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'Inflation-proofing' CPF savings

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THIS year's economic outlook is more uncertain than usual on account of global and regional imponderables.

The United States economy is improving, but whether it is sustainable is an open question. The euro zone debt problem has yet to be resolved, and the extent to which austerity measures will be imposed and their consequences remain to be seen. Japan's outlook is uncertain, China may get a soft landing, and India appears mired in political gridlock. Singapore has registered negative quarter-on-quarter growth in the last quarter of 2011. Whether there will be a technical recession this quarter, or economic restructuring and possible external improvements will "carry us through", also remains to be seen.

Against this backdrop, policymakers should attend to three broad areas – one relatively short-term and the others somewhat longer-term. Flexibility and contingency planning are needed in this year's Budget. The economy may grow reasonably well in the coming quarters, or it might slip into recession. Infrastructural plans and other improvements should be formulated well in advance, and their implementation – whether to be brought forward or delayed – made contingent upon the economic situation, to the extent practicable. We should "keep our powder dry", and be able to institute the requisite policy changes quickly in response to the unfolding situation.

Second, from a longer-term standpoint, a wide range of policy measures has been instituted (or reinforced) after last year's general election – in housing, health care, labour and immigration, the social safety net, and others – with more being contemplated.

These are very welcome developments, but the proof of the pudding is in the eating. We need to assess over time whether the measures are achieving the desired effects. Is housing actually becoming more affordable? Are our bottom 20 per cent actually getting better off, in both absolute and relative terms? Is the MRT system's congestion and overcrowding being mitigated? And so on. There is a need for continual monitoring and evaluation of policy initiatives and if they fall short, further measures will be needed.

In the current unsettled environment, low inflation cannot be ensured. ST FILE PHOTO

Thirdly, the issue of inflation and the real returns (nominal returns minus the inflation rate) on Singaporeans' CPF savings. In recent years, there have been two sharp spikes in the consumer price index (CPI) inflation rate – 6.61 per cent in 2008, and 5.05 per cent in January-November 2011. [The Monetary Authority of Singapore's core inflation measure, which among other things excludes accommodation costs, appears less appropriate since significant amounts of Central Provident Fund (CPF) balances are utilised for housing purchases].

In those years, the real return on Ordinary Accounts (nominal return was 2.5 per cent) was negative, as indeed were the real returns on Special, Medisave and Retirement Accounts. If inflation returns to low levels relative to nominal interest on CPF balances, then the foregoing spikes are not a significant concern. However, in the current unsettled environment, low inflation cannot be ensured. What if inflation hovers between 3 per cent and 5 per cent, and nominal interest rates remain low, imposing negative real returns? Should we have contingency plans for such a scenario?

A related issue deserves a brief comment. Currently, the CPF Board invests mostly in Singapore government bonds, and the general understanding is that these funds form part of the Government of Singapore Investment Corporation's (GIC's) total financial resources, which are invested in a diversified portfolio of assets worldwide. In recent years, up to half of the net investment income (NII) earned from abroad by the Government (including presumably by the GIC) can be used in its annual budgetary outlays. Does the NII arise from the investment of the Government's total financial resources, including from the CPF? Transparency on this would be enlightening.

As mentioned before, the CPF Board invests largely in government bonds, with returns set in nominal terms. The Government should also consider issuing inflation-indexed bonds, as many countries such as the United States, the United Kingdom, Japan, Canada and France have done.

According to a factsheet issued by the CPF Board in October last year, the "10-year annualised real Ordinary Account rate" has averaged about 1.5 per cent over the post-1995 period, and this appears to be a reasonable rate at which to set the real interest rate on Ordinary Accounts (with that on Special, Medisave, and Retirement Accounts one percentage point higher). So if the CPF Board were to invest in inflation-indexed government bonds bearing these real rates of return, it could provide virtually the same real returns to its account-holders.

These would be non-marketed bonds, held to maturity by the CPF Board. The bonds' maturities should be chosen over time to match the likely schedule of net total withdrawals from the CPF by individuals. As such, fluctuations in the notional market prices of these bonds would not be of material consequence. "Inflation-proofing" Singaporeans' CPF savings in this manner would be particularly beneficial if we face the prospect of negative real CPF interest rates for protracted periods under the current arrangements.

The "inflation risk" would be transferred to the Government. But given the handsome long-term returns which the GIC, and possibly Temasek as well, had previously reported – an undue portion of which should not be used to finance budgetary outlays – such risk should be manageable. Inflation indexation is potentially highly beneficial and deserves to be considered further.

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What it should have been
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MONDAY'S report, ''Inflation-proofing' CPF savings', used the wrong term to describe investment returns that can be used to fund the Singapore Budget. The correct term is 'net investment returns' (NIR), not 'net investment income' (NII).

The NII framework was used before 2009. Since 2009, the Government has used the NIR framework, which is the sum of the long-term expected real rate of return on reserves invested by the Government of Singapore Investment Corporation and the Monetary Authority of Singapore, as well as the net investment income on the remaining assets, comprising primarily those of Temasek Holdings.

We are sorry for the error.