Muhammad bin Ibrahim: Some thoughts on the new economy

Speech by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Malaysian Institute of Economic Research's (MIER) 30th Anniversary Dinner, Kuala Lumpur, 26 September 2016.

* * *

Distinguished Guests, Ladies and Gentlemen,

I am honoured to speak here at the Malaysian Institute of Economic Research's (MIER) 30th Anniversary Dinner. I would like to commend MIER on the institute's continuous efforts in expanding economic knowledge, and the commitment to research over the past 30 years. Today, we meet at a time where the global economy is becoming increasingly dynamic and challenging, underpinned by complex global interlinkages and shifting trends. The challenges posed to policymakers are immense. The rapidly evolving world also necessitates swift, yet pragmatic policies in order for us to remain ahead of the competition. Against this backdrop, a deep understanding of the core issues is absolutely critical in supporting evidence-based policy responses; not only to manage risks but also to better leverage on opportunities. Tonight, I will be sharing some thoughts about this "new world economy" that we are in, and along the way, share some policy insights and research ideas for the many economists and policy thinkers in this room.

Global macroeconomic environment is becoming increasingly challenging

The periods of strong global growth have become something of a distant memory to us. Global growth for the past 5 years has averaged 3.5%, well below the pre-crisis average of 5.1%. Trade activity, which was once itself a catalyst of growth is now lacklustre. This was evidenced by the slower growth in global trade activity relative to global growth, as reflected in the decline in trade intensity from 1.6 times between 2002 and 2007 to just around 1 time between 2011 and 2015. Trade activity in the 1990s was driven mainly by trade of intermediate goods following the proliferation of global value chains, driven in part by the ICT revolution. However, the expansion of global value chains has slowed with increasing on-shoring of manufacturing activity. Global trade has also been dampened by weaker investment growth in several major advanced economies and China's efforts in rebalancing its economy. Given these cyclical weaknesses and structural shifts, the prospects for global growth and trade are expected to remain challenging going forward. In fact, the World Trade Organisation has projected for world trade to grow by only around 3% in 2016 and 2017.

Global risks have also increased significantly. In a globalised and digitalised world, higher interconnectedness and integration have resulted in greater transmission and amplification of risks. Country-specific risks have become more eminent as they could generate broader contagion effects. Ongoing global developments such as policy adjustments in several major economies, volatile commodity price movements and geopolitical tensions have compounded the uncertainties surrounding the global economy. Although baseline growth forecasts are already relatively low, the materialisation of these downside risks could nudge growth even lower.

Unconventional policies during the challenging times fast reaching limits

At the onset of the Global Financial Crisis, immediate policy responses were largely targeted towards stabilising the financial markets. As volatility began to subside, and as financial institutions and markets were stabilised, the policy focus subsequently shifted to rejuvenating growth and raising employment. An immediate policy challenge facing crisis-affected countries was that conventional policy responses of expansionary monetary and fiscal policies have fast reached significant constraints. Let me elaborate.

In the aftermath of the crisis, public debt in crisis-affected countries reached very high levels, in large parts due to the high cost of bailing out financial institutions. In the advanced economies, public debt grew by almost half within the span of 5 years from 2007 to 2012. For Europe, it even culminated in the European Sovereign Debt Crisis. The enlarged public debt levels and fiscal deficit put a hard limit on current governments' ability to spur real activity, even as growth falters. Many governments of crisis-affected countries undertook austerity measures to avert financial market backlash. This, of course, have had a further dampening impact on growth. In short, fiscal policy has lost its ammunition and has been rendered impotent in many countries.

In many of the economies, monetary policy became the only feasible stimulus tool, so called 'the only game in town'. However, substantial easing by major central banks has led to global policy rates reaching historically low levels. In fact, the zero lower bound that was once a theoretical constraint has now been the norm for the last 8 years. Unconventional policy measures, such as quantitative easing were adopted. Next came the introduction of the negative interest rate policy, particularly in the advanced economies. First adopted by the Danish National Bank in 2012, five other central banks have now lowered their key policy rates to negative territory. The outcomes of these unprecedented policy measures remain uncertain, with possibility of unintended consequences and the emergence of yet more risks.

Fiscal and monetary policy, two of the most important macroeconomic policy tools, are reaching a point where they have very limited room to influence the desired growth and employment outcomes. This raises a few questions – have we reached a point where macro economy becomes a dismal science? Have we reached a macro-policy trap? What have we missed in the design of these policy tools? These are very important questions. They warrant a deep re-thinking of the underlying basis of the discipline, and a re-examination of the many principles that we have been relying on all these while. To apply the same solution over and over again is certainly not a viable option.

The international monetary system fosters imbalances and volatility of capital flows and exchange rates

Since the departure from the Bretton Woods system, the international monetary system has evolved to reflect on-going changes in global economic developments and economic thoughts. The architecture of our current monetary system is characterised by flexible exchange rate regimes, free capital flow and independent monetary policy. This global landscape has expanded the cross-border exchange of goods, services and capital. Importantly, the transition to more market-based foreign exchange rate system has accorded policymakers greater control over domestic policies, accelerated the development of financial sector, and, ultimately, boosted economic growth.

Nonetheless, this international monetary system also has obvious shortcomings. In the post-Bretton Woods period, the frequency of banking and currency crisis has increased dramatically with large output and employment losses. At the centre of this international monetary system, policy adjustments in major economies have led to significant volatility in the financial markets. The initial hint of tapering by the Federal Reserve in May 2013 resulted in large reversal of capital flows and exchange rate over-shooting in emerging economies. Today, the complexity of managing an economy is compounded by the impact of global shifts in capital on domestic financial markets and real economic activities.

Given our high degree of openness, Malaysia was not spared by these developments. For example, global concerns over monetary policy normalisation by the Federal Reserve continue to impact the ringgit. Ringgit volatility since September 2014 has exceeded levels in previous episodes of sharp adjustments such as the European Sovereign Debt Crisis and Taper Tantrum. The weak ringgit performance was further amplified by the misperception about Malaysia's reliance on commodities and our position as a net oil exporter. Despite Malaysia's lower dependency on commodities, the magnitude of ringgit depreciation is disproportionately higher and is even comparable to the currencies of countries that rely more heavily on commodities, such as Australia and Norway. For the record, in 2015, commodities constituted only 19% of Malaysia's total exports. For example, the oil and gas industry accounts for only 11% of total exports, about 1% of total employment, and 22% of Government revenue. I must emphasize that adjustments in the ringgit should be viewed from a long-term perspective. In the short-term, exchange rate movements could react to new headlines and market sentiments, instead of reflecting the underlying strength of the economy. What is important, therefore, is to ensure the availability of ample reserves, maintain strong economic fundamentals and manage our exposure to external debt.

There has been increasing discussion among global policymakers, including at the recent symposium at Jackson Hole, on the changing nature of our international monetary system.

Some measures proposed include encouraging the use of Special Drawing Rights (SDRs) by the International Monetary Fund to increase the flexibility of the current monetary system. The G-20 framework also stressed on countries' shared responsibility in supporting "strong, sustainable and balanced growth" globally. Ultimately, there is an increasingly compelling case for a new thinking about the international monetary system and ways to reduce excessive volatility in global markets. Managing excessive volatility is particularly pertinent for small and open economies as volatile currency fluctuations not only affect trade, external debt servicing and cost of investment, but also affect domestic business and consumer sentiments. In response, countries in the region have embarked on greater quest to use local currencies for the settlement of trade and investment activities.

Against this backdrop, I shall attempt to outline some of the core issues in need of policy responses. I will be sharing some thoughts on the so-called "new global economy", and along the way provide some policy insights that may spur research ideas for the many economists and policy thinkers in this room.

A World Defined by Paradoxes

Since the global financial crisis almost a decade ago, the world has continued to be reshaped by complex and challenging forces with far-reaching implications, both economically and politically. Some of these forces were not foreseen and are causing many unintended consequences.

So it's not surprising that some circumstances are seemingly contradictory yet in some sense expresses a possible truth. In other words, paradoxes. These paradoxes pose a challenge to us all; from policy-makers, to businesses, to academics , provoking us to question our understanding of how the world works, and forcing us to rethink the approaches that we need to formulate in response to these forces that are shaping the global economy. I have three paradoxes in mind.

The first paradox is this; **while globalisation drives the world to grow closer together,** we **are simultaneously drifting further apart.** By many measures, nations and people are closer than ever in terms of trade, investment, information exchange and physical mobility. Despite the weakness in growth and trade activities, global flows of goods, services and finance is still more than one-third of global GDP, 150% the level in 1990. Yet, social disparities, most noticeably inequality in the distribution of income, have worsened considerably. Income inequality has risen in many OECD countries since the 1980s[1]; we in Asia have not fared well either, with an average Gini coefficient that is higher than the rest of the world[2]. The distance between the reality that we live in and our idea of an ideal construct of society is thus at once both closer and further than it was in our parents' generation.

The issues underlying this paradox are complex and different for every nation. In many ways, it is driven by the very forces of globalisation that have brought our economies closer together, but at the same time undermined the welfare of the middle-class in advanced economies and driven the ‘haves and have-nots’ further apart in the emerging economies. The problems confronting us today are different from the past. The implications for policymakers and social thinkers are therefore, immense. These new challenges require more nuanced understanding and approaches, and because of this, our frameworks need to adjust accordingly. For a start, it is important to recognise that new challenges can arise as a by-product of a genuinely positive development. Indeed it has been argued that rising income inequality is a direct and unavoidable consequence of the advent of technological revolution and the expanding process of globalisation. Thus, in this new economy, one of the pressing challenges may come down to reconciling the benefactors of technology and globalisation with those who are excluded, with the intention of keeping inequality at bay.

This brings me to the second paradox. **Despite all the technological advancements that we have experienced in recent years, labour productivity has not risen in tandem**. The world is now at the cusp of path-breaking and fundamental technological changes – in the area of artificial intelligence, bio-technology, advanced analytics or ‘Big Data’, and fintech, just to name a few.

But at the same time, labour productivity has been anaemic in major economies since the global financial crisis, which in the US, is currently experiencing the longest run of declining worker productivity since the 1970s[3]. Tangible slowdown in productivity is also prevalent in many emerging economies since the global financial crisis.

This is a disconcerting trend, as productivity growth is the bedrock of sustained improvements in standards of living and income. To borrow Paul Krugman’s quote, “productivity isn’t everything, but in the long-run it’s almost everything”. It’s a real challenge, to truly understand why this is happening. Advocates of the secular stagnation hypothesis argue that this is a result of under-investment in capital; others point to declining business dynamism, excessive household debt that leads to the misallocation of resources, and some attribute it to measurement errors given the expansion of the digital economy. And then, there are those who question the productivity-enhancing-value of recent technological innovations. What is the value of an Apple Watch as compared to the invention of the internet? It is indeed a challenge to comprehend this rapidly changing complex system that we operate in, let alone diagnose it. We need to humbly recognise the boundaries of our understanding for now, but at the same time relentlessly expand the frontier of thinking and conduct robust deliberation on the implication for public policy formulations.

The last paradox, **one that is familiar to many policymakers, a disquieting calmness.** In the financial markets, the VIX – a standard indicator to measure volatility in the global financial markets – is at its lowest in the last two years. In fact, it is close to the all-time low of below 10, last seen just before the global financial crisis. Yet, a quick scan of financial news would reveal significant uncertainty in the global economy, amid an ongoing series of policy adjustments in major economies, volatile commodity price movements and geopolitical tensions. To a large extent, this paradox is an outcome of the combined policy efforts by central banks and governments worldwide to maintain stability since the global financial crisis.

But beneath this sense of calmness is a tense undercurrent. There is an underlying anxiety that prevails beyond the realm of economics, for example in relation to issues of international security, environmental change, and the global spread of disease. Despite the tremendous progress that has been achieved in many of these areas through international treaties and institutional efforts globally, anxieties remain. Extreme views are becoming more prevalent in both side of the aisle, and manifests in the form of backlash against conventional wisdom, and the establishments. We ought to be circumspect in expressing our views. As individuals and institutions that have influence to mould public thought and perception, we have the added responsibility to be balanced. We should not be too eager to discard all wisdom that have been carefully amassed over many years but at the same willing to adapt to new thinking, new circumstances and new possibilities.

As policy-makers and economists, these contemporary issues confronting the field of economics are indeed reinvigorating. New rules are being made. Old rules revisited. The contradictory forces that I mentioned earlier, are causing great policy tensions. The policies that have been implemented and experimented in recent years by policy-makers across the world might themselves appear in contradictions. And the fact that the performance so far has been mixed does not invoke confidence in some of the policy prescriptions. These ranged from continued experimentation of unconventional monetary policies and the need to 'balance' that, with preserving financial stability, to the continued reemphasis in fiscal and structural policies in both advanced and emerging economies.

But in facing a world of paradoxes, perhaps we too need to take full advantage of the strong foundations and conventions that were built in the past, yet remain sufficiently nimble and unafraid to rethink and reconstruct in facing the uncertain future. Errors will be inevitable, but the more important point is our ability to correct them and to remain committed to achieving the right outcomes. This is true for policies of central banks as well.

Bank Negara Malaysia's Approach to Monetary Policy

Within this context, please do allow me to share with you the approach to monetary policy that Bank Negara Malaysia takes. Bank Negara Malaysia's decision-making processes and governance framework today reflect the combination of the efforts and progress since the establishment of the Monetary Policy Committee (MPC) a decade and a half ago.

Not many of you might be aware, but the MPC had its first meeting in 2002. In fact, the upcoming MPC meeting in November would mark our 100th MPC meeting since 2002. Before that, monetary policy formulation was conducted under the absence of an established framework and a standard structure. Over the years however, the MPC has evolved and enhanced its effectiveness as the sole body responsible for the formulation of Malaysia's monetary policy and policies for the conduct of monetary policy operations.

Of note, the new interest rate framework which was implemented in 2004 introduced the Overnight Policy Rate (OPR) as a new policy rate and contributed towards improvements in the conduct of monetary operations.

This not only played an integral role in enhancing the effectiveness of our monetary policy transmission, it also encouraged a more market-oriented financial system. At the same time, foreign exchange administration rules were liberalised, which created the preconditions for us to shift to a flexible exchange rate regime in 2005.

These developments laid the necessary foundations for the formulation of monetary policy to be eventually formalised following the enactment of the Central Bank of Malaysia Act 2009. The Act was a significant milestone – it institutionalised the autonomy of the Bank in the formulation of monetary policy and provides greater flexibility in monetary policy implementation.

Prior to the Act, the MPC, which was an advisory committee supporting the Governor, had meetings that typically took place only within a day. In its current form, the MPC meetings are now conducted over two days. The additional time is noteworthy, as it enabled the evolvement of the MPC towards a more robust, inclusive and comprehensive decision-making platform. This extension allocates sufficient time on the first day for in-depth presentations by staff and discussion amongst the MPC members on the implications of new economic developments. On the second day, the MPC members deliberate and decide on the appropriate policy after having carefully appraised and internalised the assessment and discussion from the first day. All these proceedings are also meticulously minuted, with the intention that the Bank will one day release the minutes for transparency purposes, and for the benefit of the research community.

Even after the formal institutionalisation of our conduct of monetary policy, continuous efforts were made in the years after to further strengthen our policy decision-making framework in face of the ever-challenging policy environment. For instance, the establishment of the Joint Policy Committee in 2010, which combines members from both the MPC and the Financial Stability Committee, was done in recognition of the need to have effective coordination of monetary and financial stability policies given their increasing interdependence. The year 2015 also marked another significant milestone for the Bank. We appointed for the first time two external members to our MPC, a progress that reflected the ongoing maturity and inclusiveness of the MPC as a decision-making committee.

The inclusion of the external members has brought about additional diversity of views, and their relevant experiences have further enhanced the collective expertise of the MPC.

It is important for us to outline the philosophy that underpins our policymaking. The first is pragmatism – the need to do the right thing without necessarily being dogmatic and rigid in approaches. Our monetary policy framework is not on inflation targeting, but one with primacy placed on the price stability mandate while giving due regards to developments in the economy.

This was amply illustrated in the way that we managed the challenges in 2007 and 2008. Back then, monetary policy was faced with the dual challenge of inflationary pressures from escalating global commodity and food prices, as well as headwinds in global growth from the unstable global financial markets. In this case, despite the upside risks to inflation, monetary policy was maintained given the need to balance against the weakening global growth prospects and its implications on the domestic economy.

BNM recognised that the upside risks to inflation originated mainly from supply-driven factors, in which the members opined that monetary policy was not the appropriate tool to alleviate the impact. In this situation, raising rates to achieve a stable inflation at all cost would be against our philosophy and against public interest.

During that time, our monetary policy inaction was criticised for being behind the rate-hike curve relative to the actions taken by other regional central banks. But in retrospect, we were attempting to do the right thing based on the prevailing data and our assessment. We would like to think that our departure from the convention stood the test of time, and that we were eventually proven right when Malaysia was able to withstand the crisis.

Staying committed to our decisions, however, does not imply inflexibility in our approach. When global conditions deteriorated rapidly, monetary stimulus was swiftly and significantly front-loaded between November 2008 and February 2009, to cushion the domestic economy from adverse spillovers. Conversely, as the recovery became more firmly entrenched, Malaysia was the first in the region to normalise interest rates in March 2009 from the record-low level, well ahead of the regional counterparts.

We shall continue to strive to make monetary policy decisions based on prevailing data and the assessment to the best of our ability, even if it might be against conventional wisdom or no matter how unpopular the decisions might be.

In managing the exchange rate, a similar philosophy of pragmatism is applied. We should recognise that in today's world of greater interconnectivity, we are all susceptible to the vagaries of the global financial markets. But to distance ourselves from the global financial markets is not an option.

In this regard, despite the extreme volatility experienced in recent years, our thinking has remained the same – market forces ought to determine the direction and level of the exchange rate. The central bank's role should be to contain the degree of volatility, which we know has significant implications for an open economy like ours.

As such, there will be times when the Bank's presence is apparent in the market, to manage the degree of volatility, but there will be times when the ringgit movements will be more volatile than normal so that it will take its course in line with demand and supply in the market that reflects underlying trade transactions. More recently, the ringgit had adjusted to reflect changes in the global economy including the developments in the US economy and global crude oil prices. Certainly there are risks associated with different levels of exchange rates and that different levels of exchange rate will benefit differently the various sectors and stakeholders in the economy.

Looking forward, while the financial markets can be capricious, as market players focus on short-term developments, our role as policy makers is to look beyond these noises. As we continue to address our vulnerabilities and improve domestic fundamentals, the ringgit will eventually reflect the strength of our economy.

Our path forward would continue to be characterised by fast-moving and ever-evolving macroeconomic risks and constantly evolving global trends. In facing the complex and multifaceted risks associated with it, the Malaysian economy is subjected to concerns of price stability and many other considerations that could affect overall macroeconomic stability.

This brings me to another one of our approaches in relation to ensuring overall macroeconomic stability. We do not rely on any single policy tool. In particular, dependence on monetary policy as the sole instrument would be too narrow an approach. Monetary policy at best provides an enabling macroeconomic environment to support growth, and it should not be relied upon as the primary instrument to drive growth. In this regard, the Bank's policy toolkit relies on a broad set of instruments to achieve overall macroeconomic stability. This includes considerations of macro-prudential and pro-growth policies, as well as our advice on fiscal policy to the government. Such an approach is key in ensuring that no single tool is overburdened.

Reawakening growth, reigniting productivity and restoring inclusiveness

Before I conclude, let me suggest how we can successfully navigate this global landscape with contradictory forces held in tension. I have no precise answer. But I will highlight three important outcomes that need to be achieved jointly in order to secure continued and sustainable progress in the global economy.

First, is the need to reawaken growth. Having had sub-par growth for nearly a decade now, policy-makers need to relook what we have learnt and rethink our approaches; from fiscal to monetary policies and structural issues that need to be addressed, to enable us to remove any impediments to growth. We need to enact policies that enable the private-sector to revive their dynamism and explore new strategies to enable them to engage and uncover productive investment opportunities.

The second is to reignite productivity. To this end, just as how technology and globalisation has resulted in many of the paradoxes outlined earlier, it is also an avenue that could provide answers to our challenges. Policy-makers and the private sector need to automate and adopt technology to increase productivity and dispense the easy way out of depending on low cost labour model for competitiveness.

Third, and perhaps the most important of all – to restore inclusiveness. The socio- and geo-political paralysis that is splicing the centre towards the far-left and far-right in so many parts of the world can be traced back to the unequal sharing of global economic progress in past decades. This underscores the importance of broader-based economic growth and the urgency to close the inequality gap. Leaders from the public and private sectors must help boost labour-market participation; across genders, creed and nationalities and cushion any negative social costs that may arise as a by-product of growth.

Only by reawakening growth, reigniting productivity and restoring inclusiveness, can we reclaim a positive and sustainable future.

On that note, I would like to congratulate MIER on its commitment to research this past 30 years. It is my hope that MIER will continue to produce quality policy-informative-research, strengthening the synergies that exist between policy-making and research efforts. Finally, my wish is for MIER to become the leading “global bearer” for economic research in Malaysia; a think-tank that matters, to the sound policy formulation of the nation.

Thank you.

---

1 *Income Inequality: The Gap between Rich and Poor*, B. Keely (OECD Insights, 2015).

2 *Sharing the Growth Dividend: Analysis of Inequality in Asia*, S. Jain Chandra et al. (IMF Working Paper, 2016).

3 *The Morning Ledger: Productivity Slump Threatens Long-Term U.S. Growth*, W. Azeez (Wall Street Journal, 2016).