Muhammad bin Ibrahim: Of perception, sentiment and reality

Opening remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Persatuan Pasaran Kewangan (PPKM) Annual Dinner "Of Perception, Sentiment and Reality", Kuala Lumpur, 17 November 2017.

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Thank you for the invitation to address the members of the financial market industry at this Financial Market Association of Malaysia's (FMAM) annual dinner. I always look forward to this event as it provides the central bank with the platform to share our thoughts and expectations for the industry.

We are operating in a very dynamic environment. Last year, I stood here and explained in detail why it was a challenging year. This year is no different. As the operating climate changes rapidly around us, we need to adapt.

The theme of my speech will be a bit different this year. Titled "Of Perception, Sentiment and Reality", it will be a bit longer than usual. I shall cover four parts; financial market review, factors that drive the level of the exchange rate, comments on ringgit exchange rate and interventions, and initiatives to build resiliency and liquidity for our market.

Part I – Financial market review

It has been an eventful year and our financial market industry has gone through significant changes and developments. The ringgit, for one, has seen significant developments. Last November, it was one of the most volatile currencies. A year later, it has not only strengthened but has greatly stabilised. The implied volatility has declined from a peak of 9.7% to about 3.7% currently. The influence of offshore market activities and its damaging spill-overs to the ringgit exchange rate have subsided, consistent with the significant decline in transaction volume in the NDF market. On the other hand, foreign exchange (FX) transaction volume in the onshore market has been sustained with improving transaction costs, facilitating business transactions for all market participants.

The domestic bond market has also been more stable and the risks of significant sell-offs from non-residents and other major outflows have reduced. Non-residents now hold a more manageable level of 26.4% of total government bonds outstanding, down from the high of 34.7%.

During the early part of 2017, a period of significant capital outflows, the spike in bond yields was short-lived while the ringgit exchange rate remained well supported. This was due to the net export proceeds conversion rule that helped to balance the flows. Short-term positions by non-resident investors exited the market, and the majority of non-resident holdings now comprised of longer term investors, providing stability and depth to the domestic bond market.

All these were made possible with the measures introduced by the Financial Market Committee (FMC) and Bank Negara Malaysia (BNM). It was part of an overall strategy to deepen and broaden the financial market. The measures removed the external destabilising influence of offshore to the onshore market, while at the same time creating a conducive environment for the domestic financial market to develop.

With the influence of external factors squashed, the ringgit is now priced more efficiently and increasingly more reflective of Malaysia's strong fundamentals.

Nevertheless, questions remain as to why the ringgit is far from reflecting its fair value. Numerous research pieces by analysts based on real effective exchange rates, have in fact, indicated that the ringgit is one of the most undervalued emerging market currencies. Despite

strong GDP data for the first three quarters and better-than-expected exports performance in 2017, the ringgit exchange rate movements have remained lethargic, with flows and sentiments still driven by external factors and foreign players.

At times it appears as if domestic traders were playing second fiddle in own their market. It is time for our traders to price the ringgit accordingly, and play their rightful role in their home market. The ringgit should reflect economic fundamentals and emerging data. It is time for our local traders to be brave, stand up and be counted. This reminds me of a saying by Abraham Lincoln 'Whatever you are, be a good one'.

Part II – What drives the level of the exchange rate?

Granted, the ringgit does, to some extent, reflect Malaysia's economic fundamentals. The fact that the ringgit's recent recovery coincided with strong domestic data releases suggests that.

Nevertheless, in a global financial market that is driven by short-term developments, the ringgit exchange rate can veer in unexpected directions and reach levels that are far from reflecting economic realities. Unfortunately, most of these movements are not driven by facts, but perceptions. In ringgit's case, I would call it *mis*perceptions.

Perception is the thinking we make based on the information that we receive. Everyone thinks. It is our nature to do so. In fact, many of us in this room not only have to think, but we are tasked and compensated to think, decide and act upon our thoughts. It is said that an adult supposedly have to make an average of 35,000 decisions per day. This necessitates us to think fast and decide quickly. But studies have also shown that thinking forces the brain to consume a lot of oxygen, so much so that the process of thinking is tiring for our brain. Such decision fatigue can be paralysing.

To ease the decision fatigue, most of us begin looking for mental short-cuts, heuristics and simple rules-of-thumb to ease the cognitive load and cut decision-making time. But as we rely on simple rules-of-thumb to form judgments and make decisions, we leave ourselves vulnerable to errors, manipulations and cognitive biases. Most of the time, this is not done deliberately. The large body of research in neuroscience seems to suggest that these cognitive biases are neurologically hard-wired, afflicting us all either consciously or unconsciously. Let me touch on three instances where our perception and actions have been influenced by these biases.

First, take some of the psychological thresholds for example, loan-to-deposit ratio of 90%, ringgit level at RM4.00, and reserves level below USD100 billion is considered as vulnerable. Most of these are not statistically based, but rather convenient rules-of-thumb that ended up shaping our perception and driving sentiments. Unfortunately, in this information age, these perceptions and negative sentiments can be perpetuated rapidly and become self-fulfilling.

The widespread negative coverage in the mainstream media feeds on our confirmation bias, where we seek out information that confirms rather than contradicts our preconceptions. And when such information becomes widely available, we risk falling into a self-reinforcing process known as the 'availability cascade', whereby a simple idea, whether it be right or wrong, gains traction given repetition and inherent simplicity. As the saying goes, "Repeat something often enough and it will become true."

Second, we tend to, in some other instances, base our perception on prior evidence and situations that we are familiar with, rather than update our views with new information. For many economists and analysts, Malaysia is an oil-dependent economy. When the oil price goes south, the Malaysian economy suffers. While this *was* true many years ago, these simple relationships are continuously assumed to be fixed and hold to perpetuity. Despite the many structural changes leading to a more diversified Malaysian economy and reduced reliance on oil, this perception has persisted. For the uninitiated, the percentage of oil revenues to government

revenues was 41.3% in 2009 compared to only 14.6% in 2016. This fact seems to elude many analysts.

Third, and this is the trickiest of the three, is when individuals consciously tap on these cognitive biases to their own advantage. The rise of the asset management industry is one example, where asset managers' herd behaviour may be looked at as perfectly rational. An IMF researcher referred to such situations as "rational bubble-riding", whereby financial benchmarking and the short-term nature of performance appraisals imposed on asset managers, lead them to consciously ride on bubbles, despite believing that the prices are unjustified by fundamentals. Investors may be incentivised to herd, preferring to succeed or fail together to prevent reputational damage. As John Maynard Keynes famously said, "It is better for reputation to fail conventionally, than to succeed unconventionally".

Whether these cognitive biases are unconsciously wired in us or consciously being tapped on, we ought to recognise the power of perception. Edward de Bono aptly pointed out that "perception is real, even if it is not reality." In reality, a few of these misperceptions result in tangible consequences that influence the ringgit exchange rate level.

Let me cite five instances of misperceptions that have been making its rounds in the market:

- First, the perception that the ringgit is driven by oil prices. This was derived from fact that Malaysia is one of South East Asia's net exporters of oil and gas. Petronas is also one of the world's largest producers of LNG. Consequently, lower oil price reduces foreign exchange earnings of the country and government's revenue from the oil industry;
- Second, there is this perception, even among FX dealers and traders, that the offshore market knows how to correctly price or is better at valuing the ringgit. Despite its opaqueness and suspicious pricing, the offshore market is perceived to be better, bigger and deeper than the onshore market, and that its price discovery process is more robust in indicating the direction of the ringgit. As a result, the onshore market is looking offshore for guidance on the direction and pricing of the ringgit.
- Third, there is also the perception that the onshore market lacks the necessary liquidity, and with the decline of the offshore market, this negative perception has been driving the ringgit exchange rate weaker.

The lack of liquidity has been attributed to the inability for our forward FX volume in the onshore market to replicate the offshore market;

- Fourth, the significant non-resident participation in the onshore bond market is the main reason for the market's liquidity. Consequently, the market perceived that the reversal of NR holdings will have negative bearing on the ringgit and market liquidity;
- And last but not least, the gross misperception on the adequacy of the reserves. There is this perception that reserves of less than USD100 billion is not sufficient to provide comfort to investors. Accordingly, market pessimism reaches new levels when it falls below the threshold.

The Role of Sentiment

Other than perception, the ringgit is also driven by sentiments, mostly adverse. These are commonly cited through the various sentiment indices, for example as measured by MasterCard or the Financial Times.

Sentiments are shaped over time by analysts and interestingly, there are three factors that consistently drive market sentiment.

- One of these is the high level of external debt, frequently cited by international rating

agencies and analysts alike. The discussion on external debt has driven market sentiment negatively as it is being touted as a source of vulnerability. The fact is that some of these analysis ignore the evidence of more granular data and worse, only skim the surface without the discipline to deep dive into the available data;

- Market sentiments also play out based on the government financial position and the issue of governance. Sentiments can be easily affected if new issues or indicators are published on the Government's financial position. This is further exacerbated by the perceived governance challenges that give rise to further negativity;
- Market sentiment is also affected by a string of negative news headlines. While there were a number of news headlines on ringgit this year, about 30% of the articles by foreign and local media were written in a negative light or perspective.

This make it difficult to ensure a realistic view of the country and hence on the ringgit.

Realities and Facts

Let's examine these perceptions, or rather misperceptions.

A little bit of work and use of data, often point to these perceptions as misleading, with little reflection of reality. What is worrying is that, such perceptions and sentiments, if left unaddressed, would end up shaping reality.

- For one, a look at the correlation between oil prices and ringgit tells a completely different story as the correlation has been low in recent years. This is not surprising given that the relationship between oil and ringgit has been declining as Malaysia has come a long way in diversifying its economy. The country is no longer reliant on oil and gas for economic growth. Our growth is now driven largely by domestic consumption. On the fiscal side, efforts were taken to diversify revenues with the introduction of the goods and services tax and rationalisation of subsidies;

- Similarly, for the offshore ringgit pricing, the reality is that, it is driven by speculation and non transparent price discovery. Ringgit is not an internationalised currency and therefore any offshore trading and pricing should have no fundamental basis.

In fact, it is illegal. The sizeable speculative activities and herd-behaviours that take place in the offshore market have considerable influence over offshore ringgit pricing. Consequently, the offshore market significantly misprices the ringgit. On the other hand, onshore pricing is based on real demand and supply that reflects real economic activities.

- Despite what market had perceived, the domestic market volume has increased. It continues to record robust activities in the financial market, reaching daily volume as high as USD16.1 billion compared to USD14.1 billion recorded in 2016, The onshore market volume on forwards and swaps alone has surpassed the observed offshore forward market volume which now records an average of USD1.0 billion a day. In addition, there is a narrowing of bid-offer spreads that would indicate an improvement in liquidity. Anecdotal evidence suggests that market participants, including corporates, continue to access the market to meet their business needs;
- Risk exposure from high non-resident participation in the onshore market has effectively reduced. Risks from high non-residents holding have significantly subsided as footloose short term positions have exited the market in the early part of the year. The non-resident investors that remain in the domestic market comprise mostly of long term investors. They are less affected by short-term market dynamics. Their investments tend to remain stable and at times act counter cyclically to short-term investors, providing stability to the overall bond market;

- On reserves, our level is sufficient to meet our needs. A point often overlooked, is that the central bank's international reserves is not the only source to meet external liabilities. The availability of external assets and also currency denomination of the external liabilities are alternative sources of funding. In fact, BNM holds only 25 percent of the system's foreign currency reserves. The rest is with the financial system itself. Furthermore, while the reserves are expected to intermediate capital flows in the short run, we must not forget that the floating exchange rate framework is an important adjustment mechanism that can buffer volatile capital flows.
- Lastly, Malaysia's external debt cannot be judged based on the aggregate level alone. One-third is denominated in ringgit and is not subjected to valuation changes from exchange rate movements, limiting the risk of currency mismatches. The remainder are subject to prudential management and hedging requirements. What is more important is that more than half of the total external debt is skewed towards medium- to long-term debt, while short-term debt poses limited claims on reserves. Taking all these factors into consideration, Malaysia's external debt remains manageable.

As we can see, the reality is far different from the perception. It is important that conclusions are made based on facts rather than perceptions and sentiments. Without us delving into the details and without the availability of critical information, the probability is high that our perception and sentiment would be inaccurate. Because of this 'reality gap', the central bank needs to show its presence in the market when it is needed.

Part III – Ringgit Exchange Rate and Interventions

For this reason, interventions by central banks on the odd occasion becomes necessary. Interventions can take different forms. Many of you may focus on market or operational interventions. Indeed, this is important to ensure the market has sufficient liquidity in stressed conditions. But it must be recognised that these interventions are not to manage the level of exchange rate, as the ringgit remains a floating currency. Demand and supply forces must be allowed to determine the level of the exchange rate. But at the same time, we cannot be oblivious to the aberrations in demand and supply, originating from large speculative positions. Large swings in the exchange rate are detrimental to our country. It is highly risky for an open economy like Malaysia that relies on international trade activities and exchange rate as a price mechanism.

Through experience and practice, we have generally accepted that in a floating rate regime, the market should be left to its devices in determining exchange rate levels.

However, empirical evidence suggests that markets mechanisms often go through bouts of distortion. This is not at all surprising. It is proven time and again. The latest Nobel Prize recipient for economics, Professor Richard Thaler's work have centred on the essence that economic agents are humans. And humans are irrational. This is the opposite of conventional economics that rely on the central assumption that all economic agents behave rationally. This irrationality is the main catalyst for speculative activities in the FX market.

When speculative activities are large, they can swing towards extremes. Under these situations, and from the central bank's perspective, intervention is then necessary to rebalance the supply and demand forces, and to manage the volatility caused by violent swings in the exchange rate.

Intervention in a floating rate regime is not new. Monetary authorities have been intervening in the exchange rate market from time to time 'to calm the situation'. This is well noted in research work going as far back as 1975[1], that it is unrealistic to envisage a perfectly free floating regime.

BNM's motivation in intervention operations is to smooth out the erratic swings in exchange rate that cause disorderly market conditions. Our principles remain that the market will continue to determine the exchange rate levels. Indeed, given our sizeable FX market, any intervention to

determine a certain level is an exercise in futility, and would lead to costly distortions. In the final analysis, market forces should dictate exchange rate levels. But as a central bank, it is our duty to ensure that these forces are better balanced, and that the price mechanism is not distortionary or disorderly.

Part IV – Initiatives to Build Resiliency and Liquidity

It is also the central bank's duty to continuously be at the forefront in developing the financial market. In September 2017, to facilitate greater access by non-residents to the onshore financial market and subject to registration, BNM had introduced flexibilities for non-residents to manage ringgit exposures arising from ringgit-denominated crude palm oil (CPO) contracts traded on Bursa Malaysia. To date, the flexibility has managed to attract a number of non-residents including major CPO players with projected hedging volume of RM20 billion per year. This will deepen the onshore financial market.

On this note, and continuing the good work of the FMC, I would like to announce the third series of initiatives which will be effective immediately.

- The first initiative will be to extend the short-selling framework to Malaysian Government Investment Issue (MGII) by both conventional and Islamic banks. This will increase liquidity and boost trading activities for MGII in the secondary market as well as tighten the pricing gaps and yield differences between Malaysian Government Securities (MGS) and MGII.

Islamic banks may execute the short-selling transactions based on bilateral binding promise ("muwa`adah mulzimah") concept;

- The second initiative is to expand the eligible collateral for liquidity operations with BNM to include Bankers Acceptances (BAs) and Negotiable Instruments of Deposits (NIDs) issued by AAA-rated onshore licensed banks. Banks will now be able to obtain liquidity under BNM's Standing Facilities by pledging these money market instruments. The expansion of eligible collateral is expected to provide an impetus to the trading activities of NIDs and BAs and improve pricing. This is in line with BNM's expectations for interbank players to take on a greater role in intermediating and pricing of liquidity.
- The third initiative is the introduction of Bank Negara Interbank Bills (BNIBs) in ringgit and foreign currency. This interbank instrument will be available to onshore banks to better manage their ringgit and foreign currency liquidity and interest rate exposures and hence the capacity to provide competitive pricing on FX for all tenors.

I should highlight that these instruments are only available and tradable between the onshore banks and will not replace Bank Negara Monetary Notes (BNMNs). BNM interbank bills will be recognised as a high-quality liquid asset (HQLA) under Basel III Liquidity Coverage Ratio.

Before I conclude my remarks, let me raise two more points that involve all of you here.

First, an issue on competition for deposits. Towards every end of the year, banks rush and compete for deposits in an effort to show a good loan-to-deposit (LDR) ratio. This is disruptive behaviour. In particular, corporates, through their short-term deposit shifting, pushes up rates and create significant distortions. This is damaging to all. Borrowing costs will rise. All will be impacted. Corporates will also suffer in the end, through higher longer term borrowing costs because of these unnecessary biddings.

From another perspective, time and again, we have explained that banks should not be fixated on the LDR ratio. It is a simplistic indicator. It cannot provide an accurate representation of evolving bank balance sheets and funding strategies.

We need to rely on other important indicators. As we start to transition into Net Stable Funding

Ratio (NSFR), this ratio together with Liquidity Coverage Ratio (LCR), are the more reflective indicators of banks' funding profile and liquidity positions.

Banks will be given sufficient time to adjust before implementation of the NSFR. We therefore like to suggest to the banking community to plan wisely and avoid rushing to comply or exceed the NSFR requirement, as this will create the same disruptive cycle caused by LDR-fixation. Nobody gains from any disruption. It does not bode well for our financial market. Therefore, we need to behave accordingly and contribute in creating orderly market conditions.

Second, as an advanced and resilient financial market, we require our human capital to keep abreast of latest knowledge, skills and practices to enable us to remain professional and relevant. On this front, I am delighted that the Continuing Professional Development program will start from next year, and will become mandatory for all FMAM's members.

I am encouraged to hear that the association is working with the Asian Institute of Chartered Bankers to identify and formulate the necessary modules for treasury and financial market professionals. The modules are intended to equip association members with the relevant expertise and knowledge to serve the financial market with integrity and professionalism.

Closing

Before I end my speech, I would like to give in advance, my congratulations to the leading FX and FX derivative banks which will be announced later. Let me take this opportunity to thank the association for organising this year's dinner and I wish you all a prosperous year ahead.

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[1] Ethier, W and Bloomfield, A (1975): "Managing the Managed Float", Princeton University, Essay in International Finance, No 112