Muhammad bin Ibrahim: Recent developments and emerging trends in Asia

Keynote address by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the Second Annual South East Asian Institutional Investment Summit – "Recent developments and emerging trends in Asia", Kuala Lumpur, 2 December 2010.

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Let me first thank Asian Investor for the invitation to speak at this institutional investment forum. I am honoured to be given the opportunity to speak before such a distinguished group of investors, fund managers and government officials at this important gathering.

My remarks will consist of three parts – the first part, on the current trend of rising capital inflows to Asia and its implications, secondly on regional market developments and lastly, I will make some observations on the region's institutional and central bank investing space.

Asia as the investment destination and its implications

It has been three years since the financial crisis first erupted. Emerging market economies have demonstrated resilience, showing a steady growth path to recovery, well ahead of major developed countries which face challenges of low growth, high unemployment and mounting fiscal burdens. Such large disparities in the growth rates and economic environment have inevitably led to divergence in monetary and fiscal policies. Where developed countries had maintained low interest rates, expanded quantitative easing policies and implemented stimulus programmes to revive their economies, emerging markets had started normalising their interest rate policies.

The recent financial crisis differed from the 1997–98 crisis in many aspects. Emerging market countries have a much stronger fundamentals, better growth prospect and higher interest rates. These differences in fundamentals have attracted growing and significant capital flows to these parts of the world. Net private capital flows into emerging markets was projected by the Institute of International Finance to rise to USD825 billion by the end of 2010, representing a 42% increase from last year. Many analysts expect the recent Federal Reserve's policy decision to purchase another USD600 billion of US Treasury bonds under "QE2" will intensify further flows to the region. Economists estimated that between a quarter to half of the QE2 liquidity will flood into emerging markets. The inflows if not managed properly will pose difficulties to Asian and emerging markets. Policymakers would face several predicaments from policy perspectives.

The influx of capital inflows, have led to a rapid expansion of liquidity translating into rising prices, leading to concerns on asset bubbles and the possibility of overheating the economy. However, the impact on each economy will differ depending on the size of the inflows and the ability of those markets to manage the flows. The upward pressure on the exchange rates has also been significant as seen by the appreciation of regional currencies at an average of 4% on a real trade-weighted basis since beginning of the year. Understandably, such pace of appreciation has raised some concerns among businesses especially in highly open economies, where movements of exchange rates will certainly impact businesses. Under this new normal situation, the agility of businesses and the economy to adapt and adjust to the challenging environment is critical. There are a number of possible adjustments which can be done including raising productivity and efficiency. In formulating public policy, policymakers are faced with the challenge to strike a fine balance in handling the capital flows and its impact to the economy. Because of the enormity of the flows, a combination of approaches had been adopted by emerging economies to manage capital flows. Even measures regarded as unorthodox at one time are now being implemented. Most countries

have allowed greater currency flexibility; and many have ended up accumulating foreign reserves. These inflows were typically sterilised by the central banks to avoid pressure to domestic liquidity and price level.

Regional market developments

Turning now to the second part of my remarks on key developments in the regional financial markets. The ability of regional economies to weather the recent financial crisis has its root in the aftermath of the 1997–98 crisis. Many had use the past financial crisis period to embark on bold financial reforms and restructure their financial landscape. Of particular importance were the successful efforts and policy initiatives to develop the bond market. As a result of these initiatives, the depth and breadth of regional capital markets have reached a level of maturity which can now absorb and intermediate large and volatile flows without posing risks to financial stability. The recent financial upheavals offers the most striking evidence given that there was no disruption to the financial intermediation process, credit flows and transmission mechanism.

There are, of course, pockets of risks in individual countries, inflation and property market bubble, to name a few, where different policy instruments could be used. Central to managing these challenges are macro-prudential tools, which have been deployed by Asian countries, to prevent, amongst others, price inflation in the real estate sector. A number of Asian policymakers recently had tightened lending standards by lowering loan-to-value ratio, imposing limits on non-owner-occupied property purchases and increasing transaction costs, as pre-emptive measures to temper speculative property investments and to manage or prevent excessive build-ups in household debt, at a time of fairly low interest rates and abundance of liquidity.

At the regional level, safeguards have also been enhanced. Among the lessons drawn from the 1997–98 Asian financial crisis are the importance of early detection of cross-border risks and vulnerabilities, followed by a collectively cohesive and firm action to avert any potential crisis. Over the years, the region has developed an integrated surveillance and crisis management framework through various groupings such as the Executive Meeting of East Asia Pacific (EMEAP) members and the South East Asian Central Banks. For example, the EMEAP surveillance framework focuses closely on regional monetary and financial systems which also connect international financial institutions and member central banks' reserves management and money market teams through the Dealing Room Network. Safety nets have also been developed and enhanced, such as in the form of liquidity support to member countries via the ASEAN+3 Chiang Mai Multilateral Swap initiative which consists of a USD120 billion currency swap facility, aimed to support countries with short-term liquidity needs and to supplement existing international financial arrangements. These various developments certainly have significantly enhanced the region's capability to holistically manage the inflows and to safeguard against the risk of sudden capital flow reversal and the instability that it would bring.

Malaysian market developments

Let me turn to some recent key developments in the Malaysian financial sector. The domestic financial landscape is undergoing transformation due to our continuous efforts in financial deregulation and liberalisation. Pursuant to financial liberalisation measures announced by Prime Minister Dato' Sri Najib Tun Razak, the central bank has granted 5 commercial banking licences to foreign banks in June this year, with mega Islamic banking licences to follow suit. Foreign equity limits in investment banks, Islamic banks and insurers have been raised while more operational flexibilities have been granted. In addition, the government has announced plans to increase foreign investment limits for the government linked investment companies such as the Employee Provident Fund. Importantly, these

liberalisation measures will further strengthen our inter-linkages with financial markets in other parts of the world. Contrary to the approach taken by many during the recent crisis, Malaysia had further liberalised the foreign exchange administration (FEA) rules in our efforts to promote efficiency, reduce costs and create a more conducive environment for trade, business and investment activities. The accomplishments in financial sector reforms and the many policy changes made have augured well for the country, as evident by our ascent into the top-20 bracket in the World Economic Forum's financial development index this year.

As with other countries within the region, we have also been a recipient of capital flows. As a result of continuous effort to strengthen the financial sector, our ability to manage the volatility and other impacts of capital flows has been enhanced. The financial markets and banking sector have proven their ability to absorb and intermediate these inflows while the Central Bank is always monitoring the market on a daily basis and is also well positioned to manage the situation. The domestic economy stands resilient and inflation remains under control. Furthermore, the pace of ringgit appreciation also reflected the positive underlying fundamentals of the economy.

Trends of investing by central banks and institutional investors

i) The concept of diversification

Let me now share some thoughts on portfolio diversification. Nearly 60 years since the proposition of Modern Portfolio Theory by Harry Markowitz, many investors are still grappling with the challenges of portfolio diversification. Among the sands in the wheel of a well-diversified portfolio are transaction costs and information asymmetry. In tandem with greater financial market integration and improved information access in the advent of information technology, these obstacles have significantly diminished over the decades. The recent financial turmoil however, has ignited a debate on whether the benefit of portfolio diversification is overstated considering the relatively low idiosyncratic risk vis-a-vis systemic risk in times of high volatility, and prevalent correlation breakdowns that occurred among asset classes, especially at the height of the financial crisis.

In my view, the emergence of such findings does not question the desirability of diversification, but rather, heightens the need for new and expanded methods to fine-tune the traditional portfolio optimisation approach. A growing class of investors are steering away from the traditional portfolio theory's emphasis on a normal bell-curve distribution and choosing instead to embrace the "Black Swan" idea expounded by author Nassim Taleb or the "New Normal" proposition by PIMCO, in which the distribution of outcomes are flatter with fatter tails. The idea basically characterises higher likelihood of outlier events following the observed major structural breaks from historical trends. To my mind, such non-normal distribution even further underscores the importance of diversification strategies to attain a reasonably stable return and the necessity for investors to be nimble in the face of uncertainty.

ii) Diversification by regional central banks and institutional investors

Central banks reserves continue to serve as an important safety buffer for the country and reflect the strength of the economy. Nevertheless, the issue of diversification continues to strike a chord among regional central banks and major institutional investors, driven by the accelerated pace of reserves accumulation in the past decade, low-yield environment in the G7 economies and changing trends in trade pattern and currency regimes. This necessitates a rethinking on how reserves should be invested. The fast pace of reserves accumulation and low yields on G7 assets remained the most compelling reasons for diversification in the quest to seek better risk-adjusted returns in alternative asset classes, such as emerging market debt, commodities and equities.

Intra-regional trade in Asia has surged from 32% of total exports in 1995 to an average of 50% in 2008, while the use of regional currencies for trade settlement has started. Furthermore, most Asian economies have gradually shifted from a US dollar focus to a more flexible exchange regime against broad basket of currencies, a trend which underlies the rationale of diversifying away from US dollar. In tandem with the rising savings and reserves accumulation by regional central banks, these reinforce the argument for more intra-regional investments which will contribute to the goals envisioned by the Asian Bond Fund (ABF) initiatives. The ABF was a fund launched by EMEAP, comprising foreign reserves held by regional central banks for investments in regional bonds with the aim of contributing to the development of regional bond markets. Today, we are near the juncture of achieving a key milestone, where formal setting is no longer required to mobilise intra-region fund flows such as in the case of ABF1 and ABF2.

Instead the intra-regional investments are becoming more self-reinforcing. As a proof of this, we now have more anecdotal evidence on the rising proportion of the regional central banks' reserves invested in Asian local currency debt.

iii) Credit risk assessment approach

As we tread into uncharted territories of new asset classes, there is a growing need to enhance analytical capabilities, resources and risk controls. For example, many central banks and institutional investors have gradually moved away from over-reliance on credit rating agencies to an internally-based credit rating assessment practice in portfolio management. In the wake of the US financial crisis and recent European sovereign issue, one would question the credibility of credit rating agencies in flagging the risks built up in banks and sovereigns, ahead of the crisis. Most credit rating agencies also tend to apply ordinal ranking of credit, rather than specific risk metrics that can be mapped to default probabilities or expected losses. In my view, one of the major weaknesses of credit rating agencies is their objective to establish rating stability by applying smoothing methodology that can potentially delay minor downgrades, but trigger cliff-like and abrupt downgrades in the event of sharp credit deterioration. The abrupt regrading of credits tend to spook markets and is certainly not good for investors with a heart condition.

Regional central banks and major institutional investors are aware of such limitations; hence the best way forward is to complement rating-embedded investment guidelines with a more robust and rigorous internal credit risk evaluation framework. In tandem with diversification into alternative asset classes, there is a growing emphasis to improve the sophistication of risk modelling, taking into account how risk can be initially understated when herding behaviour dominates, but rears its ugly head during reversals.

iv) The growing importance of Islamic finance

As events unfolded in the midst of the financial crisis, the sustained expansion of global growth and development in Islamic finance has emerged as one of the most prominent trends in global financial landscape. The industry continues to draw significant interests from all corners of the world. The global financial crisis underscores the potential role and relevance of Islamic finance as a viable approach in investing. Due to the Shariah prohibition of excessive leverage and unproductive cash hoarding, Shariah-compliant funds have outperformed their conventional peers since the onset of the crisis. As a result, there has been greater appreciation of the principles of Islamic finance, as evidenced by the expansion of interest and demand for Islamic financial products on a global scale. In line with the rapid growth of Islamic finance, emphasis has been placed on the development of the international financial infrastructure such as setting prudential standards and international best practices, a role spearheaded by the Islamic Financial Services Board. The most recent significant development was the establishment of International Islamic Liquidity Management Corporation in Kuala Lumpur. This corporation will act as a conduit to issue highly rated short-term

Islamic instruments to enhance cross-border liquidity management and provide Islamic financial institutions with an additional avenue to manage their short-term liquidity.

Complemented by other initiatives under the "Malaysian as an Islamic Financial Centre", I am quite confident that Islamic financial markets in Malaysia, for both ringgit and foreign currency, is set to thrive in the coming years.

Recently, we have allocated a small portion of funds to be disbursed to prospective and existing Islamic Fund Management Companies to invest primarily in foreign currency sukuk. This will provide a platform for fledgling fund managers to build track records and spur their growth of asset under management, besides broadening the sukuk market in Malaysia. In parallel, this initiative is also expected to catalyse the development of end-to-end value chain capabilities, encompassing the areas of secondary market trading and supporting infrastructures.

Conclusion

I would like to end my remarks by concluding that in the current global economic environment, uncertainties loom large and we have to be mindful of the challenges ahead, either as an investor or policymaker. This conference is indeed very timely to encourage open discussions on key themes in global investing, and hopefully we can all gain new insights in managing the exciting and challenging times ahead.

Thank you for your kind attention.