Sukhdave Singh: Global financial markets and their impact on Malaysia

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As the *Financial Times* newspaper likes to put it: "These are financial times."

If anyone had doubts about that, the financial crisis in the advanced economies (AEs) was a reminder of how very much we do live in financial times, how large finance has become, how the tentacles of global finance have encircled the globe. A crisis that started in the mortgage market of a large nation reverberated around the world spread through the globalised financial and economic system.

To understand why, imagine a landscape – a flat plain dotted with many ponds and lakes of water. None of them connected to each other. If anything happens in one body of water, it does not affect the others. That is the global financial system before globalisation.

However, if we now dig channels between the different bodies of water so that we have a system of interconnected ponds and lakes, the nature of that system has changed. Now, if water rises in one lake, it will also flow through the channels to the other lakes and ponds.

That is the global financial system. A system of connected national financial systems and markets, large and small. Financial liberalisation and advancements in information and communications technologies have connected the different national financial systems to create a global financial network through which financial resources flow around the world. In such a system, when there are disturbances in the small financial systems, it would merely be a ripple in the global financial system. But, if something happens in a large financial system, its impact would send shockwaves across the entire network. If policymakers, especially in the large economies, do not understand this, or underestimate its implications, it could lead to an *overestimation* of the effectiveness of national macroeconomic policies and *underestimation* of the global impact of those policies.

The global financial system is in a state of constant evolution with key impetus coming from technological advancements, financial innovation, regulatory changes, financial incentives and regulatory arbitrage.

The globalised financial system and what it means to be a part of it

So, let me first turn to the implications for Malaysia of being a part of the globalised financial system for there is no doubt that Malaysia has become more financially integrated globally.

Malaysia's financial integration with the world

Based on data on Malaysia's International Investment Position, which is compiled by Malaysia's Department of Statistics, outstanding non-resident investments in Malaysia increased by almost 4½ times between 2001 and 2014 to reach US$429 billion. That is the amount that non-residents have invested in Malaysia as of 2014 in the form of FDI, portfolio investments and other investments such as deposits, loans and trade credits by banks and corporates.

But over the same period, Malaysians have also been investing abroad. The stock of resident private sector investments abroad increased almost nine-fold to US$299 billion. About half of this was in the form of direct investments and another half in the form of portfolio and other investments.

About 67% of the stock of foreign investments in Malaysia is in the form of portfolio and other investments. This reflects the high openness of Malaysia's capital account and the significant deepening of its financial markets. As a consequence, foreign interest in our markets has increased. Even as our equity market has grown, so has non-resident participation, keeping non-resident's share fairly steady at around 24%. In the bond market, non-resident holdings of Malaysian Government Securities has increased steadily since 2009, and now accounts for a relatively stable share of about 47% of total outstanding MGS.

Given the more significant foreign presence in our financial markets, the definition of Malaysia's external debt was expanded to include foreign holding of ringgit financial assets. About 40% of Malaysia's redefined external debt is ringgit denominated debt held by non-residents.

In the years before the crisis, there was also a relatively strong correlation between the performance of the Malaysian bond and equity markets and the international markets, particularly those in the US. Since the crisis, that relationship has diminished significantly as the large amounts of liquidity has flowed back and forth between the emerging market economies (EMEs) and the AEs.

The benefits of global financial integration

Financial integration brings benefits to the Malaysian economy. Being a part of the global financial system facilitates trade and investment flows between Malaysia and the rest of the world. It has allowed foreign investors to invest in Malaysia with full confidence that the profits from such investments can be easily repatriated back to their home countries. Malaysian exporters and importers can freely trade with the world in full confidence that they could conveniently receive and make payments in any currency they wish in a quick and efficient manner. At one time, the lack of banking relationships made it necessary for BNM to established bilateral payments arrangements with central banks in many other developing economies to facilitate payments for trade between Malaysia and those economies. The expansion of correspondent banking has now made such arrangements largely redundant.

The globalisation of finance has allowed Malaysian corporates to tap global sources of funds to support their investments and operations in other parts of the world, hence broadening their economic opportunities. It has allowed Malaysian fund managers to invest in other markets to diversify their investments and increase the yields to their unit holders. It has allowed foreign funds to invest in our financial markets, adding depth and liquidity to these markets. It has allowed foreign financial institutions to operate in our markets and our financial institutions to operate in foreign markets.

Therefore, our engagement with the global financial system brings real benefits to the economy.

The risks in global financial integration

However, along with the benefits, there are also risks from the growing financial integration. A more integrated global financial system has a tendency to amplify financial shocks and transmit them throughout the system.

As Alan Greenspan, the former Chairman of the US FED, once put it, *"These global financial markets, engendered by the rapid proliferation of cross-border financial flows and products, have developed a capability of transmitting mistakes at a far faster pace throughout the financial system in ways that were unknown a generation ago."* [1]

[1] Alan Greenspan, *Understanding today's international financial system*, 34th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, 7 May 1998.

This could not have been better illustrated then how the financial crisis in the major economies spread to the rest of the world through the network of financial relationships. The consequent conflagration in the global financial markets had a significant negative impact on economies around the world. For EMEs, the subsequent actions of the policymakers in the crisis-affected economies have created additional significant policy challenges in trying to manage the cross-border contagion in the form volatility of their exchange rates and financial markets.

Malaysia was not spared from this volatility. We have experienced the contagion from what was happening in the major economies. For example, in the aftermath of the crisis in Europe, when the European banks were shrinking their balance sheets and pulling back from their overseas lending, concerns were raised about the fact that the European banks in Malaysia had claims of $64 billion on Malaysians, which was equivalent to about 23% of Malaysia's GDP then. These concerns focused on the impact of a pullback by European Banks on capital flows and the availability of financing to Malaysian companies. What ultimately helped us to alleviate those concerns was the fact that two-thirds of these claims were held by locally incorporated subsidiaries of European banks. Incidences like this not only highlight the fact that being part of the global financial system brings risks of contagion, but it also points to the fact that having prudent policies – in this case, requiring foreign banks to be locally incorporated – can help to mitigate some of these risks. I will have more to say on risk mitigation a little later.

The second way that the financial contagion can spread to the domestic economy is through capital flows into domestic asset markets. These create asset bubbles and if the central bank doesn't intervene, the twin attraction of rising asset prices and an appreciating exchange rate can be an irresistible draw for foreign portfolio funds. If not well-managed, such inflows can create imbalances in the economy and financial system, which will eventually manifest themselves, usually when the flows reverse. Since the start of the crisis in 2008, Malaysia has experienced three episodes of large foreign capital outflows. Thankfully, our policy framework, a healthy level of foreign exchange reserves, and the robustness of our financial system, have enabled us to withstand such flows without significant disruption of domestic economic and financial activity.

The third form of risk is through interest differentials. Very low interest rate in the AEs do not just attract yield-searching foreign funds to the higher yields in the emerging markets (EMs), they also create a very strong temptation for residents in EMs to borrow from abroad. We saw this type of vulnerability in this region in the period before the Asian financial crisis and more recently, in the Eastern European economies. The build-up of unhedged foreign currency debt by residents can be a significant source of vulnerability during times of economic and financial upheaval.

Then there are global liquidity spillovers into domestic liquidity that put downward pressure on domestic interest rates. We see this most evidently with the negative interest rates of the ECB, which has resulted in capital flows to the neighbouring countries and pressure on their exchange rates. As a consequence, interest rates in neighbouring Denmark, Sweden and Switzerland have all also become negative. Such contagious fall in interest rates can lead to excessive borrowing, a decline in savings, increases in asset prices, and increases in leverage, which in turn increase the risks of financial imbalances developing and undermining financial stability.

Among the EMEs, this period of low global interest rates has seen strong growth of credit in many economies, and while this has supported consumption and domestic demand, it has also led to increased household, corporate, and government indebtedness. The world today is even more indebted then it was before the crisis. I am sure that some of that debt went into productive uses, but it also the case that when something is cheap, it is used wastefully. It should also be obvious after the crisis, that economic growth fuelled by high credit growth is essentially growth borrowed from the future; higher growth today will be at the cost of lower growth tomorrow.

Lastly, risks can also emerge from the current account of the balance of payments. It is important to understand that changes in the current account can be both the source, as well as an outcome, of changes in capital account. The traditional interpretation is that a country has a saving-investment gap that is reflected in its current account deficit, which then drives it to rely on foreign savings to fund that deficit. But, it is equally possible that countries can have large capital inflows resulting in excess domestic liquidity and low interest rates. Add to that an appreciating exchange rate, and you have the key ingredients for domestic consumption and investment booms, leading to higher imports and driving the current account into a deficit or a lower surplus. Hence, the adverse developments in the current account can be the outcome of capital inflows.

Before I move on, let me sum up the risks of global financial integration as I see them, for this is really where the challenge lies.

As a policy maker in an EM economy, living in a globalised financial system characterised by a huge pool of surplus liquidity is like living next to the sea. On a day-to-day basis, the tide comes in, the tide goes out. You learn to live with it. Sometimes, the waves are high and you need to take appropriate precautions.

The sea is bountiful and to some borrowers it may appear to offer the opportunity of a cool escape from the searing heat of higher domestic interest rates. Like the call of sirens to ancient mariners, it lures residents and regulators with its enchanting promise of easy liquidity and growing domestic equity and bond markets. However, this vast sea also holds many dangers. It is affected by fierce forces that can create violent and destructive waves. Even when it is calm, beneath that calm surface there are dangerous currents. To the unwary, who wade in too far, it can drag them to financial ruin, be they businesses, individuals, or governments. Beneath its surface are hidden rocks that can drive even successful economies to the bottom of the sea. The challenge for EM policy makers in a globalised financial system is not that different from the one faced by a fisherman who lives by the sea, and that is, how to benefit from the riches offered by the sea while avoiding the dangers. So let me now turn to how I believe we can do that.

Reaping the benefits and mitigating the risks

The question I would like to pose and attempt to answer is: “What can EMEs do to strengthen their buffers and increase their resilience against the risks arising from integration with the global financial system?”

I am going to frame my answers within three broad categories: one, in terms of reducing external vulnerabilities, two, in terms of improving policy frameworks; and three, in terms of strengthening domestic economic fundamentals.

First, in terms of external vulnerabilities, I think storms in the global sea of liquidity are a source of concern, but for policy makers in EMEs, the consequential concern is how seaworthy is our own boat? Can it withstand a stormy sea? In my observation, capital flows often tend to accentuate domestic vulnerabilities and that can create the greatest risk of financial instability.

For those who choose to borrow from the international financial markets, it is good to remember that even in a world of abundance, restraint is a virtue. Like the sirens of Greek mythology, the international banks may go around EMEs telling them how easy it is to get funding. However, like the ancient mariners, governments and corporates in EMEs would do well not to heed those sweet-sounding siren calls. A period of low global interest rates may be a good time to re-finance old debt but it is never a good time to accumulate excessive debt.

The temptation is strong, especially when the domestic interest rates are higher. Central banks and regulators need to monitor the use of external financing by their residents to avoid an excessive build-up of short-term external debt. This was something we did before the Asian Financial Crisis and it proved to be prudent policy. At the same time, policy makers need to focus on reducing domestic economic vulnerabilities that make the economy dependent on external savings. In this respect, the high savings rate in Malaysia has been a key factor in ensuring that we did not rely excessively on external funding. The high savings rate is not an accident, but rather the outcome of policies that have nurtured and protected such savings.

A related point is the need to be careful about the pace of capital account opening. Premature liberalisation can create instability in the domestic financial system. It may also that financial liberalisation may not work out as anticipated, or it may create vulnerabilities that were not foreseen. In this case, countries must have the policy space to step back.

So, that is about addressing external vulnerabilities. Now what about having sound and robust domestic policy frameworks. This is a particularly important source of resilience when confronted with a volatile global environment. The prudent conduct of monetary policy to ensure price stability and provide a supportive environment for sustainable growth is a key contribution of central banks. Ensuring that credit growth is not excessive and that it is not channelled into unproductive uses is important to guard against future problems with excessive leverage and bad bank assets. A financial system that is burdened by a legacy of bad lending is obviously not going to be able to efficiently perform its function when the economy is hit by an external shock. It is for this reason that over the past several years, BNM has strengthened the credit culture at our banks and non-banks, undertaken rigorous stress-testing of banks, and introduced various measures to address vulnerabilities arising from the household indebtedness.

Fiscal policy, the other tool in the macro-policy toolkit, also needs to be conducted prudently and this is to ensure that there is fiscal policy space to respond to shocks. Prudent fiscal policy can be a significant force is supporting growth in the face of adversity.

Another key determinant of policy effectiveness is whether policy makers have enough policy instruments to address the challenges that they are facing. With respect to risks related to financial globalisation, I will just mention three points.

- ***Foreign exchange reserves.*** Reserves are an important policy buffer for economies that are becoming globally financially integrated. Ideally, such reserves should be accumulated from more permanent inflows such as current account surpluses, FDI and remittances by residents working abroad create. Reserves built from short-term portfolio flows and external borrowings may be less resilient.
- ***Exchange rate.*** For EMEs, a floating exchange rate is probably optimal. Combined with adequate foreign exchange reserves, a floating exchange rate broadens the policy options when confronted with capital flows. The current volatility in the exchange rates of EMEs is in many cases unwarranted, but a fixed exchange rate under such circumstances would not be sustainable.
- ***Capital flow management measures (CFMs).*** My view is that CFMs are like quantitative easing (QE). They are not your standard policy instruments like QE is not conventional monetary policy, but it is good to have both of these policy instruments in your policy toolkit should you have need for them in a difficult situation. While the IMF has hesitantly moved its institutional stance towards supporting CFMs, many others in the AEs have not. For instance, it is often the case that trade agreements with the AEs still insist on significantly limiting the amount of policy space available to EMEs to undertake measures to manage capital flows. This is even after the post-crisis experience of significant spillovers to EMEs from the policies pursued by the AEs. However, within this region, there has been a

convergence of views. Following the joint meeting of the ASEAN+3 Finance Ministers and Central Bank Governors in May this year, a press statement was released on their common position with respect to both macroprudential measures and capital flow management measures. I quote: *"…deepening global financial integration …require MPPs and CFMs that counter increases in financial stability risks from changes in macroeconomic policies in countries with major currencies."*

Beyond the resilience of policy frameworks, my third and final point has to do with the resilience of domestic fundamentals. Firstly, having a diversified, flexible and competitive economy is a key strength in dealing with instability from the external sector, whether it is in the real economy or in the financial system.

Secondly, having a strong and resilient financial system is an important source of strength against vulnerabilities rising from living in an integrated world. In the period after the onset of the financial crisis in the AEs, many Asian economies have been able to sustain growth because their financial systems were healthy and were able to finance and support domestic economic activity even as growth in the AEs disappeared.

A deeper and more diversified financial system can also help to intermediate capital inflows in a less distortionary manner. In the post-crisis period, we have been pleased that the depth of the financial markets in Malaysia and the presence of large institutional players have contributed to stability in the domestic financial markets, even in the face of significant volatility in foreign portfolio flows.

However, when it comes to the size of financial markets, there are a couple of caveats that I wish to add.

First, a larger and deeper financial system may attract increased capital flows, and consequently, lead to increased volatility of the exchange rate. Such volatility can be mitigated if the foreign exchange markets are also deep enough to absorb the variations in the demand and supply of foreign exchange. Exchange rate flexibility is necessary and having a healthy level of foreign exchange rate reserves is also helpful in times when there is significant volatility of capital flows. During the Asian Financial Crisis of 1997–98, net portfolio outflows were RM31 billion. During the 2008–09 financial crisis in the AEs, we experienced almost three times that much outflows without any significant disruption of domestic financial intermediation.

The second caveat has to do with the question of whether a financial system can become too big whereby it becomes a drag on the economy. Based on research at the BIS and the IMF, this may indeed be the case. In July 2012, Stephen Cecchetti and Enisse Kharroubi of the BIS published a paper, where based on a study of 50 advanced and emerging countries from 1980–2009, they found that beyond a certain point, further growth of the financial system can actually reduce real growth by reducing productivity growth. Furthermore, a fast growing financial sector can also drag down productivity growth by pulling away scarce resources from the rest of the economy.

In the words of the authors: "*This evidence, together with recent experience during the financial crisis, leads us to conclude that there is a pressing need to reassess the relationship of finance and real growth in modern economic systems. More finance is definitely not always better*."

Last month, the IMF released a paper that essentially reaches the same conclusions. It identifies Ireland, Japan and the US as countries that have "too much finance" for their own good.

In Malaysia, the Financial Sector Blueprint clearly recognises the role of the financial system in serving the real economy. The economy is not subservient to the needs of the financial sector.

Regional cooperation

The final thing I wish to mention with respect to reaping the benefits and mitigating the risks of financial globalisation is regional cooperation.

During the Asian Financial Crisis, we found out that contagion can occur when our neighbours experience difficulties, even if our financial systems are not closely linked. More recently, the European countries, even those that are not in the euro area, have found themselves in a similar position. The key factor is whether a country's financial system is linked to the global financial system. Herding behaviour and generalisation among international investors and lenders will make the crisis in one country transcend borders and also affect neighbouring countries.

The possibility that the regional economies could be affected by global financial developments, as well as financial developments in countries within the region, creates a strong inventive for cooperation to create mechanisms that would pre-empt such adverse developments, and if they do occur, to limit their impact on the regional economies.

You would have heard about the resource pooling under the CMIM as well as the regional swap arrangements. These arrangements exist. They have existed for a number of years. But too be truly effective, we need to be looking deeply at global developments and how they can potentially impact the region, and more importantly, vulnerabilities within the region that could have cross-border effects. This requires having a regional surveillance mechanism, and the ASEAN+3 policymakers have set up the ASEAN+3 Macroeconomic Research Office (AMRO) in Singapore to do exactly that.

Would the regional mechanisms be better than the international mechanisms? It remains to be seen. We are still building these mechanisms, which provide us the opportunity to ensure that the bricks we put in place today will contribute to strong structures that would be able to withstand the demands placed on them in the future. In this respect, I wish to mention two points.

First, we have to ensure that whatever regional institutions we set up must have strong governance. It would be unfortunate if after criticising the governance of existing international organisations we then end up replicating similar governance structures in the institutions that we set up in Asia.

Second, regional policymakers are still trying to trying to make the cultural change whereby we are comfortable with both hearing about potential vulnerabilities in our economies and being comfortable in expressing concerns about vulnerabilities that may exist in our regional neighbours. That is a cultural change but it is a necessary change if regional surveillance and defence mechanisms are to be truly effective.

Of course, it is must be remembered that, regional or international, such mechanisms are a supplement and not a replacement for national resilience.

What the future holds?

The state of the global economic and financial system

It is indeed the case that after almost seven years of ups and downs, there continues to be plenty of uncertainty. Therefore, let me just say that we have been going through very stormy weather for the last seven years, and now we see some of the dark clouds parting and the sun shining through. Does it mean the storm is over? I cannot say. It is still the case that reading a financial newspaper on Friday can sometimes give a different picture of the global economy from what was reported on Monday. Many macroeconomic statistics continue to be volatile or show weak trends. On the other hand, many financial statistics, while also being volatile, have shown very strong trends.

After seven years of very aggressive monetary policy, we continue to face a world of weak growth. There has been much discussion of the new normal. Policymakers have expressed concern about the low level of productivity. There are questions about whether these are new trends or trends that existed even before the crisis but were glossed over by policies aimed at sustaining consumption and growth. Structural weaknesses in economies are regularly discussed, but less regularly addressed.

But despite this uncertainty, I will briefly mention two trends with respect to the global economy and financial markets that are relevant in terms of their impact on Malaysia.

First, there is better growth in the AEs but the growth remains weak and uneven. The U.S. economy is showing the strongest signs of sustained economic growth, The EMEs are continuing to experience growth but that growth is now slower.

Second, the monetary policies of the AEs remain very easy and are not likely to change significantly in the near term. This condition of sustained low interest rate continues to spur investors to frantically search for a few extra basis points in yields, undertaking larger and larger risks. This has fuelled the upward momentum of global financial markets and asset prices, which have risen to historical levels. Many market participants know that they are indulging in very risky behaviour, but feel that "*As long as the music is playing, you've got to get up and dance*" as one financier famously put it. But they are nervous and this nervousness is causing them to react to short-term developments and any sign that could signal that the music is about to stop. Note for example, the obsession of the financial markets with when the Fed is going to increase its interest rate by a quarter percentage point! Frankly, I do not think any one of the QE central banks is thinking of putting down its fiddle just yet. But the anticipation is certainly creating instability and over-reaction in the global financial markets, with EM currencies experiencing a high level of volatility. It is also not inconceivable that having run out of profitable opportunities in other parts of the markets, portfolio funds are now making currencies the next game in town.

Implications for Malaysian economy and financial system

These global developments obviously have implications for Malaysia. First, the volatility in the global financial markets will continue to wash on to our shores and create a challenging environment for both policymakers and participants in our financial markets. Such volatility does have an economic cost. Second, the fact that for the first time all the major economies are showing positive growth will provide support to growth of the Malaysian economy. However, until global growth can become self-reinforcing, the weak nature of external demand will remain a challenge.

The significant contribution of domestic demand to growth in the face of the adverse external environment over the past several years is a tribute to the resilience of our economy and financial system. It is an outcome of not only the policies that were implemented during these years but also in the years before.

The adverse global environment since the onset of the crisis in the AEs has reduced the contribution of the external sector to growth. Since 2007, the contribution of net exports to real GDP growth has been negative with the sole exception of 2014. This is in large part the outcome of the weak global growth which has reduced global demand for our exports, combined with strong domestic demand that has increased imports. Over the longer term, the contribution of the external sector will need to expand to support a healthy and sustainable economy.

With respect to this, we need to continue focusing on strengthening our economic relationships with other countries. The ASEAN Economic Community is one opportunity for us to do so. The Trans-Pacific Partnership Agreement that is current being negotiated by 12 countries, including Malaysia, is another.

Conclusion

In conclusion, it seems to me that Malaysia will over time become even more integrated with the global economy and financial system. This is necessary if Malaysia is to grow and prosper. We need global markets and we need foreign investment. So far, we have done a credible job of ensuring that the Malaysian economy and financial system evolves in response to domestic, regional and global developments. But, as I have sought to highlight in my speech, globalisation, particularly financial globalisation, also brings difficult challenges and risks. And those challenges are not likely to go away. Therefore, maintaining our focus on ensuring the resilience and competitiveness of our economy and financial system will serve us well as we sail the stormy global seas.