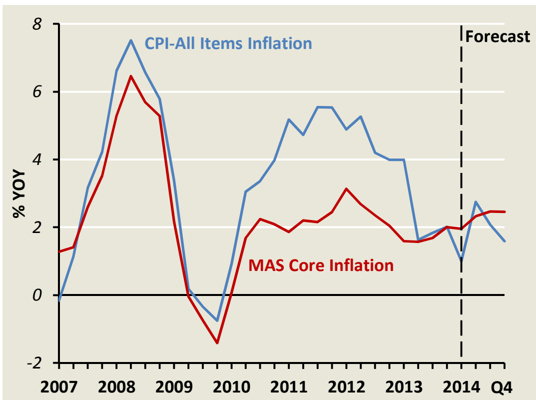



**Chart 3.52**
**CPI-All Items Inflation and MAS Core Inflation Forecasts**

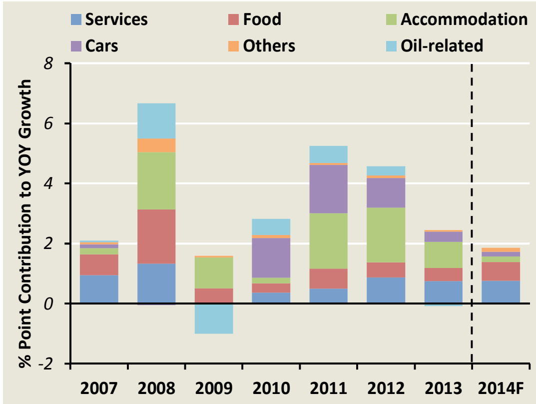



12 Since February 2014, the COE quota has been determined every three months, taking into account the number of vehicles de-registered in the preceding three months. Previously, quotas were set every six months, based on the number of vehicles de-registered in the previous six months.

13 The COEs for cars will be raised by 42% for the May to July 2014 quota period, compared to Feb–Apr 2014.

For the year as a whole, MAS Core Inflation is expected to rise from 1.7% in 2013 to 2–3% in 2014. The 2014 forecast for CPI-All Items inflation has been lowered to 1.5–2.5%, from 2–3% previously, mainly as a result of the weaker outlook for imputed rentals over the rest of the year. (Chart 3.52) Services fees will account for around two-fifths of overall inflation, while food items will contribute about a third. (Chart 3.53)

**Chart 3.53**
**Contribution to Annual CPI-All Items Inflation**



# 3.5 Assessing the Macroeconomic Policy Mix

## Monetary Policy

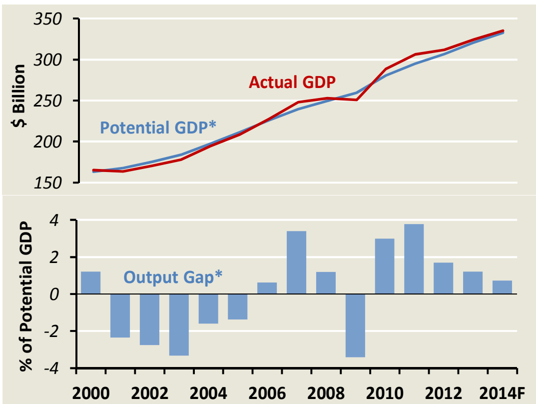
**The monetary policy stance was maintained in April 2014 as core inflation is expected to pick up and stay elevated.**

Following the robust expansion of 6.1% q-o-q SAAR in Q4 2013, GDP growth eased to 0.1% in Q1 2014, as manufacturing and trade-related activities turned sluggish. Demand for Singapore's exports moderated, reflecting temporary weather-related disruptions in the US and a soft patch in the Chinese economy. In addition, growth in the financial services sector slowed, as risk appetite waned given uncertainties surrounding the tapering of asset purchases by the US Federal Reserve and geopolitical disturbances in Ukraine.

Notwithstanding the weak Q1 outturn or the prospect of further bouts of financial market jitters, the factors underpinning a continued expansion of the Singapore economy remain intact. The outlook for global growth has improved, anchored by the recovery in the advanced economies, in particular, the US and Eurozone. This, alongside a modest turnaround in the global IT cycle, should provide a lift to regional demand and thereon to Singapore's trade-related industries. Domestic-oriented sectors, including community, social & personal services, and construction, are expected to remain firm, supported by ongoing capacity expansions in the healthcare and education segments. However, overall GDP growth could be constrained by continued tightness in the labour market. For 2014, Singapore's GDP is projected to grow by a moderate 2–4%. Against the backdrop of high levels of resource utilisation, the output gap should remain positive but will narrow slightly in 2014. (Chart 3.54)

CPI-All Items inflation has moderated in y-o-y terms since Q4 2013, largely because of the fall in COE premiums and the slower rise in imputed rentals on owner-occupied accommodation. In comparison, MAS Core Inflation picked up to average 2.0% in Q4 2013 – Q1 2014, compared to 1.6% in the first three quarters of 2013, as businesses continued to pass on accumulated cost increases to a wide range of consumer prices. Imported inflation also edged up

**Chart 3.54**
**Real GDP and the Output Gap**




* EPG, MAS estimates.

in domestic currency terms towards the end of 2013 and in early 2014, as the S$NEER weakened.

Given supply buffers for food and oil commodities, external price pressures are expected to be generally benign. In comparison, core inflation is likely to continue its rise and remain elevated due to stronger cost pass-through. With wage growth expected to hold firm and productivity growth modest, Unit Labour Cost will rise. Amid generally supportive economic sentiment, businesses will continue to pass on accumulated wage and other business costs, to consumer prices. Consequently, sequential core inflation could slightly exceed its historical trend. For 2014 as a whole, MAS Core Inflation is forecast to rise to 2–3% from 1.7% in 2013.

COE premiums could be volatile in the coming months, but are likely to fall in the latter half of the year as the COE supply is expected to rise on account of the larger number of vehicle de-registrations. Meanwhile, market rentals could ease further as more new homes are completed and foreign worker inflows continue to slow this year. As a result, imputed rentals on owner-occupied accommodation are expected to stabilise over 2014, following the recent sharp moderation in its pace of increase. MAS has thus lowered the forecast for CPI-All Items inflation in 2014 to 1.5–2.5% from 2–3% previously.

Aggregate demand in the Singapore economy is expected to rise in line with the pickup in the global economy. At the same time, domestic supply-side constraints should remain binding amid this transitional phase in economic restructuring. The level of economic activity is thus expected to expand at a moderate pace, while core inflation will rise and stay elevated over the year. MAS therefore announced on 14 April 2014 that it would maintain the modest and gradual appreciation of the S$NEER policy band, with no change to the slope, width, and level at which it was centred.

This policy stance was assessed to be appropriate for containing price pressures emanating from both imported and domestic sources, anchoring inflation expectations, and ensuring medium-term price stability as a basis for sustainable growth.

# Fiscal Policy

### Budget 2014 focused on pioneer generations and opportunities for the future.

Budget 2014 was delivered against the backdrop of a gradually improving global economy. The recovery in the G3 has been gaining traction, even as some fragilities and risks remain in Asia ex-Japan. Domestically, as the economy continues to restructure and transit to productivity-led growth, labour market constraints will become more binding and unit business costs could rise.

While previous Budgets provided some short-term support for firms and households facing temporarily higher costs, Budget 2014 focused on reinforcing the key directions in economic and social strategies set out in previous budgets: first, helping firms and the economy to restructure by providing incentives for capital deepening, innovation and the upskilling of the workforce; and second, enhancing social safety nets, in particular for the pioneer generation, and sustaining social mobility, so as to ensure a fair and equitable society. Table 3.3 below summarises the key measures of Budget FY2014.

### The Budget continued to emphasise the transformation of the economy ...

Since restructuring efforts began in 2010, past Budget measures have had some success in realigning factor prices to reflect the true cost of scarce resources in Singapore. As foreign worker levies rose, firms have begun to adjust their behaviour and the pace of foreign worker intake has slowed. Amid the general tightening in labour market conditions, firms have started adopting greater automation and re-organising their processes to reduce labour intensity. The take-up rate of the Productivity & Innovation Credit (PIC) scheme increased in 2013, while many firms have also benefited from the three-year Transition Support Package introduced in Budget 2013.[14]

### ... by providing sharper incentives for productivity investments and business transformation ...

Budget 2014 emphasised identifying and tackling micro-level hurdles to productivity-driven growth. For instance, entrenched processes in the construction industry and continued reliance on low-skilled foreign labour have made restructuring in the sector slow. Meanwhile, small and medium sized enterprises (SMEs) have likely been limited by scale and other market externalities, and have been unable to fully tap on available government measures to become more efficient and move up the value chain. The fact that SMEs and the construction sector account for 70% and 14% of the workforce, respectively, imply that they carry considerable weight in the successful restructuring of the economy.

In the construction and building industry, Budget 2014 introduced system-wide changes to encourage the adoption of manpower saving technologies and to upgrade the skills of workers. For example, developers submitting bids for selected Government Land Sales sites will be evaluated on their intended usage of productive technologies, while a new foreign manpower scheme for the construction sector will help firms retain their experienced foreign workers and upskill their workforce. Concomitantly, the Budget also announced higher levies for lower-skilled Work Permit Holders (WPH) in the construction sector from 2016, so as to continue dis-incentivising the hiring of less skilled foreign workers.

Notably, Budget 2014 extended the PIC scheme, a major support for productivity-enhancing investments, to YA2018. The introduction of the new PIC+ scheme provides additional support to SMEs which are making more substantial investments to transform their business.

[14] The 3-Year Transition Support Package (TSP) introduced in Budget 2013 aims to help businesses restructure and share productivity gains with their workers. The three planks of the TSP are the Wage Credit Scheme, Productivity & Innovation Credit (PIC) Bonus and Corporate Income Tax (CIT) Rebate. These measures are respectively targeted at firms that raise the wages of Singaporeans, invest in productivity-enhancing initiatives and are profitable.

Through the ICT for Productivity and Growth (IPG) programme, the Information Development Authority aims to help 10,000 SMEs adopt sector-specific IT solutions over the next three years, up from the 500 firms that have benefited thus far. Apart from subsidies for such expenditures, the adoption of proven IT solutions will help to significantly reduce the information costs to firms arising from the search and testing of alternatives. In addition, initiatives by the Jurong Town Corporation to cluster industries will allow SMEs to secure affordable industrial space and enjoy economies of scale through the pooling of resources across businesses.

**... and supporting the broader shift towards higher innovation and skill levels.**

Besides capital deepening, there is also a need for human capital and total factor productivity to rise in tandem with capital investment, such that overall capital efficiency is not diminished. In this respect, Budget 2014 went beyond making relative price changes to encouraging firms to fundamentally change processes and behaviours, and to innovate. For example, to incentivise research and development activities in Singapore, Budget 2014 extended the 50% additional tax deduction on qualifying R&D expenditure for 10 years. Meanwhile, cognisant of the financing needs of young enterprises and rapidly-growing SMEs, given the uncertain payoffs from developing new products and markets, Budget 2014 enhanced risk-sharing mechanisms in several schemes to help SMEs overcome the higher hurdle rate of investment. These schemes include the Internationalisation Finance Scheme, Micro-Loan Programme and Phase 2 of the Co-Investment Programme.

Finally, the Budget also topped up the Lifelong Learning Endowment Fund, which the revamped Continuing Education & Training (CET) programme will utilise to support the upskilling of workers on a continuous basis. The new CET programme will put in place a framework that will raise the quality of human capital over the long term and eventually facilitate the transformation of the economy.

**Budget 2014 rolled out measures to build a fairer and more equitable society …**

Budget 2014 also built on previous measures to raise social mobility and re-distribute the fruits of economic success more equitably. The centrepiece of the Budget was the Pioneer Generation Package (PGP), targeted at Singaporeans aged 65 and above in 2014. With $8 billion set aside for the Pioneer Generation Fund, the package will be fully funded out of the FY2014 budget, and will benefit approximately 450,000 Singaporeans for the rest of their lives. Apart from the pioneer generation, the Budget also provided measures to make healthcare more affordable for all Singaporeans. For instance, subsidies at specialist outpatient clinics for lower- and middle-income Singaporeans were raised, while the employer CPF contribution rate will be increased by 1% point for all workers from 2015, to be channelled to the Medisave Account. Older citizens who do not benefit from the PGP will also receive annual CPF Medisave top-ups for the next five years.

Budget 2014 made a special effort to allocate more resources to children from disadvantaged backgrounds. Following last year's measures to raise the affordability, quality and capacity of pre-school education, this year's budget sought to subsidise kindergarten education for lower- and middle-income families. Empirical studies, such as Heckman and Masterov (2007), show that early intervention enables disadvantaged children to attain significantly better socio-economic outcomes over their lifetimes, with notable spillover benefits to long-term productivity performance.[15] Levelling the playing field for children could also pre-empt the long-run negative consequences of a decline in inter-generational mobility.

**… but tailored these policies to the disparate types of households.**

In line with past Budget measures on social initiatives, Budget 2014 carefully differentiated between the different types of lower-income and needy households in Singapore. The PGP targets

15 Heckman, J and Masterov, D (2007), "The Productivity Argument for Investing in Young Children," *NBER Working Paper* No. 13016.

the oldest cohort of Singaporeans who are estimated to have very low levels of savings and limited ability to work, and who make up a significant proportion of the lower-income households in Singapore. At the same time, the Progressive Wage Model, coupled with recent increases in Workfare, has sharpened the incentives for younger low-income workers to upgrade their skills and earn higher wages. For middle-aged workers on the cusp of retirement, the increase in the employer CPF contributions in the FY2013 and FY2014 Budgets will encourage them to remain in the workforce for longer and build up their retirement savings. (Chart 3.55)

**The government's social spending has increased in line with its shifting priorities.**

In line with these and previous social initiatives, total expenditure on social development has risen from $15.9 billion in FY2008 to a projected $27 billion in FY2014. The bulk of the increase is due to healthcare and education. (Chart 3.56) Spending on social development has also become the largest component of government expenditure—the share of social development expenditure has increased from 42% in FY2008 to 48% in FY2014. (Chart 3.57)

**Chart 3.55**
**Employer CPF Contribution Rates by Age**

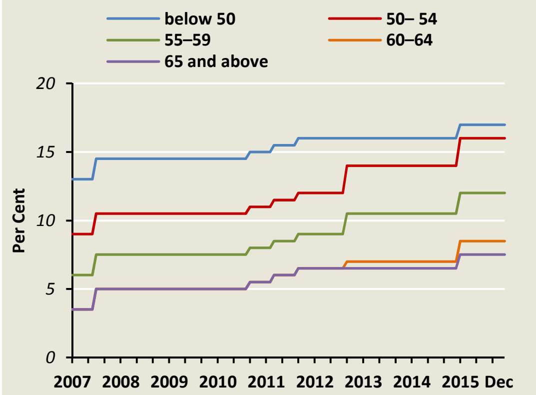



**Chart 3.56**
**Total Expenditure on Social Development**

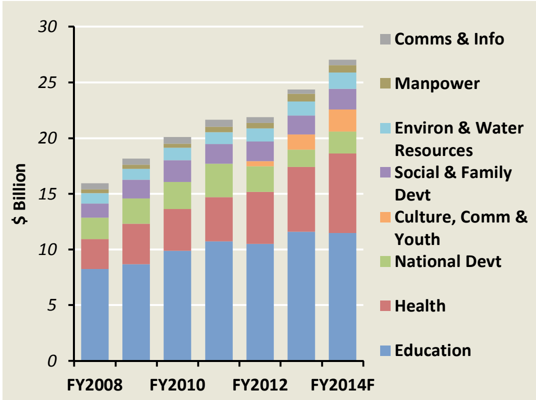



**Chart 3.57**
**Components of Total Expenditure**

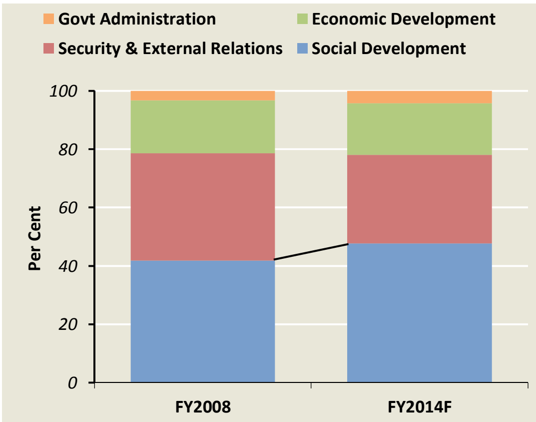


**Table 3.3**
**Key Initiatives of the FY2014 Budget: "Opportunities for the Future, Assurance for our Seniors"**

**Transforming our Economy**

*Supporting Innovation and Skills*
- Extension and Enhancement of the Productivity and Innovation Credit (PIC) Scheme ($3.6 billion over three Years of Assessment (YAs))
- Extension of the Research & Development (R&D) Tax Deductions Scheme
- Extension of the Writing Down Allowance Scheme for Intellectual Property Rights
- Extension and Enhancement of the Land Intensification Allowance (LIA) Scheme
- Top-up to the Lifelong Learning Endowment Fund ($500 million)

*Adopting ICT Solutions to Increase Productivity*
- ICT for Productivity and Growth (IPG) Programme ($500 million over three years)

*Catalysing Investment in Growth Enterprises*
- Co-Investment Programme Phase II (up to $150 million) and Enhancement of the Micro-Loan Programme

*Seizing Growth Opportunities Overseas*
- Enhancement of Internationalisation Finance Scheme
- Enhancement of the Global Company Partnership Programme

*Improving Productivity in the Construction Sector*
- Upstream Measures to Tackle Construction Productivity
- Increase in Buildability-score and Constructability-score for Private Sector Projects
- Increase in Foreign Worker Levies for "Basic Skilled" (R2) Work Permit Holders
- Introduction of Market-Based Skills Recognition Framework
- Extension of Period of Employment for "Higher Skilled" (R1) Work Permit Holders

**A Fair and Equitable Society**

*Promoting Social Mobility*
- Enhancement to Kindergarten Fee Assistance Scheme
- Increase in bursaries for students in Institutes of Higher Learning

*Enhancing Healthcare Affordability*
- Permanent MediShield Life subsidies for lower- and middle-income groups; subsidies will also be provided to offset premium increases for the first few years
- Increase in Specialist Outpatient Clinic (SOC) subsidies for lower- and middle-income Singaporeans
- A 1% point increase in employer CPF contribution rate for all workers, channelled to the Medisave Account
- More flexible use of Medisave for elderly Singaporeans

*Honouring our Pioneer Generation*
- The Pioneer Generation will receive support for their healthcare needs for the rest of their lives
    - Additional subsidies for outpatient care
    - Annual Medisave top-ups of $200 to $800 for all in the Pioneer Generation
    - Additional MediShield Life subsidies starting from 40% at age 65, rising to 60% at age 90
- An $8 billion Pioneer Generation Fund will be set up to meet the full estimated cost of the Pioneer Generation Package over time

*Further Help for Older Singaporeans*
- A 5-Year CPF Medisave Top-Up ($440 million) for Singaporeans aged 55 and above, and who do not enjoy Pioneer Generation Benefits
- Increase in CPF contribution rates for older workers
    - Temporary Employment Credit (TEC) and enhanced Special Employment Credit (SEC) to help businesses offset the increase in CPF contribution rates for workers

*Greater Support for Persons with Disabilities*
- Enhancement to subsidies for the Early Intervention Programme for Infants and Children (EIPIC) subsidies to make transport more affordable for the disabled community
- Enhancement of handicapped dependant reliefs

*Additional Support for Singaporean Households*
- One-off GST Voucher – Cash: Seniors' Bonus to help seniors with their cost of living ($170 million)
- One-off GST Voucher – U-Save Special Payment ($110 million)
- One-off Service and Conservancy Charges (S&CC) Rebates ($80 million)

*Other Measures*
- Top-up to the Lifelong Learning Endowment Fund ($500 million)

**Table 3.4**
**Budget Summary**

| | FY2013 Revised | | FY2014 Budgeted | |
|---|---|---|---|---|
| | **$ Billion** | **% of GDP** | **$ Billion** | **% of GDP** |
| Operating Revenue | 57.1 | 15.5 | 59.5 | 15.3 |
| Total Expenditure | 52.3 | 14.2 | 56.7 | 14.6 |
| Operating Expenditure | 40.4 | 11.0 | 42.9 | 11.0 |
| Development Expenditure | 11.9 | 3.2 | 13.8 | 3.5 |
| **Primary Surplus/Deficit (–)** | **4.8** | **1.3** | **2.8** | **0.7** |
| Less: Special Transfers (excluding top-ups to endowment/trust funds) | 3.2 | 0.9 | 3.6 | 0.9 |
| **Basic Surplus/Deficit (–)** | **1.6** | **0.4** | **(0.8)** | **(0.2)** |
| Add: Net Investment Returns Contribution | 7.9 | 2.1 | 8.1 | 2.1 |
| Less: Special Transfers (top-ups to endowment/trust funds) | 5.6 | 1.5 | 8.5 | 2.2 |
| **Overall Budget Surplus/Deficit (–)** | **3.9** | **1.1** | **(1.2)** | **(0.3)** |

## A small budget deficit is projected for FY2014.

In FY2014, the government is projected to post an overall budget deficit of $1.2 billion or 0.3% of GDP. (Table 3.4 and Chart 3.58) The basic balance, which is the primary balance less special transfers, but not taking into account top-ups to endowment and trust funds, is projected to be a slight deficit of $0.8 billion compared to a surplus of $1.6 billion in the previous year. This is largely due to the expected increase in operating and development expenditure.

Excluding top-ups to endowment and trust funds, the government is projected to disburse $3.6 billion in special transfers, primarily in the form of Wage Credit Scheme and PIC scheme payouts for businesses, as well as the one-off GST Voucher Special Payment and one-off S&CC rebates for households. Meanwhile, top-ups to endowment and trust funds will rise slightly from $7.9 billion in FY2013 to $8.1 billion in FY2014, the bulk of which is for the set-up of the Pioneer Generation Fund.

## The Fiscal Impulse measure indicates a slightly expansionary stance in CY2014.

The fiscal policy stance, as represented by the Fiscal Impulse (FI) measure, is expected to be only mildly expansionary in CY2014. (Chart 3.59) This is mainly due to increases in expenditure on infrastructure and larger transfers to businesses in the second year of the three-year Transition Support Package.

**Chart 3.58**
**Components of the Budget**

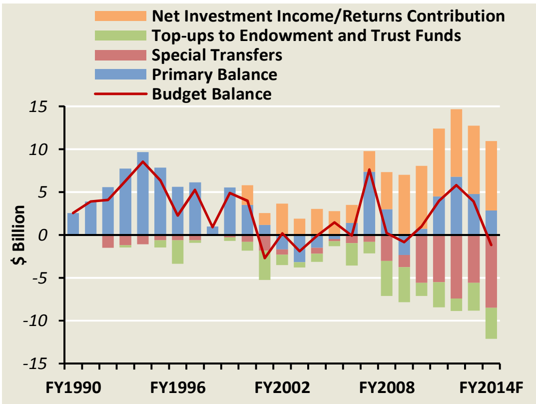
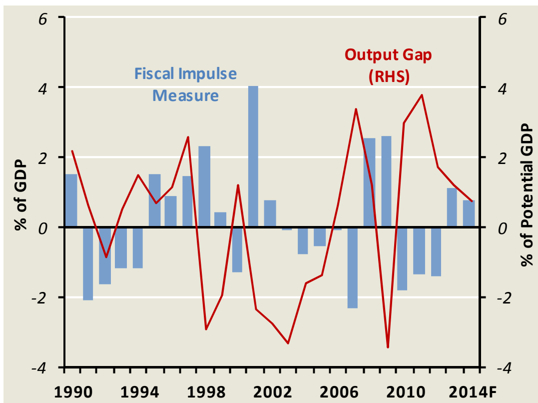



**Chart 3.59**
**Fiscal Impulse Measure and the Output Gap**



While the FI measure provides an indication of the short-term aggregate demand stimulus arising from fiscal policy, it does not fully quantify the impact of the Budget on the economy. To assess the effects of Budget FY2014 on the economy, EPG simulated some of the key budget measures using the Monetary Model of Singapore (MMS). (Table 3.5)

The macroeconomic impact of the Budget is reported in Table 3.6. GDP growth in 2014 would increase by 0.14% point from the baseline as the various subsidies and transfers to households enhance their disposable incomes and result in higher private consumption. The inflationary effects from the additional household spending will mainly be felt in 2015 due to lags in the transmission mechanism.

The measures for firms will provide some temporary relief against increasing labour costs and also support innovation and skills upgrading. These measures, which follow from similar initiatives in previous Budgets, will help to anchor medium-term growth, with GDP growth in 2016 about 0.13% point higher than baseline.

Overall, the FY2014 Budget measures are estimated to have a small impact on GDP growth and inflation in 2014.

**Table 3.5**
**Budget FY2014 Measures Simulated in MMS**

$ million

| Measures | CY 2014 | CY 2015 |
|---|---|---|
| ***Measures for Households*** | | |
| Education Subsidies and Bursaries | 125 | 167 |
| PGP Outpatient Subsidies & Medisave Top-ups | 161 | 397 |
| 5-Year CPF Medisave Top-ups | 67 | 133 |
| One-off GST Voucher – Cash: Seniors' Bonus | 170 | - |
| One-off GST Voucher – U-Save Special Payment | 83 | 27 |
| Enhanced Parent Relief & Support for Persons with Disabilities | 23 | 57 |
| ***Measures for Firms*** | | |
| PIC & IPG Programme | - | 1,367 |
| TEC & one-year increase in SEC | - | 360 |
| Extension of R&D Tax Allowance and Writing Down Allowance Schemes | - | 560 |
| CIP Phase II | 120 | 160 |
| ***Measures affecting both Households & Firms*** | | |
| Higher CPF Rates | - | 690 |
| **Total** | **749** *(0.2% of nominal GDP)* | **3,918** *(1.0% of nominal GDP)* |

Source: EPG, MAS estimates

**Table 3.6**
**Impact of Selected Budget Measures on GDP Growth and CPI-All Items Inflation**

% point deviation

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| GDP Growth | 0.14 | −0.02 | 0.13 |
| CPI-All Items Inflation | 0.01 | 0.14 | 0.06 |

Note: The measures will raise GDP levels throughout 2014–16. However, with the higher GDP level in 2014, GDP growth in 2015 will be marginally lower than the baseline.