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June 12, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Singapore—Selected Issues**

The following corrections have been made in SM/00/96 (5/22/00):

Page 32, footnote 18: Revised

Pages 51 and 52: Revised

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

The Asian Currency Market

13. The government's first move to promote its financial sector was to try to emulate the remarkable success of London's offshore center—the Eurocurrency market—by introducing its regional counterpart in 1968, the Asian currency market, commonly known as the Asian Dollar Market because most of the transactions are denominated in U.S. dollars.¹²

14. The Eurodollar market developed because of onerous banking regulations in developed countries and a large supply of U.S. dollars emanating from oil-producing as well as countries with nonconvertible currencies who maintained dollar deposits in order to finance international trade. The Eurodollar market proved highly competitive vis-à-vis the United States financial market and other advanced financial markets.¹³ Free of national controls and regulations, offshore markets enabled international banks to engage in more profitable international transactions under favorable regulatory and fiscal treatment. Countries hosting offshore markets in return enjoyed positive externalities as financial institutions established offices, hired local workers, imported technology and information, raised the tax base and attracted new business opportunities.¹⁴

15. To jumpstart the Asian currency market, Singapore authorities introduced tax and regulatory incentives to induce international commercial and merchant banks to locate their regional business operations in Singapore. These included exemptions for nonresidents from withholding tax on interest income; zero reserve requirements; no deposit insurance premiums; and a 10 percent concession on taxable income. A liberal employment policy was also adopted to attract skilled foreign workers. With these measures, the government also hoped foreign financial institutions would attract new business activities and have positive spillovers on the domestic economy through more efficient mobilization of savings and better risk management techniques so as to create a strong financial system which in turn is a key contributor to economic growth.

16. The government also exhibited flexibility and pragmatism, responding quickly to emerging market trends and competitive threats by aggressively broadening fiscal and regulatory incentives. The authorities eliminated the 20 percent liquidity requirement on foreign currency deposits that had put the Asian Dollar Market at a disadvantage to the Euromarket in the early 1970s. Following Euromarket trends, the Asian Dollar Market widened its product ranges in the 1970s by introducing money market products and longer

¹² Asian currency market and Asian Dollar Market are used interchangeably.

¹³ The Euromarket offered attractive deposit rates because it had no reserve requirements, deposit insurance premiums or interest-rate ceilings (regulation Q); its lower lending rates reflected the absence of entry restrictions and cartel-like structures that characterized United States banking. (Sarver, 1988).

¹⁴ For fuller discussion on the development and role of international offshore financial centers, see Cassard (1994).

term securities such as the Asian dollar bonds. Tax incentives encouraged the establishment of international money brokers to intermediate sales and purchases of foreign exchange.

17. All told, the creation of the Asian Dollar market was a success and Asia's rapid economic growth fueled its explosive expansion in the 1970s and early 1980s.¹⁵ It played an important role in channeling savings from Europe, the United States, the Middle East and Japan to the fastest growing countries in Asia. The Asian dollar market together with special tax incentives helped lure multinational corporations to establish their regional headquarters for regional treasury and financing operations in Singapore, buttressing demand in the foreign exchange market.¹⁶ Regional central banks also flocked to Singapore's foreign exchange market because of strict prudential and supervisory standards, which restricted participation to only the most creditworthy and strongest financial institutions.¹⁷ Interbank lending, largely to finance trade, accounted for roughly two-thirds of the Asian Dollar Market's business, with the remainder going to nonbank customers (Figure III.1). Most of the lending was denominated in foreign exchange and was short-term and unhedged, with maturities averaging less than three months.

18. The rate of expansion of the Asian dollar market slowed in the mid 1980s, and contracted in the 1990s when Japan—a large provider of interbank offshore funds—went into a recession, forcing Japanese banks to consolidate their international positions. Deregulation in OECD financial markets also caused a gradual shift toward securities-based lending in the home markets and the Eurobond market. Still, the Asian Dollar Market remains one of the largest offshore markets, with total assets reaching US\$503 billion at end-1998 more than 600 percent of Singapore's GDP.

The "separation fence"

19. The second major initiative was to introduce financial legislation that would separate domestic financial intermediation from international banking (the Asian currency market).¹⁸ Separate accounts were introduced for international and domestic transactions. Banks were required to record their international transactions in the Asian currency market through so-called Asian Currency Units (ACUs), while Singapore dollar transactions with residents were booked through domestic banking units (DBUs).

20. The bifurcation served a threefold aim. First, the government wanted to discourage the Singapore dollar from being traded internationally (known as the policy of "non-internationalization of the Singapore Dollar") to stem currency speculation and preserve

¹⁵ For a detailed account of the development of the Asian currency market in the 1970s, see Hudjera (1978).

¹⁶ Currently more than 5,000 multinational corporations have made Singapore their regional headquarters for treasury and financing operations.

¹⁷ Cassard (1994).

¹⁸ Bryant (1989).

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