Capital flows, exchange rates and financial conditions in an evolving international monetary system – Malaysia's perspective

Central Bank of Malaysia

Introduction: Where Malaysia sits in an evolving system

The global monetary and financial landscape has, in recent decades, been characterised by large swings in global liquidity, shifts in international risk appetite and an expanding role for market-based finance. These dynamics affect how capital flows move in and out of emerging market economies, shaping both their size and how external shocks impact domestic financial conditions.

Malaysia has also been subject to these capital flow dynamics. Our openness has supported the development of deep and liquid local currency markets, drawing a wider range of foreign investors. This is complemented by the strong presence of domestic institutional investors (DIIs), whose expanding balance sheets and longer investment horizons have added depth to the market while serving as an important anchor of stability during periods of volatility.

Greater integration with global markets has also required our policy framework to adapt to an environment in which financial conditions can turn quickly and, at times, unevenly. The way investors allocate capital, shaped increasingly by benchmark-driven behaviour and the rising influence of non-bank financial institutions (NBFIs), has altered the way global developments interact with domestic conditions. These shifts have reinforced the importance of a framework that retains domestic monetary policy autonomy, maintains prudent policy buffers and underscores the importance of a flexible set of instruments to preserve domestic stability in the face of external shocks. Amid all this, the exchange rate remains a key absorber of external developments.

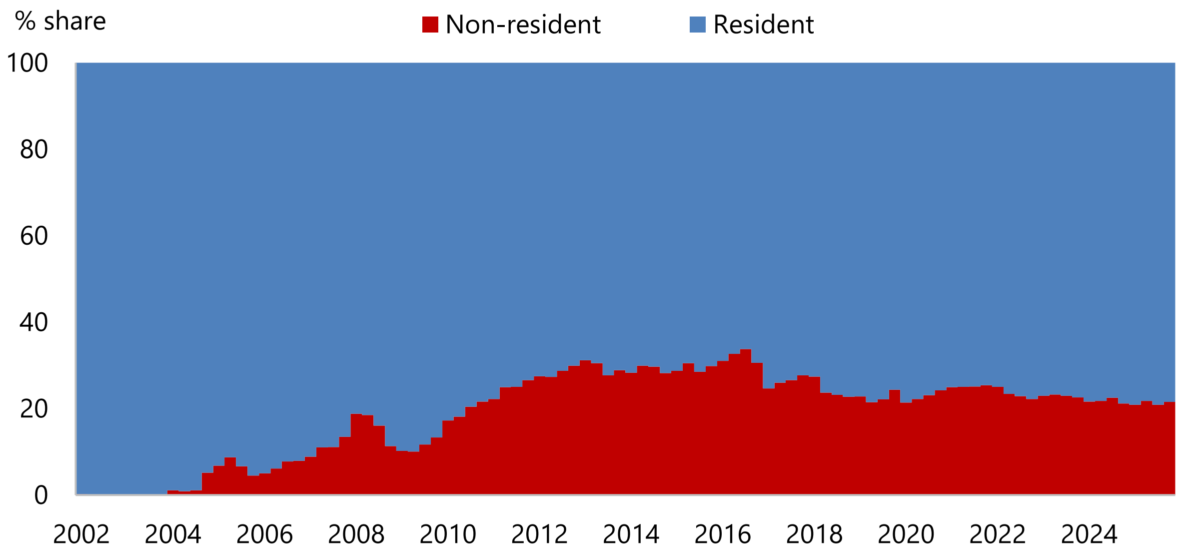
This note explains Malaysia's perspective in four parts. The first section describes the rising prominence of foreign and domestic NBFIs and examines how these shifts in market participation have shaped the resilience of our financial system. The second part considers the interaction between exchange rate dynamics, capital flows and domestic financial conditions, drawing on recent episodes to illustrate how global shocks transmit through Malaysian financial markets. The subsequent section discusses Malaysia's policy approach, centred on domestic objectives and delivered through a flexible, multi-instrument framework underpinned by strong buffers and clear communication. The final section looks ahead to emerging sources of risk in an environment marked by geoeconomic fragmentation, persistent global volatility and new market fragilities and outlines the policy priorities needed to sustain resilience going forward.

Part I: Structural shifts in investor participation and domestic resilience

Malaysia's financial markets have continued to grow following the Great Financial Crisis (GFC). The development of deeper domestic markets has attracted a broader set of foreign investors, while DIIs have expanded in scale and significance. These shifts have gradually reshaped the structure of intermediation and the ways the market adjusts across financial cycles.

A **first feature** of this evolution is the rise and subsequent easing of foreign participation in Malaysia's domestic financial markets. Foreign NBFI involvement increased markedly in the years post-GFC, reflecting a broader portfolio reallocation into emerging markets following quantitative easing and a period of favourable interest rate differentials. As the government bond market[1] expanded, non-resident holdings rose to almost one third of outstanding securities by 2016, before gradually settling into a more stable range in recent years (Graph 1). Although the non-resident share has declined from its peak, it now hovers around one fifth of outstanding securities – still elevated relative to many regional peers. This pattern suggests that Malaysia has maintained a substantial degree of foreign participation, while earlier inflows have stabilised into a more durable participation profile.

Resident and non-resident holdings of government bonds | Graph 1



Source: Central Bank of Malaysia.

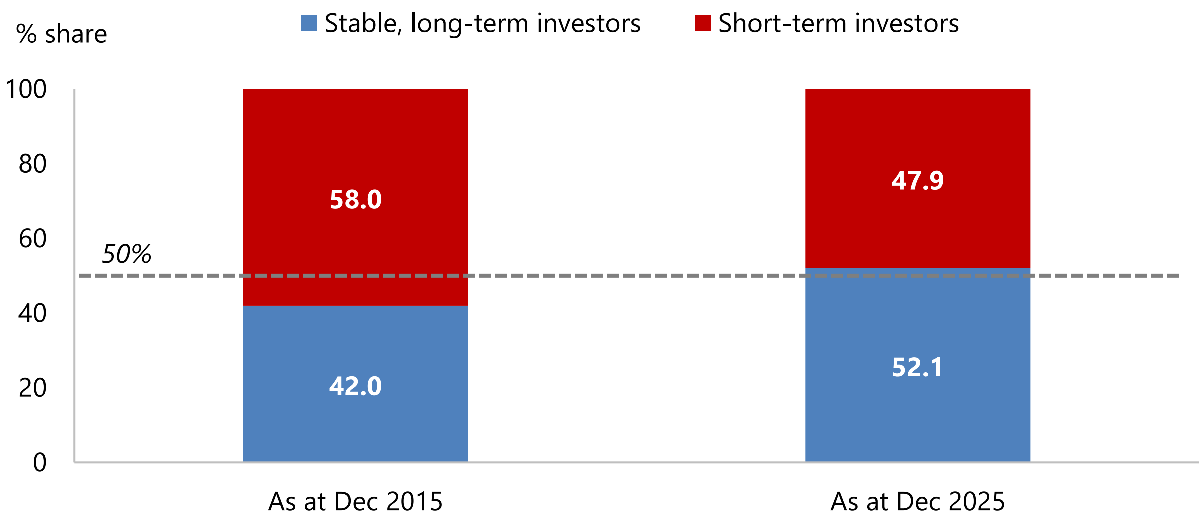
[1] Malaysian government bonds include Malaysian Treasury Bills (MTB), Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII).

A **second feature** is the shift in the nature and composition of foreign participation. In the post-GFC years, Malaysia attracted sizeable inflows from short-term, benchmark-driven investors. These flows expanded rapidly in response to accommodative global liquidity conditions, but were also quick to reverse during bouts of risk aversion or changes in interest rate expectations, resulting in periodic outflows.

Over time, however, positions held by longer-horizon investors, such as central banks, pension funds and insurance companies, have increased. The growing presence of these long-term institutional investors reflects greater confidence in the Malaysian market, supported by a track record of domestic macroeconomic resilience, a credible policy framework and ongoing efforts to strengthen market depth and liquidity. As a result, today's foreign participation constitutes a more balanced mix of long-term institutional investors and short-term benchmark-driven funds (Graph 2).

This rebalancing matters greatly for resilience. Longer-horizon investors help anchor market depth, provide more stable funding along the sovereign yield curve and reduce the likelihood of one-sided positioning during periods of uncertainty.

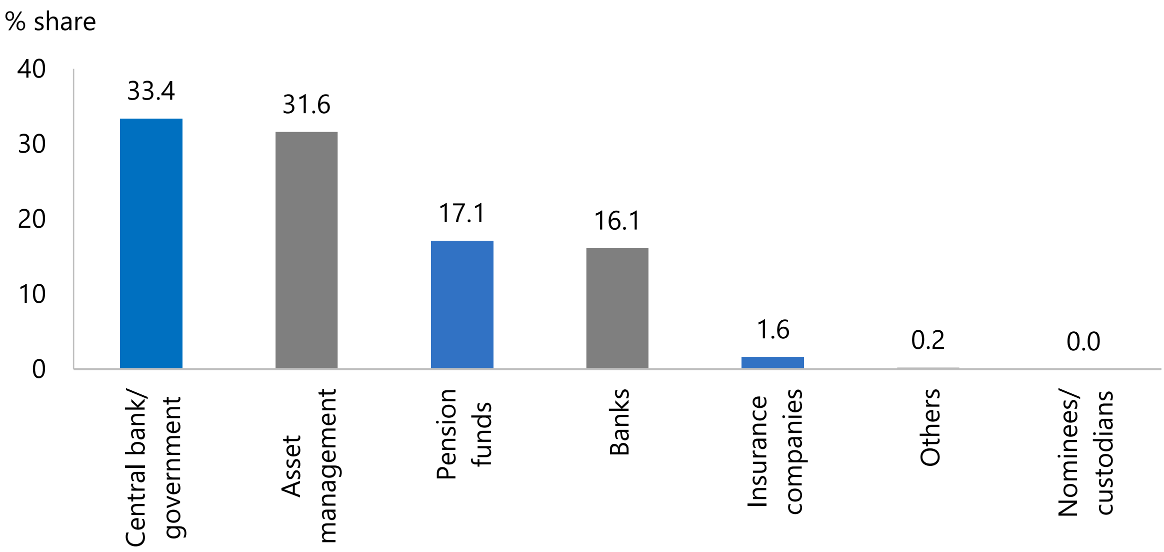
Distribution of non-resident holdings in government bonds Graph 2



Source: Central Bank of Malaysia.

Even so, short-term investors continue to account for a significant share of foreign holdings, especially among benchmark-tracked asset managers (Graph 3). While these funds remain one of the largest foreign holders of Malaysian government bonds, their share has nonetheless edged down over the past decade, from roughly two fifths to about one third of total non-resident holdings more recently. Their behaviour, by design, is more procyclical and sensitive to shifts in global risk sentiment and yield differentials. Their adjustments, therefore, can amplify market volatility during risk-off events, particularly through the exchange rate and domestic yields.

Distribution of non-resident holdings in government bonds as at December 2025 | Graph 3



Blue bars refer to the share of stable, long-term investors.

Source: Central Bank of Malaysia.

These structural shifts have shaped the policy and market development priorities adopted in recent years. Episodes of volatility have underscored the importance of deeper and more liquid secondary markets, prompting measures such as the promotion of a securities-driven interbank repo market and the use of bond switching operations[2] to replace less liquid MGS with benchmark securities. These initiatives have improved market liquidity and enhanced secondary market trading. At the same time, sustained investor outreach and the broadening of product offerings, including the expansion of the Islamic sukuk market, have supported a richer investor ecosystem. Malaysia has also widened access to the onshore market by enabling multilateral development banks (MDBs) and development financial institutions (DFIs) to issue ringgit-denominated bonds for domestic use, further anchoring longer-horizon participation. These initiatives have been complemented by Malaysia's inclusion in major global indices,[3] which has raised its international profile and

[2] Bond switching operations (i.e. MGS switch auctions) refer to debt management operations involving the replacement of previously issued, less liquid MGS, with current benchmark issues of either the three-, five- or 10-year sector. Increasing issuance of these benchmark MGS and reducing the outstanding amount of off-the-run MGS enhances trading in the secondary market, thereby improving the overall liquidity in the Malaysian bond market.

[3] Malaysian bonds are included in various global bond indices such as the Bloomberg Global Aggregate Index, FTSE Russell WGBI, JPM GBI-EM and Markit iBoxx ALBI, due to the country's

encouraged participation from a broader range of foreign investors. Collectively, these efforts have strengthened market functioning and enhanced the capacity of domestic markets to absorb external shocks.

A **third feature** is the growing significance and influence of DIIs. Over time, pension funds, insurers and government-linked investment companies (GLICs) have steadily increased their holdings across domestic asset classes. The growing presence of domestic NBFIs across key asset classes has naturally enabled them to play an important stabilising role across periods of external volatility. During risk-off episodes such as the 2022–23 US tightening cycle and the phase of delayed US monetary easing in 2024, these institutions increased their holdings of government bonds and equities as foreign investors pared back their exposure (Graph 4).[4] The purchases by domestic NBFIs during periods of stress reflected their long-term investment mandates and the more attractive asset valuations at those points in time. Such countercyclical responses have helped to cushion volatility and support market functioning at times when external pressures might otherwise have been more disruptive.

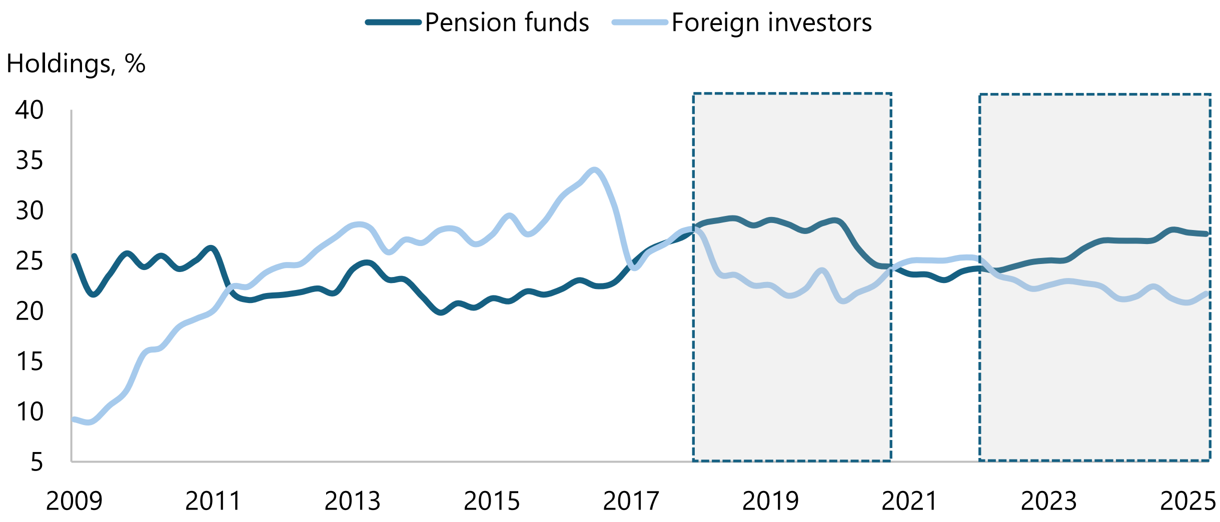
The growing prominence of domestic NBFIs reflects not just their size, but also the breadth of their presence across government bonds, listed bank equities and banking system deposits. These exposures underscore the dense interlinkages between NBFIs, banks and capital markets. Recognising this interconnectedness, the central bank (BNM) applies regular stress tests to evaluate the resilience of systemic NBFIs. The results suggest that they maintain adequate liquidity buffers and have the capacity to provide capital support to investee banks if needed. Regulatory oversight and prudential safeguards further help contain the risk of contagion across the system.

Beyond their domestic role, these NBFIs have also broadened their international portfolios as part of their portfolio optimisation strategies and in their search for higher returns. A growing share of their assets is now allocated to US dollar-denominated markets, particularly US equities. Although this global diversification brings portfolio benefits, it also raises the need for careful management of currency exposures. In practice, GLICs and other large institutions operate within BNM's hedging requirements for foreign exposures, which help mitigate currency mismatches and limit the risks of external shocks amplifying domestic volatility. These safeguards ensure that global diversification enhances long-term portfolio resilience without creating unwarranted procyclical spillbacks into domestic market conditions.

investment grade credit rating, progressive and inclusive financial market policies, developed infrastructure and ample secondary market liquidity.

4 Domestic NBFIs, particularly pension funds' holdings of Malaysian government bonds, have consistently demonstrated a countercyclical pattern relative to non-resident holdings, as reflected by the long-term (2009–25) negative correlation of –0.34. Recently, the correlation between government bond holdings of NBFIs and foreign investors has strengthened to –0.81 in the post-pandemic environment, underscoring its role as an automatic stabiliser in the domestic bond market. This inverse relationship was particularly pronounced during episodes of non-resident outflows, notably between 2017 and 2019, when the correlation reached –0.84.

Percentage holdings of Malaysian government bonds	Graph 4



Shaded areas represent the periods of capital outflows. Domestic NBFIs (e.g. pension funds) acted countercyclically, increasing their government bond holdings and helping to stabilise market conditions.

Source: Central Bank of Malaysia.

Taken together, the broader foreign investor base and a stronger domestic NBFI presence have enhanced Malaysia's overall market resilience compared with the immediate post-GFC period. This provides a firmer footing to navigate changes in global sentiment over time, even as ongoing vigilance remains important in light of evolving risks.

Part II: Exchange rate dynamics, capital flows and domestic financial conditions

Given this underlying configuration of foreign and domestic investors, and Malaysia's position as a small, open economy, domestic financial conditions remain closely linked to developments in global markets. The exchange rate and portfolio flows are often the first channels through which external shifts register domestically, shaping domestic asset prices, funding costs and credit conditions more indirectly. Changes in global risk appetite, interest rate expectations and the broader dollar cycle tend to affect the ringgit (MYR) and the direction of flows into local currency assets.[5] Surges in inflows are typically associated with appreciation, while sudden reversals during periods of risk-off trigger depreciation.

[5] See Singh (2014). This paper discusses Malaysia's experience and policy responses with respect to spillovers of global monetary conditions.

The ringgit's flexibility allows much of this adjustment to occur through the exchange rate rather than through abrupt changes in domestic interest rates or liquidity. Even so, concentrated inflows or outflows can influence financial conditions in the near term, particularly when global shocks coincide with heightened investor uncertainty.

Recent episodes illustrate these dynamics clearly. At the onset of the Covid-19 shock,[6] a sharp deterioration in global risk sentiment led to sizeable non-resident bond outflows of USD 3.8 billion and a 5% depreciation of the ringgit, with domestic yields rising and credit spreads widening, tightening overall financial conditions. As global liquidity conditions stabilised, flows gradually returned and market pricing retraced, easing the financial conditions. A similar pattern was observed during the 2022–23 US monetary tightening cycle. Together with a stronger dollar, rising US yields following 525 basis points (bp) of policy rate increase placed renewed pressure on regional currencies, including the ringgit, despite Malaysia's own 125 bp policy rate adjustment. During this period, financial conditions similarly tightened, mainly through the foreign exchange (FX) and capital markets. In both instances, movements in the exchange rate and term premia accounted for much of the movement in domestic financial conditions. These episodes highlight the extent to which global monetary conditions can affect domestic markets, irrespective of underlying domestic fundamentals.

Beyond the immediate effects on the exchange rate and market pricing, the dynamics of capital flows can also shape broader domestic financial conditions, particularly when inflows or outflows are sustained. Strong and persistent inflows have, at times, been accompanied by easier funding conditions, firmer asset valuations and a more supportive environment for credit expansion. This was especially evident in the post-GFC period, during which Malaysia experienced a sustained period of easy liquidity conditions and strong credit expansion alongside cumulative net portfolio inflows into the economy following quantitative easing abroad (Table 1).[7] These inflows reinforced risk-taking and compressed risk premia,

Capital flows, financial market performance and macro indicators during major global events

Table 1

Event periods	Post-GFC (end-2008–12)	Aggressive Federal Reserve hikes (2022–23)	Delayed easing of Federal Reserve's MP (end-2024)
Cumulative non-resident flows into domestic bond market (USD bn)	4.2	–4.1	–0.6
Ringgit's performance against US dollar (%)	+12.4	–9.3	–7.8
10-year MGS yield (bp)	–108.0	14.0	11.0
Credit growth (%)	11.5	5.4	4.9

Sources: Central Bank of Malaysia; CEIC; EPFR Global.

6 Refers to April–December 2020.

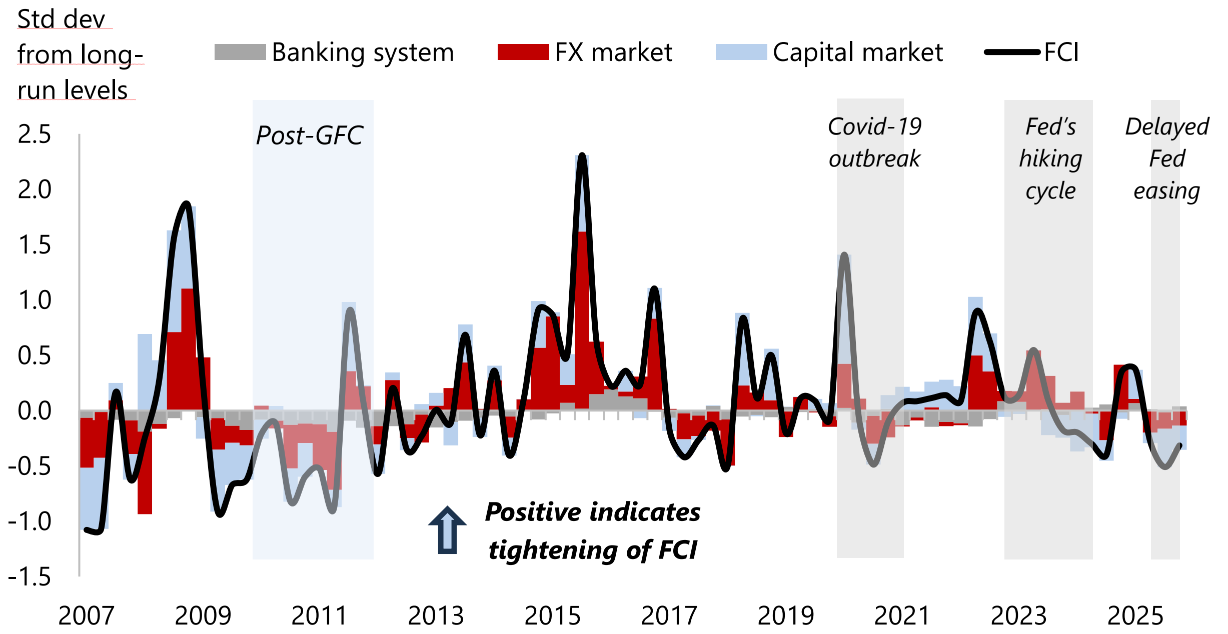
7 During this period, domestic credit grew at an average annual rate of around 11.5% between end-2008 and 2012, coinciding with cumulative net portfolio inflows into the domestic financial market.

supporting asset valuations and easing funding conditions.[8] When flows reverse, especially in relation to a weaker currency or a shift towards greater global risk aversion, funding conditions can tighten even if domestic fundamentals remain sound. While these effects differ across episodes, they illustrate how the ebb and flow of global capital can influence domestic financial conditions over time, through its effects on sentiment, asset valuation and the pricing of risks.

Shifts in global sentiment, particularly those accompanied by US dollar strength, can amplify these dynamics. Risk-off episodes, typically characterised by depreciation pressures and rising bond yields, tend to tighten financial conditions and dampen investor confidence. The impact can be more persistent when depreciation pressures are prolonged, leading to a longer period of tighter conditions and muted sentiment.

In this context, BNM's Financial Conditions Index (FCI) provides a summary measure of how movements in asset prices, yields and other market indicators affect overall financial conditions (Graph 5). The FCI typically loosens when the domestic exchange rate appreciates, amid capital inflows, lower bond yields and narrower spreads, and vice versa. During the onset of Covid-19, the FCI tightened to around a 1.4 standard deviation (std dev) from long-run levels, driven mainly by the capital and

Malaysia's Financial Conditions Index — Graph 5



The shaded bands help interpret the index, where blue denotes periods of easing and grey, periods of tightening. The FX component reflects ringgit movements and volatility. An appreciation typically coincides with easing, while depreciation typically coincides with tightening. The capital market component covers both bonds and equities; easing is usually accompanied by declining bond yields and firmer equity prices, while tightening is associated with higher yields and softer equities. The banking component captures funding and credit conditions, including interest rates for retail and business borrowers.

Source: Central Bank of Malaysia.

[8] See Central Bank of Malaysia (2014).

FX market components. The FCI subsequently moderated as stress in the FX and capital markets subsided. Likewise, during the 2022–23 Federal Reserve tightening cycle, the FCI tightened to around a 0.9 std dev from long-run levels due to FX and capital market tightening before easing as pressures moderated in early 2024. In Malaysia's case, however, the impact on the real economy depends on its underlying drivers. While earlier estimations indicated that the FCI for Malaysia tended to lead real GDP growth by two to four quarters,[9] changes in the FCI do not necessarily translate into co-movement with economic activity. When tightness is contained within the domestic financial markets, such as the foreign exchange and capital markets, spillovers to real activity have historically been more contained. When such tightness coincides with signs of pressure in the banking system, however, the real economic transmission tends to be stronger. The FCI is therefore interpreted alongside a wider set of indicators and used to contextualise evolving financial conditions, rather than as a mechanical guide for policy.

One factor supporting Malaysia's resilience in absorbing shifts in global conditions is the structure of domestic intermediation. Malaysia's bank-based financial system provides an important buffer. While tighter conditions may have some bearing on banks, especially during periods of tighter liquidity following capital outflows, the impact is mitigated by banks' predominantly domestic funding base and their strong liquidity and capital buffers. Banks' relationship-based lending and credit assessments also respond more to underlying borrower fundamentals than to short-term movements in capital flows or market sentiment. Exchange rate flexibility reinforces this by allowing the ringgit to adjust to external pressures without forcing abrupt changes in domestic interest rates or liquidity. Together with macroprudential safeguards and strong supervisory oversight, these features have helped limit the extent to which global shocks spill over into broader strains within the domestic economy.

Such resilience in market functioning, however, does not fully insulate domestic sentiment from external developments. The ringgit's movements against the US dollar often attract significant public attention. A sharp or prolonged depreciation may be interpreted as a broader signal of economic weakness. When such perceptions take hold, households and firms may turn more cautious, raising the risk of a larger-than-intended pullback in consumption or investment. Such shifts in sentiment may differ from market-based adjustments, yet remain relevant in assessing the broader influence of external shocks on domestic financial conditions.

The direct inflationary impact of exchange rate movements, however, has historically been contained. Malaysia's exchange rate pass-through (ERPT)[10] to core inflation is relatively low, supported by well-anchored inflation expectations and the structure of domestic price formation. As a result, even when the ringgit experiences episodes of volatility during global risk-off periods, the immediate effects on inflation have tended to be moderate.

[9] See Central Bank of Malaysia (2017).

[10] A 5% change in the MYR/USD exchange rate is associated with approximately a 0.1 percentage point change in core inflation in the next quarter (short run) and 0.2 percentage points over a year (long run). For further information on the extent to which the ERPT channel affects domestic consumer prices in Malaysia, please refer to Central Bank of Malaysia (2022), box article titled "Revisiting exchange rate pass-through to inflation in Malaysia".

This broader context forms the operating environment within which domestic policy navigates external shocks while maintaining its focus on Malaysia's underlying economic objectives.

Part III: Malaysia's policy approach

Malaysia's policy approach therefore reflects this balance, managing external influences while preserving the conditions necessary for domestic stability. The framework draws on a wide set of instruments to support orderly market functioning and anchor confidence through periods of global volatility. Within this broader architecture, monetary policy remains focused on domestic inflation and growth objectives, while other tools help manage the shorter-term effects of external shocks. These policy tools are further complemented by ongoing structural and market development efforts that strengthen market depth and resilience over the longer term. This pragmatic approach is operationalised through several core principles that inform how policy is calibrated and deployed.

Principle 1: Build buffers and fortify foundations during good times

The core pillar of Malaysia's approach is to build buffers and strengthen foundations during periods of benign conditions. This creates room for policy to respond flexibly, rather than defensively, when global conditions turn. Doing so involves strengthening several layers of resilience: accumulating adequate foreign exchange reserves during periods of sustained inflows; maintaining robust capital and liquidity positions across banks and NBFIs; and using macroprudential tools to contain the build-up of vulnerabilities across households, corporates and financial intermediaries. A key element of this effort is surveillance of structural vulnerabilities such as net open positions (NOPs), liquidity mismatches and pockets of hidden leverage, particularly within segments of the NBFIs. These imbalances can amplify market stress, even when headline indicators appear sound. Early identification and mitigation, through prudential requirements, supervisory engagement and strengthened liquidity risk management, help prevent such fragilities from intensifying external shocks.

This philosophy of building resilience ahead of time has served Malaysia well. In the period prior to Covid-19, for instance, BNM had accumulated reserve buffers and strengthened balance sheets across banks and other financial institutions.[11] This groundwork provided room for BNM to take decisive steps to preserve orderly market functioning when the Covid-19 shock unfolded, while still being able to deliver the monetary and liquidity easing that domestic conditions warranted, including sizeable policy rate cuts and a reduction in the statutory reserve requirement (SRR).

11 The banking system remained strong and well positioned to support financial intermediation in the face of the Covid-19 shock. As at end-December 2019, banks were well capitalised, with a total capital ratio of 18.6% and excess capital buffers of MYR 122 billion (as of February 2020). Funding and liquidity positions were also sound, with a Liquidity Coverage Ratio (LCR) of 149%. Refer to Central Bank of Malaysia (2020) for further information.

Importantly, banks continued to intermediate credit without major disruption, reflecting their strong capital and liquidity positions entering the crisis. The experience underscores the value of reinforcing buffers during more stable periods, ensuring that the policy framework has sufficient space to respond swiftly and flexibly when needed.

Principle 2: Targeted tools for targeted risks

Policy tools are most effective when they are aligned with the source of the risk. While some challenges warrant a broad, system-wide response, other risks are better addressed with more targeted instruments. Matching the tool to the nature of the risk ensures that policy actions are proportionate, effective and minimally disruptive to the wider economy. In managing episodes of exchange rate volatility, for instance, the central bank conducts foreign exchange interventions judiciously, focusing on smoothing excessive movements rather than resisting market-driven trends. In this context, BNM does not seek to defend any specific exchange rate level, nor does it intervene to resist fundamental capital flow movements. Additionally, measures under the foreign exchange policy help reinforce prudent behaviour by limiting excessive risk-taking and ensuring that corporates and financial institutions maintain sound currency risk management practices. Alongside these measures, direct engagements with key market participants, including corporates and DIIs, also play an important role. Initiatives such as the Qualified Resident Investor (QRI) framework,[12] which encourages resident corporates to repatriate earnings in exchange for flexibilities for investment abroad in the future, support the timely conversion and repatriation of foreign currency funds, helping to ease frictions when market conditions are tight and strengthening two-way liquidity in the onshore FX market.[13] These tools provide a means of addressing imbalances close to their source, allowing monetary policy to remain focused on domestic inflation and growth while other instruments manage market-specific pressures.

A recent episode illustrates this approach. When global risk sentiment deteriorated in early 2024 following the delayed monetary easing by the Federal Reserve, the ringgit faced renewed depreciation pressures. During this period, while the ringgit was affected, the underlying outlook for domestic growth and inflation did not materially shift. Thus, adjusting the domestic policy rate to offset the higher US rates was neither warranted nor would it have been effective or proportionate. Instead, the central bank focused on targeted measures, including closer engagement with corporates to encourage the timely conversion of export proceeds and improve onshore FX liquidity. These steps contributed to restoring more orderly market

[12] The QRI programme is a foreign exchange policy flexibility for resident corporates which are looking to repatriate and convert foreign currency funds from overseas investments and may have interest in undertaking new or further direct investment abroad (DIA) in the future.

[13] While BNM's FX interventions help manage excessive volatility, BNM supplemented FXI with initiatives to encourage healthy two-way flows in the onshore FX market through the full implementation of the QRI programme. The programme has yielded encouraging results as it has attracted more than USD 2 billion in inflows from participants since its launch in 2024.

conditions, with onshore FX trading remaining active and daily turnover rising to about USD 18 billion[14] from around USD 15.5 billion[15] prior to the measures.

Principle 3: Active communication to anchor expectations and build confidence

Clear and consistent communication is an integral part of Malaysia's policy approach. In periods of sharp exchange rate movements, timely messaging helps prevent negative sentiment from becoming self-reinforcing among both domestic and foreign market participants. This is particularly relevant in Malaysia, where the public often views the ringgit's performance as a barometer for overall economic conditions, and exchange rate depreciation can quickly be interpreted as signalling broader weakness.

For this reason, communication is calibrated to reach multiple audiences, including investors, analysts, businesses, the media and the wider public. During 2022–23, when aggressive US monetary tightening weakened regional currencies including the ringgit, concerns emerged among both market participants and the general public. BNM clarified that the depreciation primarily reflected global factors tied to US policy rather than domestic fragilities.[16] This communication, coupled with the measured calibration of the domestic policy stance, supported credibility and helped ease misinterpretation at a time of heightened uncertainty.

Communication also plays a practical role in setting expectations around the broader policy framework. Reinforcing that monetary policy remains focused on domestic objectives, while other tools address short-term market pressures, helps clarify policy intent. Restating BNM's commitment to orderly market conditions and its readiness to smooth excessive volatility when warranted likewise provides reassurance during periods of stress. Together, these efforts help support confidence and maintain clarity around BNM's policy approach.

Principle 4: Reinforce long-term resilience through structural measures

Beyond tools used to manage near-term pressures, BNM places equal emphasis on strengthening the longer-term foundations of Malaysia's financial markets, financial system and economy. Market development efforts such as the Principal Dealer (PD)

[14] Refers to the period from the start of coordinated efforts until end-2024.

[15] Refers to the period prior to the engagement, ie 30 December 2022 to 23 February 2024.

[16] The ringgit's weakness during 2022–23 was mainly attributed to the widening interest rate differentials between the United States and Malaysia, amid aggressive Federal Reserve monetary tightening. The rapid adjustment in US interest rates shifted global portfolio allocations towards US dollar assets, contributing to outflows from emerging markets and exerting depreciation pressure on the ringgit. These movements reflected external monetary conditions and global risk sentiment, rather than changes in Malaysia's underlying fundamentals.

system, the Dynamic Hedging Programme[17] for non-residents and the promotion of a securities-driven interbank repo market aim to deepen liquidity, broaden the investor base and strengthen market functioning. The PD system supports liquidity provision and market-making along the sovereign curve. The Dynamic Hedging Programme enhances FX risk management and participation in local currency assets. Meanwhile, a more active repo market improves collateral mobility and broadens funding options, strengthening market functioning especially during periods of stress.

Complementing these market initiatives, BNM continues to pursue broader measures that reinforce financial system resilience. This includes ongoing work to enhance prudential oversight and risk management practices across banks and NBFIs. These efforts help maintain a stable and well-functioning financial system that can support economic activity through varying conditions.

At the national level, these initiatives are complemented by a broader national reform agenda aimed at supporting Malaysia's long-term economic resilience. Since 2023, the government has undertaken renewed efforts to strengthen fiscal sustainability and enhance productivity. Fiscal reforms, including the phased rationalisation of subsidies for electricity, water, diesel and petrol, have been implemented carefully to balance growth, inclusion and price stability. Structural initiatives such as the New Industrial Master Plan 2030 and the National Energy Transition Roadmap seek to upgrade Malaysia's industrial capabilities, deepen value chains and position local industries for emerging opportunities in strategic sectors. Collectively, these efforts strengthen Malaysia's long-term fundamentals and enhance the country's attractiveness to investors.

Structural reform is not new to Malaysia. Decades of steady progress have helped build the foundations that support resilience today. BNM continues to work closely with the government, in its role as economic adviser, to support and advocate for these reforms. More importantly, these broader economic reforms help provide enduring confidence in the ringgit, attract a wider base of stable investors and position Malaysia's financial system to better withstand external shocks.

Part IV: Emerging challenges and policy priorities moving forward

Looking ahead, the global environment is likely to remain shaped by forces that could generate more frequent and complex spillovers for emerging markets. Two developments, in particular, have broad and lasting implications: policy-driven geoeconomic fragmentation and rapid advances in artificial intelligence (AI).

Geoeconomic fragmentation is structurally shifting the global economy from the earlier era of deep integration towards one of de-integration and rising

[17] The Dynamic Hedging Programme is part of BNM's initiative to provide market access for institutional investors to actively manage the FX exposures of their invested assets. This programme, which was first introduced in December 2016, provides the flexibility to actively manage FX risk exposure via forward hedging activities with onshore banks or an Appointed Overseas Office without the need to show documentation.

protectionism. The steady build-up of tariffs, export controls and investment restrictions reflects a broader policy-driven shift in which trade, technology and national security concerns increasingly overlap. Governments are reassessing supply chain dependencies and reshoring or "friendshoring" strategic sectors. Geopolitical tensions, shifting trade patterns and uncertainty over US monetary policy further heighten the risk of abrupt changes in global risk appetite, with spillovers to emerging markets regardless of domestic fundamentals.

In parallel, rapid advances in AI are reshaping production, investment and market behaviour. AI is emerging as a new form of capital – scalable, rapidly deployable and capable of transforming supply chains. These shifts have contributed to strong investment momentum and, in some market segments, elevated valuations, particularly in AI-related technology sectors. While innovation brings opportunities, high valuations and concentrated exposures also heighten sensitivity to changes in market sentiment. A sharp correction in AI-linked assets, or broader US equity valuations decoupling from fundamentals, could trigger a wider repricing of risk and spill over into emerging markets through wider term premia, weaker sentiment and renewed FX pressures. Given the potential for AI to amplify market adjustments, such spillovers can be transmitted more frequently and with greater speed, compressing the window for markets and policy to adjust in an orderly way.

These dynamics interact with the structure of global financial intermediation. The growing role of NBFIs internationally, including the use of leverage, liquidity transformation and complex funding structures in some segments, has at times amplified market adjustments during periods of stress. While Malaysia's domestic NBFIs remain well regulated, the global dimension of these risks highlights the need for continued surveillance of cross-border exposures and the channels through which liquidity tensions abroad may affect local conditions. Benchmark-driven allocations can also accelerate the pace of flow adjustments, making domestic markets more sensitive to shifts in global sentiment.

Emerging digital assets may also introduce new risks. The expansion of US dollar-backed stablecoins and other crypto instruments raises the possibility that during stress episodes, some cross-border movements could bypass traditional intermediaries, reducing visibility and complicating the effectiveness of conventional tools. Although such activity remains limited in Malaysia, the trend points to the need for enhanced surveillance, improved data collection and tighter cross-border coordination to identify and manage evolving risks.

Malaysia's ability to navigate these emerging risks will depend on the country's capacity to adapt and the robustness of its foundations. Policy priorities in this environment are clear. The framework must remain adaptable, with sufficient operational flexibility across instruments to respond swiftly and proportionately when external shocks occur. Preserving policy buffers, broadening the domestic investor base and keeping the macroprudential toolkit up to date remain important elements of resilience. Clear and consistent communication continues to play a key role, helping to anchor expectations and reinforce policy credibility at times when external signals are volatile.

As AI adoption accelerates, greater attention will need to be given to valuation concentrations, financing structures and third-party dependencies, including data governance and operational risks. Meanwhile, proactive risk monitoring should remain attuned to NBFI exposures, leverage and liquidity mismatches, as well as to valuation risks that could propagate through global repricing episodes. Oversight of stablecoin and crypto-related activity adds another dimension, helping reduce blind spots in liquidity management and limiting the risk that such flows complicate conventional policy tools.

Continued market development will complement these efforts. Wider access to hedging instruments and greater transparency in FX liquidity can help smooth market adjustments during periods of stress. Stronger local currency market infrastructure and a more diversified, longer-horizon investor base across both conventional and Islamic finance further support orderly market functioning. At the same time, investments in data-driven supervision and regtech or suptech capabilities enhance the timeliness and coverage of macro-financial surveillance and strengthen early warning capacity.

Conclusion

Overall, Malaysia's experience highlights the reality that global conditions will continue to shape domestic financial markets in ways that require ongoing vigilance. While these external influences cannot be fully avoided, flexible policy frameworks and sound buffers, underpinned by steady structural progress and clearer visibility over evolving risks, can help ensure adjustments remain orderly. These elements support a policy environment that stays oriented towards domestic priorities, even as the external landscape becomes more complex.

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