Second Reading Speech for

Constitution of Republic of Singapore (Amendment) Bill 2008

By Minister for Finance Tharman Shanmugaratnam in

Parliament, 20 Oct 2008

1. Mr. Speaker Sir, I beg to move, “That the Bill be now read a Second time”.

2. The Constitution Amendment Bill before the House seeks to revise the framework by which the Government is allowed to draw from investment returns on our reserves for spending each year.

A Key Asset for Singapore

3. This framework is important to Singapore because it governs how our reserves should be conserved, and the returns equitably shared between current and future generations of Singaporeans. A country’s reserves are a key asset in a globalised and uncertain world. But they are especially valuable for a country completely lacking in natural resources, extremely open to the world, and very small in size in a region of large players. Our reserves are our only resource besides our people, and a

major strategic advantage for Singapore.

4. We started off without this advantage. When Singapore became independent, we had very little in reserves. It is only through hard work, consistently prudent fiscal policies, and successive strategies that grew the economy over the years, that we have arrived at where we are today. We lived within our means, and painstakingly built up the country's reserves. Even so, although our reserves are now a sizeable asset for Singapore, they remain smaller in value than what many other countries have in financial reserves and natural resources combined.

5. As a strategic asset, our reserves serve two purposes. First, they provide a key defence for Singapore at times of crisis. We cannot know in advance what crises will hit us, whether caused by economic happenings in the world, natural calamities, pandemics or events that impact our security. But they are not hypothetical rainy day scenarios, as we can see in today's global financial crisis. The use of our reserves to back the Government guarantee on deposits that we issued last week underscores how important the reserves are in responding credibly and confidently during a crisis. Our reserves provide confidence in Singapore, contribute to a stable Singapore dollar, and keep our economy resilient at times of

difficulty.

6. Second, our reserves provide for a continual stream of income that can be spent or invested for the benefit of current as well as future generations. The Government is allowed to spend part of the investment returns on our reserves.

Conserving Our Reserves

7. For both of these purposes - to ensure that we will have ample reserves to deal with major crises, and to provide a stream of income that lasts across generations - it is essential that we have a sound framework of governance and policies for the management and use of the reserves. This is the only way we can keep and enhance the value of this strategic asset over the long term. There are a few pillars to this governance framework:

8. First, Singapore's Constitution was amended in 1991 to provide for an Elected President to safeguard the reserves and prevent a profligate government from squandering them. Specifically, the President has the right to veto the Government Budget if it is likely to draw on past reserves.

The President's concurrence is also necessary for the appointment of the Board members and CEOs of MAS, GIC and Temasek, to ensure that these are persons of ability and integrity.

9. Second, also within these Constitutional provisions, the Government can spend only from the investment returns on our reserves and <u>not the principal sum</u>. Further, the spending rule is designed to allow only <u>part of</u> the investment returns (50% of Net Investment Income, or NII) to be tapped for the Budget, thereby providing for the remaining part to augment the reserves so that its value grows over time.

10. Third, Singapore's financial reserves are managed by professional investment teams, who aim to deliver sustainable returns over the long term. GIC and Temasek are both well-respected internationally for their strong, proven track records. They are rigorous in their allocation of assets and in managing risks, and have achieved consistently creditable returns. The MAS has also managed our official foreign reserves prudently, while fulfilling its other central bank functions of promoting monetary and financial stability.

11. However, this framework for conserving and growing our reserves

cannot stand on its own, without being matched by the principles that underpin our budgetary policies. We spend prudently and live within the constraints of the revenues that we are able to raise, so as to avoid running persistent budget deficits. This is why our total Government spending is only 15% of GDP currently, much lower than most other countries. It is this approach of fiscal prudence that has allowed us to keep the Government lean and our taxes low, so that both individuals and enterprises have incentives to work hard, grow their incomes and strengthen our economy.

Preparing for Future Spending Needs

12. We must keep to these fundamental principles as we introduce new rules to allow the Government to draw on more of the investment returns from our reserves for spending.

13. In the past, the Government has only been allowed to spend from the interest and dividend income, and not the capital gains. This was conservative, but it has served our fiscal needs adequately while allowing us to build up our reserves. In the 1990s, after the Constitutional amendments were passed in 1991, the economy was growing rapidly, we

were running large surpluses, and the investment

income comprising only interest and dividends was more than adequate to meet fiscal needs. The Government moved to lock up 50% of the NII in the constitutional amendments of 2001 to ensure that we continue to grow our reserves and not spend all the income on current fiscal needs. By this judicious use of NII to supplement the Budget, and prioritising between competing budgetary needs, our budget has stayed neutral on average, with surpluses and deficits balancing out over the years that followed the 2001 amendment.

14. But the current NII spending rule will not be adequate as we go forward, as we expect our expenditures to increase, even over the next five years. Over the long term, Government spending will need to rise significantly. We have to find new revenue sources, and the spending rule, if revised judiciously, can provide more to help meet these demands.

15. There are three main reasons for this increase in budgetary needs. I will spell them out, as they are the essential reasons why we are amending the Constitutional framework now to draw on more investment returns.

16. The first is that we must do more to invest in capabilities and stay competitive, so that we grow our economy.

a. We want to invest in the best quality education for our young and continual learning for our adults.

i. That is why we are moving towards more single- session primary schools and improving pupil-teacher ratios across the school system. We are also increasing university participation rates for Singaporeans and building two more ITE colleges similar to the ITE College East at Simei, which is already regarded as best-in-class internationally.

ii. We are also substantially scaling up our investments in training and continuous learning, to retain the competitiveness of our workforce. MOM and WDA have embarked on the National Continuing Education & Training (CET) 10-year Masterplan this year, which will significantly increase the annual CET institutional capacity from 50,000 training places today to 250,000 training places in three to five years" time.

b. We need to invest in R&D, to build new capabilities that will drive our future growth. Singapore is already emerging as a key R&D player in areas linked to industries with high growth potential globally, such as the biomedical sciences, interactive and digital media, and environmental and water technologies. We have also deepened our incentives for making innovation pervasive across the economy, among both big and small enterprises.

c. Together, these increased investments in our human capital, knowledge and innovation will benefit all Singaporeans. They will sharpen our capabilities, enabling us to move up the value chain and keep our relevance in a much more competitive global economy.

d. Taxes are the other key consideration in competitiveness. At the same time that we invest more, we have to maintain a competitive tax environment for both companies and individuals. With tax rates coming down internationally, we have to be ready to make further cuts in direct taxes where required to maintain Singapore's attractiveness as a key business hub in Asia.

17. The second reason why our budgetary needs will grow is that we are doing more to make Singapore a top quality home. In the years to come, we will enhance almost every facet of the city, both in the city centre and across our neighbourhoods, to make this a highly liveable and inclusive home.

a. We are transforming Marina Bay into a place with something to appeal to everyone – business, entertainment, the arts, unique gardens, the F1 at night and even the peace of a reservoir – all rolled into one. We are also enhancing our green lungs and blue waterways across the island. And we are rejuvenating our housing estates, to create a first-class and inclusive living environment that enhances the assets of Singaporeans.

b. We are investing in new commercial and lifestyle hubs outside the city centre, such as the Jurong Lake District, Kallang Riverside and Paya Lebar Central, which will spread out the economic activity around the island and bring jobs and attractions closer to homes.

c. Transport alone will be a substantial expense, in fact the largest increase in our Budget in the next 5 to 10 years. To achieve our vision of a people-centred land transport system, we will have to ramp up our spending on land transport over the next 10 to 15 years. In fact, transport spending will rise from 0.8% of GDP last year to about 2.9% of GDP in five years‟ time and stay at that level over the next five years. This is even with significant borrowings by LTA to smooth out expenditures over the long term. These investments would allow us by 2020 to double our rail network, increasing both capacity and coverage, expand our network of expressways, and achieve better integration between road and rail to improve both public and private transport.

18. The third reason why we will have to spend more in the future is the need for <u>higher social expenditures in an ageing society and one facing growing income gaps</u>.

a. Our population is getting older, and this will create new demands on resources to look after our elderly.

i. We will have to spend more on healthcare, both in the Government's budget and nationally, including private expenditures. Health Minister Khaw Boon Wan has highlighted the challenge on several occasions. We are already spending an additional $2.4b over the next 5 years to recruit and train manpower, build new hospital capacity and upgrade existing facilities, and enhance the capabilities of community hospitals and nursing homes. These are new expenditures. We will also invest more in preventive care. Altogether, in constant dollar terms, we expect to more than double the Government's healthcare expenditures over the next decade. But we must be careful in how we design the framework for financing healthcare to keep us from going the way of countries that have seen their budgets balloon uncontrollably, placing increasing burden on taxpayers.

ii. On top of healthcare, we will introduce new measures to push ahead on the 'active ageing' agenda, and will continue retrofitting parts of Singapore such as providing more barrier-free access for elderly pedestrians and bus and train commuters.

b. A further social challenge is the widening income gap that is being seen in every city plugged into the global economy. This is a challenge that will be with us for some years to come. We have already embarked on major new programmes to help lower income Singaporeans and strengthen our social compact. We have implemented the Workfare Income Supplement Scheme, and the Government and NTUC are both expanding schemes to help low-income workers upgrade their skills. We have also augmented a broad range of social assistance and community support programmes to help the most vulnerable members of our society, including developing capabilities to help dysfunctional families and ensure that their children are not disadvantaged.

c. We are also redoubling our efforts to counter low fertility rates, through the recently introduced Marriage and Parenthood package. In addition to increasing the financial and workplace support for parents, improvements in the quality of kindergartens and childcare will help to give every child a head start towards fulfilling his or her potential.

19. For all these reasons that I have mentioned – the increased investments needed to keep Singapore competitive and a highly liveable city, the need to keep taxes competitive, as well as the need to cater to an older population and to keep our social compact intact – we need additional resources. We expect a significant increase in our expenditures amounting to about 3% of GDP each year in five years' time (FY2012), and moving slightly higher thereafter. This is on top of the 15% of GDP that we are currently spending. These are large increases, although our total expenditures would still remain amongst the lowest internationally as a percentage of GDP.

20. These are key programmes for expenditures that we are able to anticipate and prepare for. But besides these programmes, we must always provide a buffer in our fiscal planning to deal with unexpected adverse events or downturns, and give the Government the flexibility to implement countercyclical measures when necessary. This year for example, we are spending $3.3b on measures that are helping low-income and other Singaporeans cope with the increased cost of living. With the likelihood of a weaker economy next year, we will also consider how we can help Singaporeans and our businesses through these difficult times and position the economy for a robust recovery.

The New Fiscal Framework

21. The Government therefore needs a larger budget in the future, but we will retain our basic principles of sound fiscal management. We have a systematic framework in place to ensure prudent spending amongst all agencies, and we will keep improving it. Under the block budgeting framework, Ministries have to ensure that their budgets do not grow faster than our resources can support, and must prioritise and reallocate funds so that they live within their means. New requests for funding are prioritised and evaluated by the Ministry of Finance, and all major development projects have to be approved by the Developmental Planning Committee. We also conduct reviews during and after each project to ensure that the outcomes are met, and that taxpayer monies are spent effectively and efficiently.

22. However, even with tight budgetary practices in place, we face the fundamental need of having to spend and invest more in the future. We will need more revenues to meet this need. This is why PM stated in 2006, during the Debate on the President’s Address, that we had to make two key revisions to the structure of our fiscal revenues. The first

was the GST increase of 2% which we made in 2007. This contributes about 0.8% of GDP per year to our revenues, and has allowed us to proceed with important initiatives such as Workfare, as well as to begin ramping up our expenditures on healthcare and continuous education and training. The second revision that PM indicated the Government would have to make was a new framework for spending the investment returns from our reserves that should take into account capital gains, thereby enabling us to tap on more of the returns to finance our growing spending needs.

23. Both these changes, the GST increase and the revisions to the rules for spending investment returns, are necessary parts of our new fiscal structure. They will allow us to meet Singapore's future needs with confidence.

New Framework for Spending from Investment Returns

24. This Bill therefore seeks to revise the rules for spending from investment returns to allow us to tap on more of these returns for the Budget but on a basis that is sustainable over the long term. The new framework retains the 50% cap on spending from investment returns.

But the spending rules will be based on a new and broader definition of investment returns, with the following key features: (1) total returns, including capital gains; (2) long-term expected returns, instead of year- to-year actual returns; and (3) real returns, to preserve the purchasing power of our reserves. I will set out each of the changes in turn.

Total Returns

25. Capital gains and losses are part and parcel of investment outcomes. This is true not just for investments in equities, but for interest-yielding bond instruments where the value of the investment goes up and down as interest rates move. In changing the definition of investment income to include capital gains, and not just interest and dividend income, we are adopting the right basis for determining how our reserves have grown.

26. Furthermore, a Government spending rule based only on interest and dividends could lead to bias toward investments that generate income rather than capital gains. This will be inconsistent with our objective of maintaining a diversified investment portfolio aimed at achieving long-term returns. GIC for example has in fact substantially

diversified its investments over the last 30 years, and even over the last 5 years, with significant allocations to various asset classes such as public equity, private equity and real estate. The new rules will be consistent with a strategy of asset allocation that is focused on maximising total returns – including capital gains – over the long term.

Expected Long-term Returns

27. However, as we have discussed in this House before, capital gains are inherently volatile. Take a look for instance at the MSCI World Index over the last 10 years, from 1998 to 2007, which captures the market value of global equities and hence includes capital gains and losses. If annual returns were computed based on the index, they would have been negative in three of those years and above 20% in another three. And in 2008 so far, we have seen a 40% drop in the MSCI World Index.

28. If we had to spend based on actual total returns each year, the volatility would severely constrain how we plan the Government Budget and commit ahead for future expenditures. Furthermore, it would be imprudent for the Government to overspend in a bull market, and end up finding itself short of resources in a bear market. Therefore, in studying

how to tap on capital gains for the Budget, our key consideration was to determine a smooth stream of returns that can be taken in for spending on a year-to-year basis. We considered two alternatives to achieve this smoothing effect.

29. The first way is to rely on a historical rate of return, based on a suitably long period into the past to smooth out the volatility in returns. This is doable, but not satisfactory, because past performance in global markets may not be representative of likely future outcomes. Markets can and have gone through extended bullish or bearish periods of as long as 10 – 15 years, before eventually changing course. Consider if we were standing in 1997, for instance. In the 10 years before 1997, the average annual nominal return for the MSCI World was 9% - a strong and positive result. But in the 10 years following 1997, the figure fell to 5%.

30. A further problem with using historical returns, computed over a long period, is that it does not take into account the fact that returns from our investments depend on the asset allocation mix, which can change over time. Historical returns can therefore only provide a useful

reference for future returns, but are not accurate as a predictor of future returns.

31. The second approach to smoothing out the volatility of returns is to look at the ***long-term expected returns*** on an investment portfolio. This is a forward-looking assessment of the overall returns that we expect over the long term. Actual returns will of course vary from these expected returns each year, sometimes very significantly. This year, for instance, should be a very bad year for most international investors, who would have found it difficult to achieve investment returns that meet their long-term profile of expected returns. But in making projections of expected returns, we are estimating what actual returns in the years ahead will look like when averaged out over the long term.

32. In deciding on our framework, we have studied and adapted from good practices in various international funds with endowment characteristics, which are invested for the long term just like our reserves are. The expected returns concept has been practised for several years amongst several endowment funds. For instance, since 2001, the Norwegian Government has adopted fiscal guidelines to spend the expected real return on its Government Pension Fund – Global, a fund

that holds its petroleum revenues and fiscal surpluses. Similarly, Yale has a spending framework based on long-term expected returns, which it has been running successfully for many years.

33. While each of these endowments has its own unique characteristics and spending rules, the principles are essentially similar. All of them seek to achieve some budgeting stability, while seeking to achieve inter-generational equity - in other words, to balance the spending needs of current and future generations, whether of citizens or student cohorts. This is similar to what we are trying to achieve with our spending rules.

34. We have decided to adopt the second approach for estimating total returns without being saddled with volatility – which is to determine the returns for spending based on ***long-term expected returns*** on the reserves***.***

35. The expected returns will be based on an investment horizon of 20 years, which is roughly equal to three investment cycles in global markets. This is consistent with the investment strategies that our investment companies have adopted, which is to invest for the long term

and ride out the market cycles. This ability to ride out the cycles is a key advantage that well-run endowment funds have in their investments, which sets them apart from many other financial investors.

36. However, an assessment of expected returns cannot be made in one year and then left unchanged for 20 years. If we do that, chances will increase that the actual returns will deviate from the estimate of expected returns, even when the actual returns are averaged over the 20 years. Much in the world can change in between, which could mean a very different outlook for the years ahead. This is why we have to <u>keep refreshing our estimates of long-term expected returns</u>, taking in all the information and assessments available at the time, including the actual historical performance of the markets. As I will explain later, we will do this <u>annually</u> – so that we make a thorough assessment each year of the long-term expected returns on our investments.

37. I should clarify that in looking at long-term expected returns, the distinction between <u>realised</u> and <u>unrealised</u> capital gains and losses does not arise. The long-term expected return depends on <u>how the market value of our reserves will grow</u> over the specified time horizon. This does not depend on when the assets are sold, i.e. when the gains

and losses are realised. The distinction between realised and unrealised capital gains would be relevant only if we were spending based on actual returns each year rather than long-term expected returns. As I have explained earlier, however, spending on the basis of actual returns would subject the Budget to too much volatility. Furthermore, if the spending rule was based only on realised capital gains, there could be incentive to sell assets to make capital gains available for spending, even if it means doing so at an inopportune time. We should therefore keep our investments focused on maximising long-term value, and spend on the basis of total returns expected over the investment horizon.

38. There are further technical rules that we will apply to avoid volatility of returns available for spending. The market value of the asset base itself goes up and down depending on the state of the market. We have to ensure that the asset base, which is what the long-term expected rate of return would be applied to in order to derive the investment returns for spending, is also smoothed and not heavily influenced by market cycles. This too will ensure that Governments do not overspend during boom years and underspend when the markets are down. We will follow established methodologies. Yale University, for example, applies its expected rate of return to a smoothed asset base, which takes into

account past market values of the asset base but gives greater emphasis to those in more recent years. The Government will adopt this concept of smoothing, the details of which will be agreed with the President.

Real Returns

39. The third key feature of the framework is that we will spend based on ***real*** returns. This is unlike the current framework, where spending is based on nominal dividend and interest income. Our spending rules must ensure that we continue to maintain the international purchasing power of our reserves. Otherwise, in a scenario of sustained high inflation globally, even if we were to earn decent investment returns, our past reserves would be gradually eroded in real terms. From 1998 to 2007, for instance, the MSCI World index returned an average nominal return of 5.4%. Over the same period, global inflation in US dollar terms was about 4%, and would have wiped off almost 75% of these returns. This is before taking into account the large negative real returns on the MSCI index in 2008 thus far.

40. The new framework will therefore allow the Government only to spend out of real returns, that is, returns adjusted for the effects of global inflation. This means that at minimum, past reserves will continue to grow at the same rate as global inflation.

Applying New Framework to MAS and GIC

41. The new framework will be applied to reserves invested by **MAS and GIC**. The Bill refers to these as “relevant assets”, which are also net of the liabilities defined in the Constitution. By netting off these liabilities, such as Government Securities, Treasury Bills and Social Endowment Funds, we are in effect setting aside returns to cover the costs of servicing the liabilities.

42. We are not applying the new framework of spending on the basis of long-term expected returns to **Temasek Holdings**. We have studied this carefully, and the Government’s assessment is that it is prudent to retain Temasek on the existing framework. We have decided to do so for two reasons. The first reflects the nature of Temasek’s investment strategy, which involves taking concentrated stakes in companies, including direct investments. Like other such investors, this strategy

entails higher risks, with the expectation of higher returns – and it has indeed yielded higher returns historically for Temasek than seen for traditional global portfolio investors. However, this approach makes it more difficult for us to project a long-term expected rate of return on Temasek's portfolio to a reasonable degree of certainty. It is unlike the case for global portfolios like that of GIC"s, which are spread widely across the public markets, and for which there are established methodologies for projecting expected returns.

43. The second reason is that Temasek's investment strategy is still evolving, having begun a major effort to diversify its investments geographically and sectorally in 2002. Temasek today operates very differently from the way it was operating six years ago, and its strategy will continue to evolve in response to the investment climate.

44. It will therefore be prudent to leave Temasek out of the new framework, although we will review this again after some years, once Temasek's diversification strategy is more settled. However, we will continue to draw on Temasek's actual investment returns each year in the meantime, as the Government is already allowed under the current NII framework to tap on 50% of the dividends from Temasek. In so doing,

we already tap on part of Temasek’s capital gains for spending under the existing framework, because Temasek declares dividends based on its net profit, which takes into account the realised capital gains and losses from its investments. This will remain the case.

Summary: Government to spend up to 50% of Net Investment Returns

45. As I mentioned earlier, we will retain the 50% cap on the amount of returns that can be taken out for spending. This is in addition to setting aside the full inflation component of our returns in past reserves. In this way, the real returns on investments will be shared between the current Budget and past reserves. This allows the past reserves to grow in real terms, and thereby provide for a growing economy in the years to come.

46. To summarise, the Government will spend up to 50% of our Net Investment Returns (NIR). NIR is the sum of: (1) the long-term expected real rate of return on the reserves invested by GIC and MAS, and (2) the NII on the remaining assets, comprising primarily Temasek.

47. This framework strikes the right balance between the needs of current and future generations of Singaporeans. It would allow us to take

in more for spending, but not so much as to prevent our reserves from growing in line with the economy and providing for future generations.

Presidential Safeguards

48. Let me finally return to the issue of governance procedures. The new framework will require an important change to the budgeting process each year, so as to operationalise the concept of long-term expected returns and ensure that the Presidential safeguards on our reserves are maintained.

49. The projection of the expected long-term real rates of return is not a mechanical process, but one that involves both professional expertise on the part of our investment agencies and sound judgment. We have therefore designed a systematic and robust process by which the Government determines the NIR each year for spending, and by which the Elected President can perform his role as custodian of our reserves. I will bring the House briefly through the sequence of events that will take place each year.

50. Before the start of each financial year, the Government will propose the expected long-term real rates of returns for GIC and MAS for the President's agreement. In order to do so, the Government will ask the GIC and MAS Boards to provide and certify estimates of the long- term expected rates of return on the assets they manage. These Boards would evaluate the future outlook on their portfolios, taking all factors into consideration – including the overall investment environment, bottom-up assessments for each asset class and peer comparisons of expected returns. They would take into account historical rates of return, which provide a useful check for what is realistic going forward. Although the measure of expected returns is fundamentally forward-looking, the projections cannot completely ignore historical performance.

51. The Government will propose the long-term expected real rates of return to the President, taking reference from the rates certified by the respective Boards. The President will consult with the Council of Presidential Advisers (CPA) before deciding on whether to agree with the Government's proposal. If the President disagrees with the proposal, the average historical real rate of return over the previous 20 years would be used. I have explained earlier why it is not ideal to use historical rates in the first instance. However, the 20-year historical rate

of return provides a neutral and pragmatic basis for resolving any dispute between the President and the Government, and avoids paralysing the government of the day.

52. Once the President has agreed with the Government on the expected long-term real rates of return that are to be applied, the subsequent processes are fundamentally similar to the current approach. After the close of the financial year, the Minister for Finance will still certify to the President the amount of NIR that the Government has actually taken into the Budget, within the caps specified in the Constitution.

53. The dispute resolution mechanism, as well as other details and working arrangements to implement the new framework, will be stated in a set of Principles to be agreed upon by the Government and the President. The Principles will be tabled to Parliament for information after the Bill is passed and gazetted.

54. The President and the Council of Presidential Advisers have been briefed on the framework proposed by this Constitution Amendment Bill, and have deliberated the issues. The President is satisfied that the new

framework is a sustainable one that will continue to preserve and grow the past reserves, and will be in Singapore’s interests.

Deletion of Reference to EDB Act in Article 144(3)

55. Mr. Speaker, Sir, allow me to present a further amendment to the Constitution, which is not related to the proposal to implement the new NIR framework that I have just described. Article 144(3), which governs guarantees and loans raised by the Government, currently makes reference to the EDB Act. This House had earlier updated the EDB Act to remove the provisions for Government guarantee on EDB‟s bonds and debentures. Consequent to this amendment, the reference to the EDB Act in Article 144(3) will be deleted.

Conclusion

Mr. Speaker, Sir,

56. The changes we are putting into place in the new NIR framework will not deviate from the fundamental principles that we have adopted towards our reserves. We will maintain and grow our reserves, so that they serve both as a strategic buffer to tide us through unforeseen crises

or emergencies, and generate returns for spending on a sustainable basis. The new rules are a fair and equitable basis for sharing the benefits of the reserves between present and future generations.

57. The new NIR framework will contribute to strengthening the Government's revenues so that we can position Singapore to meet the challenges of the future with confidence. The GST increase in 2007, which contributes an additional 0.8% of GDP each year, together with the additional revenues made available from NIR which we currently expect to be slightly above 2% of GDP each year, will allow us to press ahead with our expenditure plans, which should require additional resources of 3% of GDP within the next five years. They will allow us to upgrade our economy, strengthen our society, and make Singapore amongst the most vibrant and liveable cities in Asia.

58. The funds made available through the revised rules for spending from investment returns will be channeled mainly towards building up Singapore's capabilities and infrastructure – through education and R&D, and the major programmes to expand our transport infrastructure and rejuvenate the city. These investments will position Singapore for the next stage of growth, and ensure that we continue to attract investors,

create jobs and open up opportunities. They will be for the better of all Singaporeans, now and in the future.

59. Mr. Speaker, Sir, I beg to move.

Round-up speech by Minister for Finance, Mr Tharman Shanmugaratnam for Second Reading of the Constitution of the Republic of Singapore (Amendment) Bill 2008 in Parliament

21 October 2008

Mr Speaker, Sir, I would first like to thank Members for their very good contributions to the debate and their support for the Bill. I will be addressing the main issues that Members have raised yesterday and today in this round-up speech.

2 The Bill introduces a new framework for spending the investment returns of the assets managed by the MAS and the GIC. The Government will be spending on the basis of total real returns, which include capital gains and losses. But it will do so by applying a forward- looking assessment of the long-term expected rate of return on these assets, rather than go by actual returns earned year by year. I have explained the reasons for this framework yesterday. There are two outcomes coming out of this new framework.

3 First, we expect to have available additional resources estimated at slightly over 2% of GDP for spending. If you add that to what we currently already derive from Net Investment Income (NII) in the current framework, that will give a total of about 3% - 3.5% of GDP.

4 The second outcome is that we do expect that, with the new framework, our reserves will continue to grow minimally at the rate of inflation. But under most likely circumstances, there will be real growth of our reserves – real growth that should keep pace with the growth of our economy over the long term.

5 Together with the GST revenue which amounts to about 0.8% of GDP, the additional revenues that we are getting through the new NIR framework of slightly over 2% will give us an additional 3% of GDP, which should be sufficient for the Government to fund its additional expenditure plans. Hence, we do not expect to raise additional revenue in order to implement our plans. We aim to spend, but spend judiciously, to build up capabilities for the future and strengthen our society.

6 Members have generally agreed that the new spending formula is fair and equitable. We have also agreed that it is a sustainable formula,

one that will not lead to the reserves being drawn down, and one that ensures that we continue to generate a future stream of income that will be stable across generations. The questions that have been raised, which are important ones, are largely to do with ensuring that this new framework is implemented prudently and that what we derive in revenues will be spent wisely.

Long-term expected returns

7 Let me first turn to the broad theme that cuts across many of the comments raised by Members, which is: how do we derive long-term expected real returns? Many Members have raised this – Dr Ong Seh Hong, Mr Inderjit Singh, Mr Seng Han Thong, Mrs Josephine Teo, Mr Gautam Banerjee and Ms Jessica Tan. How do we derive long-term expected real returns? And what happens when actual performance, over a number of years, does not match what we expected? This is a valid concern, and I am glad that the whole tone of Members' comments was to underline the importance of not overspending on the basis of expected returns, rather than a desire to want us to spend more, even when actual returns are not sufficient. I think that is the right tone for our debate. Let me explain how we go about this.

8 But before I do, I want to first address a point that both Mr Christopher de Souza and Prof. Thio Li-ann raised, which is about the lack of precise definition of certain terms in the Constitution – terms such as "long-term", "expected rates of return" or the inflation indices that we will use in deriving real rates of return.

9 It is a valid question and we did think hard about what we put into the Constitution or, instead, leave out of the Constitution and put into a White Paper which will be tabled to Parliament after the Bill is passed and gazetted. We have decided to put the technical procedures and operational definitions into the White Paper so that they can be reviewed after some years of experience, rather than hard-wire such details in the Constitution. The details are really quite technical: the exact time horizon that we will use in determining long-term returns, the specific definition of global inflation – whether it is G3, G7 or some other global index – or, even more technical, the exponential weighting system by which we smooth our asset base.

10 If we put all these things into the Constitution, the Constitution will be even more detailed than the Financial Procedures Act. So, we put it

in the White Paper, and let us review it from time to time as we gain experience with the system. In that way, we can make changes from time to time and incorporate them in the way we work the system.

Governance and transparency

11 Let me, therefore, move to the broader issue that was raised with respect to the governance of this process of determining long-term expected returns and transparency. First, let me say that there are basically two approaches to how we can go about this. Two fundamentally different approaches to how we can go about determining long-term expected returns for spending on the Government budget.

12 The first approach is to be fully transparent and have Parliament evaluate whether the expected rates of return are appropriate. I am glad Mr Siew Kum Hong raised this because it is an approach that a few other places practise.

13 The second approach, which is the one that we have adopted, is not to go for full transparency but to insulate this process of determining long-term expected rates from political pressures or the mood of the

day. This second approach relies on us having the right people in charge. It relies on us having robust checks and balances within the system. It is also an approach which says that if, even with the right people and robust checks and balances, we cannot come to an agreement on the long-term expected returns, then let us have a pragmatic dispute resolution mechanism. And we are opting now for a dispute resolution rule that says we fall back on the last 20 years of historical returns – neutral, factual and objective.

14 PM has spoken about what happens under the first approach. There are live examples of this. PM spoke about Norway and Australia. There are other examples like Chile. And it is almost in the natural workings of society and parliaments that, over time, full transparency and leaving things to the market of political opinion lead to a desire to spend more, conserve less and leave less for future generations. There is an upward bias that is inherent in the spending rules in these countries. At the very least, I would say the jury is out on the model of full transparency in Norway, although I think a sensible person looking at what is happening will want to be very cautious about even trying it out.

15 Our approach is a different model, which we believe over time, faces less danger of bias in favour of overspending and not conserving our reserves. We insulate the process of determining long-term expected rates from political pressure. We derive the rates of return on the basis of the best professional inputs and advice, so that we get the most realistic assessment of what is likely in the future. But we also set a spending cap in the Constitution, based on the expected real rates of return, a spending cap that is not open to fiscal discretion, no matter what majority the Government has. It is written into the Constitution - 50% – in addition to writing in sufficient checks and balances in the system between the Government and the President as advised by the CPA.

16 It is an imperfect system. The approach that we have adopted is an imperfect system - it relies on judgment, it is not about perfectly objective data and, more importantly, it relies on having the right people in the right places. That is the pre-condition for this approach to work well. If we do not have the right people in place, it will be a highly imperfect system. But if we do have the right people in place, it is a system which is likely to be superior to the alternative system of

complete transparency, in the faith that this market of political opinion will somehow or other conserve resources, spend wisely and prudently. That is our belief, and it is also a belief that has been evidenced by what we can see around the world.

Process for determining the long-term expected rate of return

17 So that is the governance part of it. Next, how do we actually go about the process of determining the long-term expected rates of return? It is not a mechanical process, it is not a purely technical process, but neither is it pure judgment.

18 It is not putting a finger in the wind. It is a combination of objective analysis, hard data, professional inputs, but it also relies on seasoned judgment by people who have been in the business for a long time and who are cautious about short-term cycles determining their long-term views of the world.

19 Each year, the estimated rates of return will be reviewed by the Boards of MAS and GIC, and the Government. Each year, the Boards will take a fresh look at the long-term expected return over the next 20

years on a rolling basis, so that they can take all new information into account. The Boards will certify to the Government what they believe to be the most realistic view of the next 20 years. The Government considers this and then provides its proposals to the President. The President consults the CPA and then decides whether to concur with the expected rates of return proposed by the Government each year. And if there is no agreement between the President and the Government, then we fall back on the dispute resolution mechanism, uncontentious and simple.

20 I do not want to get into great detail on how the Boards of MAS and GIC will, in fact, determine this. Let me just assure Members that there are established methodologies used by well-run endowment funds. And indeed these are methodologies that have been practised for some time for the Boards‟ own purposes in the MAS and GIC. Starting with individual asset classes, for instance, looking at government bonds across various countries, looking at the inflation and growth outlook, and determining the expected rates of return for that asset class – government bonds. Next, looking at corporate bonds, applying a credit risk premium on top of what we derive for government bonds, and looking at listed equities applying an equity premium, and so

on. So, they do it for each of the asset classes. And for each of those asset classes, they also look at historical returns, not just over the last five or 10 years but over decades. And then, finally, adding up the asset classes together, aggregating it into an expected return for the overall portfolio based on the asset allocation strategy of the Board.

21 These are robust methods established internationally, which are constantly refined. They are not perfect and they are not purely technical exercises as judgment is involved, but they are robust methods that we can draw on and we constantly share amongst comparable organisations internationally. I would emphasise, once again, that the Boards will take reference from the historical performance of each asset class over varying periods of time. But seasoned investment professionals and the boards of MAS and GIC do also know that historical returns do not always repeat themselves. And, in fact, the historical rate of return that has been earned in the past 20 years is very unlikely to repeat itself in the next 20 years.

22 There was not much discussion on this five years ago. But now with the crisis that we are in, there is a sobering up and there are some very good articles on this. I just read one recently in the latest issue of

the *Economist*, either last week or this week, a very useful article pointing out that bear phases and bull phases in the stock market do not just last for five or six years; they last for 17 or 18 years. In fact, if we look at the last two decades, it comprised a 17-year bull run, from 1983 to 2000. Then it collapsed with the tech bubble bursting in 2001. But then there was another bull run from 2003 to October last year. So, despite the tech bubble crash, if we take the 20 years leading up to October 2007, with all the ups and downs, the Dow Jones Industrial Average had an average annual return of 10.2%. And MSCI World global-listed equities averaged 7.4% – a remarkable performance over a long period of time despite cycles in between. So, that is what is called a "secular period" in the investment world – not a cycle, but something that stretches across cycles. It is a secular phase which seasoned investment professionals do not believe will be repeated in the next secular phase.

23 So, that is worth bearing in mind, that the Boards will look very carefully and rigorously with the advice of their teams of investment professionals at what has happened historically, but they are not simply going to project the future based on what happened in the past. Judgment is involved.

24 The Boards will then provide the Government with what they believe to be the most realistic projections, completely uninfluenced by the spending rules that the Government has employed. The Government then has to decide whether to accept the Board's judgments on the expected rates of return. I would say, in particular, that where there is significant uncertainty over the outlook, the Government will want to err on the conservative side in deciding on whether to take the Board's projections as they are, or whether to moderate it. Where there is uncertainty, as a Government, we will want to err on the conservative side.

25 So I quite agree with the MPs – Ms Lee Bee Wah and Mr Liang Eng Hwa who spoke this afternoon, and several others – who cautioned against over-exuberance in projecting expected rates of return, and emphasised the need to be prudent in our projections.

26 Next, the Government provides its proposal to the President, who will seek the advice of the CPA. We do not simply provide the President with a figure. He is not opening an envelope and taking out a piece of paper and the figure is written on it. He will be provided with a full basis

from which we have derived the figures. And this means a fair bit of information and analysis – the historical rates of return for each asset class, why the Government or the Boards believe that those rates of return will or will not be repeated in the future, how we add it all up to derive finally a long-term expected real rate of return. And we will not just provide the President with a 20-year expectation but also with a five- to 10-year expectation of the investment outlook, so the President knows how it compares to our long-term view. It is not blind to what we expect over the next five to 10 years. So full information will be provided to the President, so that he, together with the CPA, would be able to form a judgment as to whether this is a well-reasoned assessment.

27 The CPA is a highly competent group of people – experienced, seasoned professionals and business persons who know something about markets. And, more importantly, although they are not investment experts they know how to assess an argument and the information that is put before them. The current Chairman of the CPA, Mr J Y Pillay, was the former Managing Director of MAS and GIC, and is currently Chairman of the SGX; Mr Yong Pung How was the first Managing Director of GIC, and also a former Managing Director of MAS; Mr Dhanabalan is currently Chairman of Temasek, which is not part of this

framework for now; Mr Lim Chee Onn is Chairman of Keppel Corporation, and the others, such as Mr Stephen Lee, who all know their stuff.

28 Going forward, the President will always want to ensure that the CPA continues to comprise people who have experience and a proven track record of good judgment. Ms Jessica Tan, in particular, and several other MPs have asked whether the President would also be able to get independent advice and assistance from other competent persons. Certainly. First, I should emphasise, of course, that the CPA is an independent panel. These are not Government representatives. All the members are appointed by the President. But the Government will certainly be very happy to facilitate the President getting advice on the investment environment from other experts, investment consultants or anyone that the President would like to get a view from. Ms Jessica Tan had also asked about whether the scheme allows for constructive dialogue, so that it is not a binary system where the President either agrees or disagrees, and if he disagrees, it falls back to the 20-year historical rule. That is the way it should work in practice – constructive dialogue – where the President will ask questions and ask for further clarifications. And that dialogue will, I think, facilitate agreement in most

circumstances on the long-term expected real rate of return to be adopted. So the dispute resolution mechanism is not the first recourse, but the last recourse.

Other clarifications

29 Prof. Thio Li-ann had also asked a question, which is how the President is going to carry out his constitutional duties without the necessary and complete information. The President has full and accurate information on MAS and GIC, for that matter, Temasek. He can ask for all information that he deems necessary to perform his Constitutional functions. And there has never been any doubt about the President having full and accurate information on these relevant assets – MAS and GIC. I think Prof. Thio was a little confused by what happened in the previous episode when former President Ong Teng Cheong had asked some questions that had to do with compiling an inventory of the Government's physical assets. The matter was resolved but it had never anything to do with the investment assets managed by the GIC and MAS, which have always been fully transparent to the President.

30 So, there is no issue of the President not knowing what it is that we are trying to preserve, and not knowing what it is that we are projecting expected rates of return on. The process which I have laid out to the House will be sufficient for the President to perform his custodial role. It is a custodial role, it is not a role which involves the President counter-proposing estimates of his own based on advice from the CPA, but it is a role which requires the President, advised by the CPA, to assess whether the Government's proposal is reasonable and well founded.

31 Ultimately – to go back to my earlier point about having the right people in charge – the President would be able to trust in the collective judgment of MAS and GIC's boards. The Board members are people of high standing, integrity and competence. And in response to Mr Liang Eng Hwa's query, each appointment has to be made with the approval of the President based on the President's evaluation of the integrity and ability of each member, whether it is a Minister, someone else in the Government, or someone in the private sector. And the Boards are supported by a whole cast of professionals, some of whom have been in this business and the organisation for a long time, who have been through the market cycles, who know their technical stuff but also come

with judgment of their own as to how the markets work. These are well-oiled professional organisations, always improving, and I can tell Members that they are held in rather high regard internationally.

32 Determining the long-term expected real rates of return is not a process which is completely untransparent. I was comparing the two approaches earlier; one, full transparency, let Parliament or the people decide; the other which depends on the right people being in charge and ensuring robust checks and balances within the system, and then a dispute resolution mechanism if you cannot agree. But the second approach which we have taken is not completely untransparent.

33 Mr Siew Kum Hong had thought that people do not know the size of Temasek's assets or returns. Temasek publishes an annual report every year – size of assets, and, in fact, different ways of computing annual returns, both on market value and shareholder funds. GIC has now published an annual report – and it will be published every year – which also provides its average rate of return over the long term, updated each year, and people will be able to see the trend very clearly. Indeed, if you look at GIC's report, you can already see a trend in the rates of return because of changing market circumstances. And

we will also publish the dollar amount of NIR in our Budget, just like we currently publish the dollar amount of NII. So, if there is a sudden spike or dip, questions can be asked. So, this is not an untransparent system. Ultimately, it is a system that relies on robust governance. It sets in place in the Constitution checks and balances, and the Government believes this system will work more objectively than alternative systems and better ensure that we preserve our reserves, and that we spend prudently and wisely.

Risks of actual returns deviating from expected returns

34 There is a risk that actual returns will deviate from expected returns. Several MPs have pointed it out, the last was Ms Penny Low. Actual returns may well deviate from expected returns. The markets are uncertain and no one can forecast with precise accuracy.

35 Mrs Josephine Teo had asked what if we find that over the first five years, actual returns are significantly different, for instance, significantly lower than expected returns. It is the right question to ask. How have we addressed it in this framework? First, as Mr Gautam Banerjee has pointed out, the risk is mitigated somewhat by that fact that

we are only spending 50%. Although expected returns may be higher than actual returns, we are only spending 50%. That is the first mitigant.

36 But most important is the second factor, which is that we will review the expected rate of return annually, afresh, taking all prevailing information into consideration. And it will not be possible to ignore performance over a five-year period in determining what the most realistic forecast is for the next 20. It will not be possible for the Boards to ignore that. They will not ignore actual performance, but they will ask themselves: is this a cycle which is likely to rebound after a few years or is it a secular change in the investment environment that is likely to persist for many years – in which case, better to adjust the long-term forecast?

37 My first point is the 50% rule, as a mitigant; second point is that there is an annual review and that is the most important point. Thirdly, there is the check provided by the President each year as well, advised by the CPA, who will question the Government on its assumptions. And if the President feels that the last several years are cause for concern because actual performance has been less than expected performance, he will ask the Government some fairly searching questions. And the

Boards will have to justify why they have adopted what they proposed for the long-term expected returns.

38 I should finally mention as a fourth factor, somewhat technical, that there is a self-correcting mechanism in this as well, because if indeed we have persistently lower actual returns, it will reduce the asset base upon which the rate of return is computed. Even with the smoothing mechanism we are adopting, there is greater weight given to recent years. So if we have persistent underperformance, it will reduce the asset base and the Government would have less to spend. So, there is some element of self-correction in the system.

39 But I should also caution, lest we get too caught up with this idea of paying close attention to actual performance in the bad years, that the whole basis for this framework is to derive a stable stream of revenues for Government based not on one cycle, but the long-term expected performance. We want to avoid being caught up by short-term developments. This is why the task requires considerable judgment on the part of the Boards, the Government, the CPA and the President. When times are exuberant, we have got to avoid being too caught up by it and raising our long term forecast. When we are down in the bear

market, we should also avoid being too caught up by it. Make the most realistic and objective judgment of the future investment environment. That is the task.

Should Temasek be included in the framework?

40 If I can now turn to the question of Temasek. Several MPs had raised that issue which I had explained in my Second Reading speech as to why we have chosen not to include Temasek Holdings in the framework. Mr Inderjit Singh, Mr Siew Kum Hong and others had asked about this.

41 I had basically highlighted the main difference between Temasek and traditional international portfolio managers, like the GIC. Temasek's investment strategy involves taking concentrated stakes, both in the public markets, the listed equity markets, as well as in the private markets, direct investment, concentrated stakes. And this means two things. First, they expect to make higher returns, because they are taking higher risks, and indeed they have achieved higher returns. Second, with this strategy, it is inherently more difficult to project well into the future, what your expected returns are. This is common

internationally, eg, amongst the major private equity players. If you talk to the major players who have been in this business for a long time and ask them what their expected return is, they will tell you they have a hurdle rate, not an expected return. I have a hurdle rate for any investment I make. That hurdle rate depends on my cost of capital or weighted average cost of capital. And I try and exceed it as much as I can to serve my clients. But they do not come out with an expected rate of return, quite unlike the GICs of the world, for whom there are established methodologies, there are market comparators and benchmarks, which go through constant refining, but there are ways of projecting, five, 10, 20 years into the future.

42 Mr Inderjit Singh had also asked if the reason why we did not include Temasek was because "it needs time to digest its recent investments that had come unstuck". The exclusion of Temasek has got absolutely nothing to do with its recent performance or what we expect over the next few years. I have given the reason why Temasek is excluded. But if the Member is curious, Temasek publishes its results every year. It published its results a couple of months ago. People know what they are – 7% return market value over the last year, rather difficult year. And next year, I do not have any update on this, but if we have to

go by global market conditions, it will be a rough year. They will be publishing their results once again. And you can scrutinise it, evaluate it and make your own judgment about Temasek. So Temasek is transparent in its returns and the Government is not hiding anything in leaving Temasek out of its framework. It will continue to be transparent.

43 Mr Inderjit Singh has a good point. We do want to make sure that we continue, with this new framework, to coordinate Government's overall investments, overall allocation of funds between the MAS, GIC and Temasek. And this new framework will not impair that internal coordination that we do. These are different approaches: MAS – conservative, somewhat more liquid; GIC – higher risk than MAS, very broadly diversified across asset classes; Temasek – heavily focused on equities and taking concentrated stakes as well, the high risk end of the spectrum. What the Government does continually and will be doing going forward, is deciding on how much money to put in each of these bodies. That is why last year, we put an extra $10 billion into Temasek, which is published and known.

44 Mr Siew Kum Hong asked a specific question which I thought is important for me to address, about the new framework, where we are

shifting GIC onto the NIR framework, where we spend 50% including capital gains, and Temasek being left on the NII framework, where we spend 50% of NII which is based on dividends – which reflect capital gains as well, but not to quite the same extent. His question is whether that framework will incentivise Government to shift funds from Temasek to GIC, in order to get more out and spend now. I think it is a valid question. In theory, it can. It will not happen, certainly, under this Government, because our concern in deciding how much money to put in MAS, GIC and Temasek, is to maximise the value of our overall assets. That is our mission – maximise the value of our overall assets and ensure that we diversify and allocate funds to achieve that objective, subject to the risk thresholds. We have no incentive to shift funds between agencies in order to spend now. But, in theory, it can happen and that is an imperfection in the system. And I think it is better that we live with that imperfection, rather than try to overcome the imperfection by taking Temasek and putting it now in the NIR framework and facing the problems I spoke about yesterday, which is the difficulty of making the projections and the high degree of uncertainty that we will have in our Budget if we do that. The deviations between actual and expected returns will widen in either direction, with either actual being significantly more than expected or significantly less than expected.

45 So, I think this is the best approach. We are not casting this in stone for all time. I mentioned yesterday that after some years, we will look at Temasek again once it has settled its diversification strategy, to see whether we want to include it. In the meantime, we continue to spend on the basis of dividends paid by Temasek, which does reflect some of its realised capital gains. That is the prudent approach, in my opinion.

Liquidity issues

46 Mr Gautam Banerjee and Dr Lim Wee Kiak had asked questions which pertained to liquidity and this is an important issue. Because, as they pointed out, we are spending now on the basis of long term expected returns, which include both realised and unrealised gains because the distinction does not arise when we look at the long-term value of our assets. So, if we are spending on that basis, how do we make sure that we have enough inflow of funds based on actual dividends and interest and realised capital gains – because the monies we get from the agencies are based on the actual investment

performance, not their expected investment performance. So, how do we make sure we have a liquid flow of funds?

47 First, just to repeat very quickly a point I made yesterday, by including both realised and unrealised gains in the framework, we avoid a bias in our investments of wanting to sell assets now in order to realise capital gains so that the Government can spend it. This way, we are neutral. We include both the realised and unrealised gains, so that when we sell our assets is of no influence at all. But the question is valid – do we have enough liquid flow of funds at all times to meet the needs of the Budget without GIC or MAS having to inopportunely sell and liquidate in order to provide the Government with the money?

48 We have studied a range of scenarios and it will be highly improbable that we will end up with this problem. We have asked ourselves the question and studied it, and we will not have that problem. There is a net inflow of funds that the Government gets each year from a variety of other sources. Singapore Government Securities (SGS) issuance alone is quite sizable – it is about 4% of GDP annually. That alone in almost all market circumstances gives us the fresh liquid flow. Plus there are other sources of liquid funds that we will have at our

disposal in other areas, like land sales. We convert land and put it into the reserves, but, in the first instance, you are getting financial assets and if need be, we can use the fund flows for the Budget immediately.

49 So, this is a problem that we can tolerate because we do not envisage scenarios where we will really face a shortage of liquid funds.

Borrowing for expenditure

50 Mrs Josephine Teo had asked another important question – are there alternative sources of funding instead of drawing on reserves to meet these important expenditure needs? For instance, can we borrow? And as she put it, currently, Government is, in fact, able to borrow quite cheaply because of our very good credit rating, while we are earning more from investing our reserves, at least historically. Instead of drawing from our reserves and losing the opportunity reward of what we earn on our reserves, why not we just borrow?

51 First, our statutory boards borrow. LTA is going to borrow a significant amount for our transport plans. HDB already borrows very substantially. They issue bonds. And the Government is borrowing

through the Singapore Government Securities market, quite a large sum, not for spending, but the funds are invested. The Government borrows in order to develop the financial market and create a risk free yield curve, but we do not spend the money. It is all invested. But there is a limit to how much the Government or the statutory boards can borrow, because credit rating agencies study this very carefully. I think it is absolutely critical that we keep our sovereign credit rating unimpaired through rough times especially, and across the cycles. So, we have got to be very cautious about borrowing more.

52 But, more fundamentally, I would say, let us not get into the game of exploiting spreads, exploiting situations where your borrowing cost is lower than what you hope to earn in your returns, and, therefore, find complex strategies to exploit that spread. We have seen how some countries have gone completely awry that way. We have seen how AIG went completely awry that way. AIG had a strong credit rating, borrowed cheaply and invested in high risk complex instruments and did very well for a long time, until the spreads changed. I do not need to elaborate on what happened to AIG, but AIG had problems. So, avoid this problem. There is a good reason why the Constitution has written in safeguards against borrowing in order to fund spending and deficits. This is a sound

rule, and there are enough examples of how things have gone wrong otherwise.

What NIR will be spent on

53 Finally, let me come to the question on what we will spend our money on. This additional 2% of GDP, or slightly more, that we will get through the new NIR framework, when added to the revenue of 0.8% of GDP that we obtain from the GST increase, gives an overall revenue of about 3% of GDP. There was a range of views amongst MPs. Several wanted more social spending, to meet a variety of social challenges. Ms Sylvia Lim had emphasised that. Mr Lim Biow Chuan and several others also felt that there was a need to engage in more social spending.

54 But I have to say that our bias and view is squarely in favour of what Mr Christopher de Souza, Mrs Josephine Teo, Mr Seng Han Thong, Mr Liang Eng Hwa and others have said. We have to focus on building up capabilities and productive infrastructure to generate future growth. I will explain why. It is not an irrational bias. We have to bear in mind that NIR, under the new framework, is going to be quite a significant percentage of our total revenues. At 3%-3.5%, say, 3.5% of GDP, the

total NIR revenue, if you include the NII already allowed, will be about one-fifth of our total revenues (20%). If we then use that money to invest in social expenditures or consumption of one form or another, that keeps us happy for the moment but it does not generate future growth and future revenues. So, over time, what you find, when you are not generating future growth and future revenues, is that the NIR, as a percentage of total revenues, keeps going up and as a nation we get to be increasingly dependent on this new form of oil. We should avoid being dependent on this new form of oil, but keep to the principle, as PM says, of "Save, Work, Earn" as the basis of our society. And avoid pain- free spending. If you want to spend more, let us get revenues for it. If you do not have revenues for it, do not spend more. I think that is the right approach.

55 I have to emphasise once again what I said yesterday, because we are quite serious about this, that is, whatever we are spending, we have got to keep a very close watch on avoiding wastage and unnecessary expenditures and frills, which Mdm Ho Geok Choo and others have pointed out. There is a lot of work going on in Government which does not create headlines but which really leads to savings. Quite recently, we put in place a whole set of smart procurement practices where we

procure in bulk across Government agencies, and share services across our statutory boards and Government Ministries, which have reduced transaction costs significantly. We have put in place a capital charge framework so that our agencies will maximise their returns on the resources that are made available to them. And we recently put in place value-for-money reviews where we go in to have a look at how the funds have been used after a project has been implemented, whether the goals have been achieved and whether the funds were used wisely. With all these processes, we will keep disseminating best practices within and across the system. This is continuous work, making sure that we keep a culture of efficiency, economy and stewardship in the use of public funds.

Growing our reserves

56 Finally, let me take from where I started off. This is not just a framework about deriving more money for spending, but a framework for ensuring that we continue to conserve our resources for the future and that our reserves will continue to grow in line with our economy. To answer Dr Ong Seh Hong's question, which also includes our population size, because if you have a growing population, you have a growing

economy, you do want your reserves to be able to cover that. This formula will assure us that our reserves will not decline over the long term in relation to the size of our economy. The ratio of reserves to GDP will not decline over the long term. There will be cycles, but there will be no long-term trend of decline.

57 Mr Lim Biow Chuan had in fact asked whether we had a fixed target for our reserves. What size do we aim for? We look at this from time to time and we get teams of economists to try and study the optimal size of reserves. In fact, in my earlier days as an economist at the MAS, I tried this myself. There is frankly no answer to that question. We do not know what crisis will hit us. We do not know what natural calamity, what war, what economic crisis will hit us and what the scale of the damage will be. The more important point is that we must ensure that the reserves continue to grow in line with the size of the economy, and that is what I can assure Members this formula will be able to do.

58 The current crisis that we are going through internationally is throwing up very interesting lessons about the dangers of not storing up enough in reserves, and living for today. Iceland is the latest example – it is being played out this week itself, day by day. The Icelanders are

very tough, hardy people because of the extreme climate and the way they have had to survive beside large neighbours over the course of their history. They were regarded as a self-reliant people – and until very recently, Iceland was regarded as the "darling of the Nordic model". In fact, their per capita GDP is double that of Singapore"s. Iceland is now technically bankrupt. Its reserves are 25% of GDP, but its borrowings, largely by its banks, are seven times its GDP. So its system has collapsed. Foreign banks are no longer willing to accept its currency even for trade payments. So trade has come to a standstill, supermarket shelves are empty, and the government is restricting the use of foreign currency to food, oil and medicine. And, yesterday, they decided to accept a $6 billion loan from the IMF. Strong people, bright people, capable, and they used to be self-reliant, but a huge error over a relatively short space of time – over exuberance, over leverage, and not realising the importance of erring on the safe side.

59 As Mr Arthur Fong said, "if you save, you will be safe", and it is as simple as that. I think we can be confident. We have got strong reserves. It keeps our credit rating strong, good not just for government but, more importantly, for our businesses and banks, lowers the cost of

borrowing. And in that way too, our reserves generate sustained income over the long term which will benefit both current and future generations.

60 Ensure that when we spend more, we spend on the basis of what we can afford and we keep that spirit of self-reliance and living by our wits, which Josephine and many others spoke about. That way, we make sure that Singapore continues to be built to search for excellence, and built to last.