SGD
Outlook

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Singapore dollar to rally against currency basket on MAS tightening, but may struggle to outpace the US dollar

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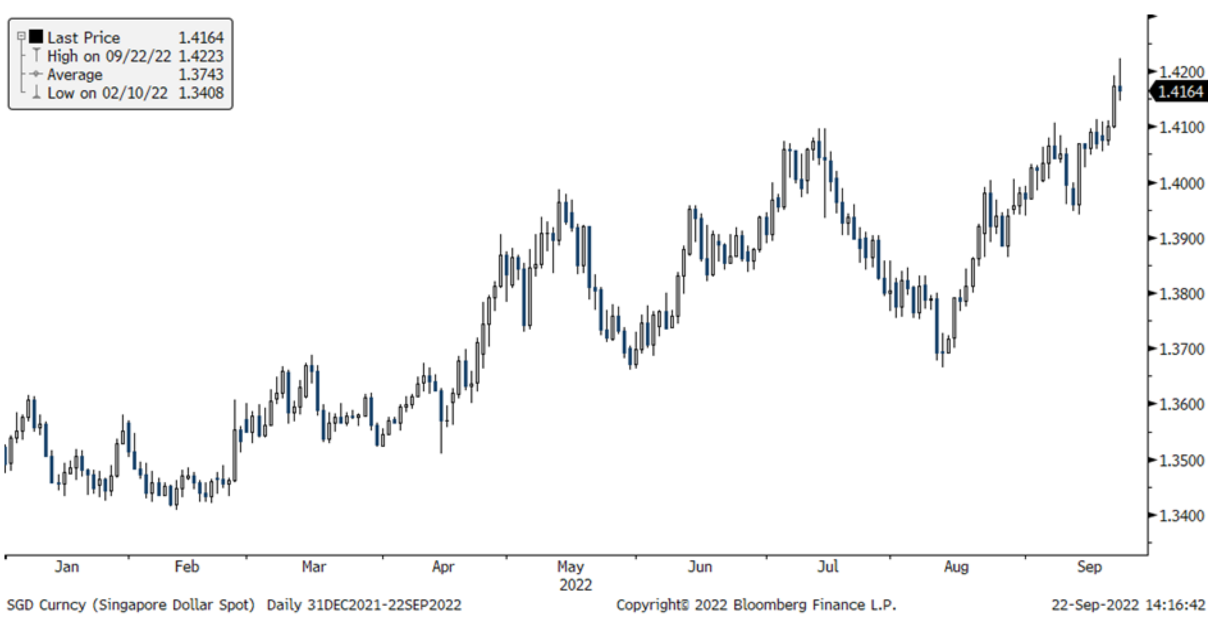
The Singapore dollar has weakened against the US dollar for nearly two years now, with losses accruing to 4.3% year-to-date. Despite this longer-term trend, the path has been far from smooth. Nevertheless, this year's story is less about SGD weakness and more about USD strength: out of 32 currencies in the expanded majors category, USD is ranked 5th in terms of year-to-date performance, while SGD is close behind in 7th place. Within the APAC region, SGD has been the top performer excluding the Hong Kong dollar which is pegged to USD. As a result, the trade-weighted currency index that the Monetary Authority of Singapore (MAS) uses to evaluate the stance of its monetary policy, known as the S$NEER, has appreciated 4.8% YTD despite the near 25% weight that the US dollar holds within the basket. The dynamic of a strengthening S$NEER is by design, as the MAS judges that long-term currency appreciation is consistent with its historical trend, as well as Singapore's strong banking and financial system, deep FX reserves, prudent fiscal policy, and wide current account surpluses. Over the past year, the pace of S$NEER appreciation has been more rapid than usual to offset imported inflationary pressures.

Since the start of the year, USDSGD has risen by more than 5%



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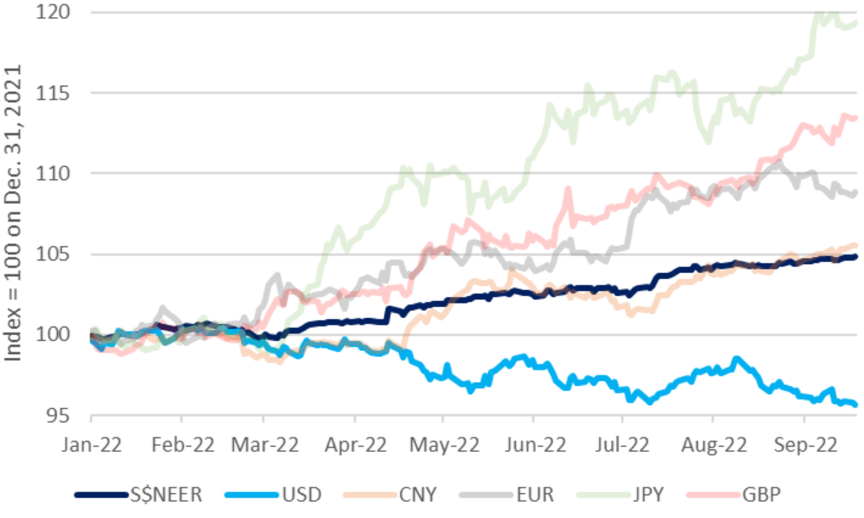
Our base case sees USDSGD rising to 1.44, but risks are tilted to the downside

Given the Singapore dollar's stronger performance against its regional peers, the year-to-date rally in USDSGD isn't necessarily a concern for the MAS. However, recent dynamics within the S$NEER basket may be starting to turn. Over the past 24 hours, intervention by the Bank of Japan to lower USDJPY has posed a new threat to this year's upward trend in USDSGD. Since JPY holds the fifth-largest weighting in the S$NEER basket, the fact that BoJ officials are actively buying yen to prevent further depreciation is beginning to place downward pressure on the S$NEER.

> While under our base case scenario, **a more hawkish Fed and rising cross-asset volatility should continue to support a rally in USDSGD to 1.44 by year-end**, downside risks to the pair associated with direct intervention by APAC central banks have materially increased.

Accordingly, the possibility of pushback from regional central banks could lead currencies such as JPY, KRW, and CNY to strengthen against the dollar, in which case USDSGD will likely fall, acting as a counterweight to maintain the MAS's hawkish monetary policy stance. In this risk case, markets might do all of the work themselves and push USDSGD lower in anticipation of MAS intervention, a credible risk considering Singapore's FX reserves are valued at US$278bn, or 65% of GDP. Should the central bank still judge that the S$NEER is not appreciating in line with its target, however, direct intervention by the MAS is a real possibility.

The US dollar is the main counterweight to an appreciating trade-weighted Singapore dollar



MAS to continue tightening in October as inflation risks are skewed to the upside

The main reason for the Singapore dollar's strength relative to its APAC peers stems from the MAS's aggressive response to high inflation, which has risen to 7.0% YoY as of July. Typically, the MAS adjusts policy twice per year, in April and October. In 2022, however, the MAS has tightened policy three times, once in the scheduled April meeting and twice in impromptu inter-meeting announcements. Within those meetings, the central bank has increased the slope of the S$NEER band all three times and re-centred the midpoint of the band higher twice. As we approach the MAS's next meeting, which does not yet have a firm date but is anticipated to occur between October 10th and 14th, there is a reasonable chance that we could see another adjustment, especially considering the S$NEER is merely 0.4% below estimates of the top end of the band, inflation pressures continue to climb, and MAS managing director Ravi Menon recently warned that medium-term inflation will likely be "higher for longer" going forward.

The pace of inflation has steadily risen, with year-on-year headline CPI either rising or holding flat over the last 11 months. The 7.0% all-items print in July was up three tenths from the month prior, driven by food, electricity, and gas, while core CPI reached 4.8% YoY, which was up from 4.4% in June.

> Both of those metrics are running above the MAS's July forecasts, which were already upgraded to ranges of 5 to 6% for headline and 3 to 4% for core at that time.

Even if August's CPI, which is released on Friday, September 23rd, were to ease, it is highly unlikely that either headline or core inflation would fall back to the MAS's forecast ranges. Currently, the median economist forecast points to 7.2% headline and 5.0% core CPI over that period.

Turning to monetary policy, the degree of tightening slowed at the most recent MAS meeting. In April, both the slope and midpoint of the band were adjusted, but back in July, the MAS chose to merely maintain the slope of S$NEER appreciation while re-centring the target. The MAS is unlikely to change the width of the band, as it typically does so only when the degree of economic uncertainty has dramatically changed, and it has not done so in a decade. Re-centring the band higher would be hawkish and have a large near-term impact on inflation. While increasing the slope of the band would also be hawkish and is arguably a more aggressive policy action over the medium to long run than a re-centring, it would take more time to impact inflation than re-centring alone, which is why both policies are frequently combined when decisive action is needed to lean against inflation.

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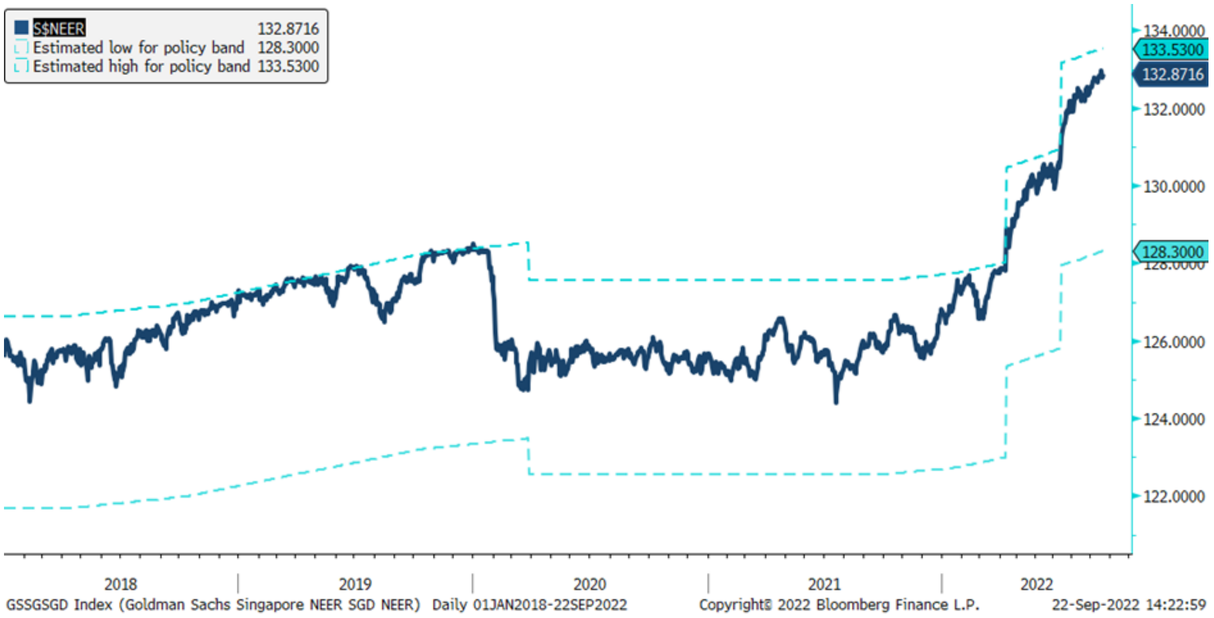
The Monetary Authority of Singapore has aggressively tightened policy in 2022



Given current inflation dynamics and the slight distance between the S$NEER and the top end of its range, we believe it is highly likely that the MAS will readjust the centre of the band upward. While Singapore's growth outlook is still positive, with private sector economists expecting 3.6% growth in 2022, it has deteriorated considerably over the course of the third quarter, making the combination of a recentring and an increase in the slope less likely.

> Nevertheless, the risk of maximum hawkishness cannot be ignored, considering the strength of the latest inflation data and the focus on upside inflation risks in recent commentary from MAS officials.

Appendix: Singapore's monetary policy regime

One of the most famous ideas in international macroeconomics is the "impossible trinity," which posits that out of three desirable policies—managed interest rates, a fixed exchange rate, and free capital flow—a central bank can only maintain two. While most advanced economy central banks, such as the US Federal Reserve and European Central Bank, have free capital and conduct monetary policy via interest rates, thus letting their exchange rates float, the Monetary Authority of Singapore (MAS) chooses instead to influence inflation and output through the exchange rate channel and allows markets to set interest rates. The main reason for the MAS's policy choice is that Singapore is a small open economy with a relatively huge trade sector: exports and imports are 1.9x and 1.6x the size of GDP, meaning that inflation is primarily driven by external rather than domestic developments.

The MAS's exchange rate management framework is known as "band, basket, and crawl." In essence, it means that Singapore's currency is allowed to float within an internal tolerance band before the MAS intervenes, the exchange rate is measured on a nominal, trade-weighted basis against a basket of currencies (S$NEER), and the target for the exchange rate is not a specific level but a generally upwardly moving target that reflects historical SGD appreciation over a multi-decade horizon. Despite its unconventional framework and implementation for monetary policy, the MAS's objective is similar to other central banks. The bank's singular mandate is to achieve "price stability conducive to sustained growth of the economy." Despite not having a specific inflation target enshrined in its mandate, the MAS aims to keep core inflation just below 2%, close to Singapore's historical average inflation rate and in line with most other advanced economy central banks.

The MAS intentionally creates ambiguity with respect to several of its specific policy parameters. The six main unknowns are:

1. The currencies included in the S$NEER basket
2. Weights for the currencies in the basket
3. The level at which the policy band is centred
4. The slope of the policy band target
5. The width of the policy band
6. Periodic adjustments to the currency basket

Nevertheless, the bank discloses weekly indexed data on the S$NEER, which allows external analysts to triangulate estimates of the currencies and weights. Furthermore, the monetary policy statements offer qualitative descriptions of adjustments to the policy parameters (e.g. a 'slight' increase in the slope of the band). Although the MAS uses the S$NEER to benchmark its monetary policy stance, it does the vast majority of its FX intervention by buying and selling spot USDSGD, as the US dollar accounts for approximately one quarter of the total basket, is the most liquid currency in the world, and is commonly used in global trade.