Muhammad bin Ibrahim: Perspectives and issues in navigating the development of the Malaysian financial market

Remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the ASEAN Risk Conference 2017 “Perspectives and Issues in Navigating the Development of the Malaysian Financial Market”, Kuala Lumpur, 24 May 2017.

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Thank you ladies and gentlemen. Two years ago, I spoke at this very conference on ASEAN integration. Two years on, I am pleased to share that we have achieved substantial progress on this front. Among others, the ASEAN Banking Integration Framework and the bilateral frameworks to settle trade in local currencies are two significant milestones for financial integration.

Today, I intend to speak on a few issues relating to ASEAN integration and outline the latest developments and challenges in the domestic financial market.

For decades, globalisation has been the cornerstone of global economic development. Globalisation was a way to bring the countries of the world together to gradually flatten the inter-country disparities in income, wealth and overall standard of living, in hope that the motivation for war and conflict among countries would gradually reduce as disparities narrowed. Globalisation expanded trade and the free flow of capital, allowing countries to reap the benefits of comparative advantage while facilitating the growth of new sources of income and the transfer of knowledge and technologies.

Truth be told, globalisation bore fruits that lead to greater economic growth, prosperity and wealth. However, in the dogmatic pursuit of inter-country convergence, intra-country disparities have become increasingly apparent. As nations across the globe were brought closer together, citizens within each nation were pulled further apart, separated by the rising inequality, the declining share of labour income versus capital, and the displacement of workers.

The unfettered market openness by advanced economies had caused unintended consequences that have ignited the rise to populism, inward-looking tendencies and potentially protectionist policies. If left to run its course, this will be a setback to global prosperity. In ASEAN, we are no stranger to this perspective. Our own experience is highly relevant.

We learnt from the Asian Financial Crisis, that pushing countries to adopt policies when readiness is suspect is a design for failure. Without the necessary preconditions of sound institutional frameworks, adequate safeguards and capacity and robust domestic financial markets, premature financial liberalisation will expose the economy to waves of destabilising short-term speculative flows. When these flows leave, a trail of destruction is left behind. We also learnt that proper sequencing and readiness of financial liberalisation is key.

The criticism that ASEAN’s ‘steam engine’ may not be ‘full speed ahead’ does not capture the full picture. This view fails to consider and understand that quality, not the speed and quantum of integration, is what really matters. The focus of integration should not be on speed, but on building the collective capacity, readiness and resilience of member countries.

ASEAN is committed to pursue market openness within this region, but also wants to remain deeply integrated within the global economy. A ‘Global ASEAN’ is not an oxymoron – rather it is a declaration of our inclinations, aspirations and direction for the future. Rather than a narrow pursuit of openness for its own sake, experience taught us that balance, readiness and inclusiveness is critical for the success for an open market economy. As a group, ASEAN has been very mindful of the stage of financial and economic development of individual countries.

ASEAN pursues ‘smart’ integration that is based on the readiness and capacity of member countries.

From the global financial crisis to the present

We are now entering a decade after the Global Financial Crisis (more apt to be called Trans Atlantic Financial Crisis) and two decades after the Asian Financial Crisis. The implementation of unconventional policies and a prolonged period of low interest rates, led to financial and economic distortions, some severe, around the world. Emerging markets, including Malaysia, witnessed large waves of capital inflows into capital markets, primarily in search of better yield.

For our onshore domestic market, we saw the ringgit strengthening following the demand for ringgit assets. Between 2011 to 2013, the ringgit traded at its strongest levels since the Asian Financial Crisis, between 2.90 to 3.30 against the US dollar. FX trading volume also increased, contributing to the overall liquidity of the onshore FX market. At the same time, the increased levels of non-resident investments in Malaysian financial assets had pushed non-resident holdings of Malaysian government bonds to rise to the height of 33.6% in May 2013.

These heights came with costs, heightened risks and vulnerabilities. From the Taper Tantrum in 2013 onwards, our markets went through several bouts of volatility. These were largely driven by volatile portfolio flows. During the Taper Tantrum in 2013 itself, we saw outflows of USD19.1 billion and a depreciation of 9.7% of the ringgit against the US dollar.

Despite this, our capacity, capability and resilience in managing these sizable and volatile financial flows have been fortified in a number of ways. Our economic fundamentals have remained healthy and our financial market is more diversified and well-developed. This enhanced the ability of the financial system to absorb capital inflows and outflows, thereby minimising disruptions while ensuring that these flows can be effectively intermediated to support real economic activity.

Malaysia’s exchange rate regime has also accorded the necessary flexibility for the exchange rate to adjust to the changing conditions. This has provided a good balance between flexibility and stability. Our ability to manage domestic liquidity has also improved significantly, supported by a wider range of instruments to conduct monetary operations and strengthened surveillance systems.

Pervasive impact of the offshore markets

However, one noticeable observation over the years was that, for each episode of volatility we faced, the subsequent calm would see an even larger build-up of risks. In particular, with the high non-resident investors’ participation in the onshore financial market, we saw significant growth in the ringgit NDF market. More recently, in November 2016, non-resident investors’ holdings reached a record high of 34.7% of Malaysian Government Bonds. While some argue that the ringgit NDF market is used by non-resident investors to hedge their ringgit assets, the reality is far more sobering. It is mostly used for speculative purposes.

These speculative activities have shown to have adverse negative spillovers to the onshore financial market due to its volatility. More importantly, the sheer volume of this market, which surpassed over 300% of GDP in 2015, underscores the extent of disconnect between NDF trading and economic reality. Given the size, onshore markets were vulnerable to the arbitrary and unpredictable nature of the offshore market.

Besides this vulnerability, there was an even larger long term challenge that we faced. The offshore market was developing and thriving at the expense and detriment of the onshore market and domestic stability. The recent developments following the US presidential election have attested to this fact. Following the results of the presidential election, the ringgit NDF was traded as high as 2168 pips away from the onshore market close during the New York trading hours. Such a significant move is obviously driven more by speculative activities and misplaced market sentiment rather than any significant change in the economic fundamentals of the country.

Given the divergence between offshore and onshore ringgit prices, arbitrage opportunities for non-resident investors persisted. To make things worse, even our own market players, began to consistently take the cue from the NDF market. This placed unwarranted downward pressure on the ringgit. Most unfortunate is the lack of concern by regulators where the NDF activities were thriving despite of the adverse impact on the affected currencies.

With the extreme destabilising effects of the offshore ringgit NDF market on domestic ringgit pricing, we took a broad spectrum of measures to reduce the speculative and damaging influence of these activities. Part of this was our stricter enforcement of non-facilitation rules for offshore derivatives. The long-standing prohibition on domestic players to facilitate transactions of offshore markets was extended to non-resident financial institutions via a compulsory attestation requirement. We also facilitated and managed the exit of significant short-term positions related to the NDF market. Certainly, these aggravated the immediate pressures on the ringgit but were very necessary to any eventual stabilisation of the currency.

I am pleased to share that a number of global financial institutions have complied with our requirements. But, there are still a few holdouts. We are perplexed as to how these financial institutions can continue to operate or facilitate an activity that clearly contravenes our rules and regulations. We will continue to enforce our measures and look at avenues to deal with those who facilitate the ringgit NDF activities.

The destabilising implications arising from the offshore activities gave a bad name to the market-based mechanism. It corrupted the idea of market openness and the liberalisation process. Such destabilising risks bear upon the integration process among financial markets of this region.

Developing long term solutions through the Financial Markets Committee

Addressing the speculative impact of the NDF market is only part of the solution. Of greater importance is the need to put in place sustainable long-term solutions. With this in mind, the Financial Markets Committee (FMC) was established in 2016, and tasked with the responsibility to look into the overall development and strategy for the Malaysian financial market. The FMC also looked into the factors that caused imbalances in the demand and supply of foreign currencies in the domestic market, including the reduced capacity of the market to provide liquidity to intermediate the portfolio adjustment by non-residents.

The underlying motivation of the FMC is to create a deeper and more liquid onshore market that will enhance its capacity to intermediate these flows and strengthen our resilience against excessive volatility. Despite the havoc caused by episodes of volatility from the opaque, unregulated and value destroying activities of the NDF market, the FMC in identifying the possible remedial measures have concluded that market based mechanism and solutions is still the best way forward.

Through close consultation with various stakeholders, including corporate entities and small and medium size enterprises, the FMC developed a series of targeted initiatives to develop the onshore financial market. The first series of initiatives announced on 2 December 2016, seeks to provide greater room for the onshore ringgit hedging for both resident and non-residents. The focus was on ensuring better access to the onshore financial market.

In particular, residents can now hedge without providing underlying documents up to certain limits, while registered non-resident investors have the flexibility to carry out dynamic hedging. At the same time, the scope of the appointed overseas office framework was widened to provide greater avenues for non-residents to access the onshore financial market.

The second series of initiatives announced on 13 April 2017, introduced greater flexibility for investors to manage currency and interest rate risks. Registered investors can now conduct full dynamic hedging and resident investors can now conduct short-selling for Malaysian government securities. All these flexibilities are expected to increase the ease of hedging business risks. The aim is to promote a two-way liquidity in the onshore financial market. At the end of the day, we envision that the implementation of these initiatives will make the domestic financial market a market of choice, where prices are determined by the real economy devoid of speculative and damaging activities. In this respect, we have introduced initiative that enables non-resident investors to access and hedge ringgit assets in the domestic markets.

We are mindful that for the NDF market to truly reduce in significance and adverse influences, the onshore market must become highly competitive, not just the foreign exchange market but also all aspects of the financial market. We are determined to realise the idea of having a market that possesses the breadth and depth to cater to the increasingly complex and diverse needs of the economy, and a market that is able to sustain and weather volatilities that contribute to the overall wellbeing of the economy.

The early positive results of the measures speak for themselves. The onshore foreign exchange market now regularly records a healthy daily volume. In addition, the ringgit exchange rate has remained stable with volatility reducing by half since the introduction of these measures. The domestic bond market is now more resilient as speculative positions have mostly exited the market. There is a larger composition of stable and longer term investors. This fact is much more important than just looking at the percentages or size of non-resident holdings. Our experience suggests that there is a threshold where non-resident investors will become a destabilising force.

The success of our measures and our continued faith in the market mechanism is now validated and restored.

Ensuring trust, confidence and integrity of the financial market

There are many lessons that we ought to learn. Some of the disruptions were caused from the uncompetitive market behaviors and questionable conduct by players. More evidently in recent times, cases of market manipulation and illegal fixing of interest rate and foreign exchange benchmarks have surfaced globally. These cases were only possible because of collusion and have collectively undermined the trust, integrity and confidence in the global financial market. The consequences are dire. As the saying goes, *'trust takes years to build, seconds to break, and forever to repair'.*

One significant example of such far-reaching incidents that undermined trust, was the manipulation of the LIBOR benchmark, a benchmark rate used to price a market estimated at USD450 trillion. Ineffective due diligence in the case of a rogue trader of a French bank and the 'London Whale' incident has also tarnished the credibility of some international institutions. Closer to home, two Australian banks were charged for manipulating the NDF ringgit fixing rate in Singapore.

For the Malaysian market, we have recently introduced the Principles for a Fair and Effective Financial Market (Principles) on 13 April 2017 as part of our market development strategy to uphold and maintain the trust, integrity and confidence. These principles represent the universal overarching ideals for a fair and effective financial market. It complements the rules-based guidelines and regulations, including the recently revised Code of Conduct.

I wish to highlight these principles;

1. Professionalism and integrity, through universal adoption of best market practices;
2. Full transparency and accountability, in all aspects of market participation;

3. A competitive environment that is free from collusive, fraudulent and manipulative activities;
4. Good internal governance and due diligence, supported by robust internal surveillance and reporting mechanisms; and
5. Compliance to prevailing rules, regulations and market codes while extending full cooperation to the authorities.

The Principles should be universally applied, internalised and practiced by all parties that transact in the Malaysian financial market. These Principles must be demonstrated consistently in the daily conduct of market participants.

Outcomes of the Adherence to the Principles will result in a well-functioning market

The Principles are intended to result in a fair and effective financial market that efficiently intermediates the funding needs of the economy and resilient in the face of shocks. One particular aspect of the Principles is on the adherence to rules and regulations, a critical pillar of financial stability, and a Code of Conduct expanded to explicitly prohibit transactions in unauthorised markets. This includes, in particular, the NDF market.

These Principles ought to result in three key outcomes:

1. Firstly, balanced perspectives when formulating policy and assessing market development. Such balance is needed between growth and stability, whereby growth of the financial market must be consistent with economic fundamentals. We have seen in many instances how the size of the financial market can be disconnected, and has grown too large for the real economy.

   Most of the activities in these outsized markets do not contribute to sustainable growth and consist mainly of speculative activities. Speculative activity is a major source of vulnerability not only for the financial market but also to the real economy, which if left unattended, could lead to devastating financial crises. Arguments expounding that these activities provide liquidity are delusional, and at best deflective.

2. Secondly, the outcome of the Principles is to level the playing field among market players. This means a market that cannot be distorted by any institution or individual. All participants, either large or small will have fair access to the market, without fear of being subjected to market collusion and manipulation. It ought to create an efficient, competitive and transparent market that will contribute to economic prosperity.
3. Thirdly, the outcome of the Principles is a strengthened regulatory framework. The Principles of transparency, accountability and good governance will promote market discipline. The Principles will serve as guidepost for us to effectively supervise and regulate the market and is necessary, given the increasing complexity of the financial market, exacerbated by the disruptions arising from technological innovations and greater interconnectedness.

Achieving these three outcomes is central to our development strategy and policies for the financial market. Together with the various FMC measures and initiatives already announced, we have laid the foundations to redirect the growth and development of the ringgit foreign financial market from the offshore to the onshore market.

After all, a thriving, open and robust onshore financial market is a prerequisite for a stable financial system and sustainable economic growth.

Conclusion

This year is the 20th anniversary of the Asian Financial Crisis and close to the 10th anniversary of the Global Financial Crisis. Anniversaries such as these are opportunities to pause, reflect and ponder on the past, present and future. There are many lessons to be learnt from recent episodes, and let us not repeat them. For if we do, only misery and hardship await us.