Muhammad bin Ibrahim: Public policy perspective - some thoughts and contemplations from a central banker

Remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 40th Harvard Business School Alumni Club Malaysia Anniversary Dinner, Kuala Lumpur, 9 February 2018.

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Thank you for the invitation to speak tonight, among such impressive luminaries. I would like to take this opportunity to share, reflect and learn from past experiences. Since my line of work relates to public policy, I would like to approach it from this perspective.

The remarkable paradox of public policy

Public policy has never been easy. It is deceivingly simple if we just think about the outcomes. For example, the country needs more public healthcare; or prices of goods need to be lower; or people should have more access to credit. In practice, the policymaker makes difficult decisions involving complicated trade-offs, competing objectives and priorities. Resources are limited and invariably, any allocation made will affect many persons in different ways. Public policy can never ever meet the needs of everyone all at the same time.

Given these challenges, it stands to reason that there can be no set template or rules when it comes to executing public policies. From this perspective, it is therefore a remarkable paradox that policymaking at the international level is steeped in conventions, rules and norms that set out expectations on how policymakers should behave and conduct policies. These hard and soft rules, have at times, guided policymakers through some turbulent episodes. Of concern however is when this set of prescriptions act like a straitjacket, constraining policymakers from making bold and necessary policy decisions, just because it does not conform to ‘consensus thinking'. This is in spite of universal acknowledgment that we are experiencing change that is unmatched, both in pace and dimensions. Clearly this changes the rules of the game. Conformity could come at a cost. And that cost can be significant if it is driven solely by ideology.

John F. Kennedy once said, “Conformity is the jailer of freedom and the enemy of growth". The issue of conformity and how it affects social behavior has been the subject of study for decades. It was in 1972 that Irving Janis, a psychologist at Yale and forerunner in the field of social dynamics, first coined the term “group-think".

Professor Janis described this collective behaviour as “a mode of thinking that people engage in when they are deeply involved in a cohesive in-group…when the members’ strivings for unanimity override their motivation to realistically appraise alternative courses of action". In other words, group-think occurs when there is pressure to conform to an over-arching view or strategy. As a result, members of the group often feel uncomfortable to deviate from the “norm", leading to tunnel-vision and a fear to voice out opinions and come up with new ideas. Sometimes, it can provide dubious cover for doing less than what is appropriate, and what is needed.

To put this into perspective, consider the case of a large US automobile manufacturer. Often cited in the fields of organisational ethics and industrial psychology, this case was seen as a prime example of how conformity and group-think led to costly outcomes. In 2014, the motor company was forced to recall nearly 30 million cars worldwide as faulty ignition switches were found to have led to a loss of electrical power and sudden engine shutdown.

This malfunction also caused the airbags, power steering and power brakes to become dysfunctional, risking the safety of drivers. As the scandal was uncovered, it was found to have caused an estimated 124 deaths.

What is particularly harrowing, was the fact that this faulty ignition switch was known by the company's employees for at least a decade before the recall. An independent probe subsequently pointed to a corporate culture, which the then new CEO, described as "a pattern of incompetence and neglect". Various case studies on the crisis highlighted that the tight financial position in the early 2000s festered a corporate culture that was heavily focused on cost-cutting, shaping employees' mindsets, conduct and ultimately values. Internal email transcripts revealed that it would have cost an extra 90 cents per unit to modify the ignition switches. An internal probe reported that the problem was misdiagnosed and dismissed as a "customer-satisfaction" issue, rather than a safety problem. The company then advised their customers to remove heavy objects attached to their car keys, such as bulky keychains, rather than fixing the root of the problem itself. This story is not strange. It happens elsewhere as well.

In the world of central banking, serious risks can similarly arise from groupthink. There are many rules governing policymaking that policymakers tend to follow rigidly, despite its waning effectiveness. This increases the risks of being blindsided and promotes a culture that is resistant to change.

An example of this in central banking is the 'inflation-targeting framework' which was considered the international best practice in monetary policy framework for many years before the Great Financial Crisis. My remarks are not a critique of the framework but rather, to highlight that there are other approaches as well.

The premise behind the framework is very simple. It is also elegant. If the inflation trend deviates beyond a central bank's expected target, typically around 2%, the central bank should use its policy tools, namely the interest rate, to bring inflation back to target. Inflation targeting enables monetary policy to focus on domestic variables and respond to external stimulus that impact domestic price stability.

Since it was first adopted in 1989, it was seen as a simpler and more transparent policy framework because it allowed the public to easily understand and observe the central bank's motive, which is ultimately low and stable inflation. Within a short span of time, the popularity of this new framework spread widely in both the advanced and emerging economies. It is quite understandable. The framework is theoretically attractive, easily understood and simple to communicate.

Deviating from the norm: Malaysia's approach

The theoretical elegance of inflation targeting appealed to many central banks to tread on the same path. In Malaysia we had considered this approach but decided to forge our own route. While the broad framework was appealing, we concluded that adopting an explicit inflation target would have the unintended effect of 'straitjacketing' our policy flexibility. We believed that the inflation targeting framework was not ideal for an open and small economy with a sizeable financial market like Malaysia.

An economy such as ours is susceptible to real external shocks and could also face problems such as large and volatile capital flows and exchange rates. Therefore, we did not adopt the inflation targeting framework. We adopted what we characterised as 'inflation anchoring'. The policy outcome is similar, stable inflation. But the process and focus are different. There are several reasons for this approach.

First, we did not believe in confining ourselves to a single overarching target for price stability, especially not when the economy is complex and consists of many moving parts. We wanted to avoid a situation where too much focus on achieving a single target could lead to potential blind spots. In particular, we did not want our monetary policy to be driven predominantly by movements in one single price indicator, to an extent that we ignore other important risks such as asset price bubbles and the destabilising unwinding of these assets.

Second, our experience showed that Malaysia's episodes of high inflation are typically externally driven, such as through global oil prices. In fact, inflationary episodes in Malaysia have rarely been a monetary phenomenon.

That being said, external shocks that drive inflation do not require a monetary policy response if it does not affect domestic demand or cause undue wage pressures.

I recall in 2008, that when global oil prices surged to a height of around USD140 per barrel and Malaysia faced strong inflationary pressures that breached 7%, we were perceived as being 'behind the curve' for not raising interest rates. Under the inflation targeting framework, on the other hand, logic dictates that in response to this period of supply-driven inflation, raising policy rates by as much as 100 to 175 basis points in some countries were merited. The monetary policy response is premised on the argument that anchoring inflation expectation supplanted every other consideration including the source of inflationary pressures.

Allow me to illustrate how inflation expectations work. If you do not believe that the central bank's monetary policy can bring inflation back down in say, two to three years' time, then inflation expectations are considered unanchored. What this means is that if members of the public do not believe in the central bank's ability to control inflation, a rise in prices could trigger public expectations that prices will rise even more in the future.

Businesses will soon raise prices of goods, and workers, in facing higher prices, will in turn demand for higher wages, leading to a vicious inflationary cycle. Inflationary expectations, if unhinged, would eventually become a self-fulfilling prophecy. As such, the interest rate increase reflects the central bank's strong commitment to control inflation. A central bank that is seen as having a strong commitment and is credible in its actions to fighting inflation would therefore have a higher probability of success in anchoring inflation expectations. This is essentially what we will find in every textbook on monetary policy. In reality, however, there is more to inflation expectations than meets the eye.

A case in point is Malaysia's inflation experience in 2008. At that time, we had the firm conviction that the spike in inflation and inflation expectations during the period would be temporary, as the prospect of weakening demand would dampen price increases in the future. Most importantly, we also saw the sharp spike in commodity prices and increasing risks from the US financial market which posed significant downside risk to future growth. As events began to unfold, this conjecture turned out to be the baseline case.

When the Great Financial Crisis of 2007–08 erupted with both economic growth and financial stability at stake, our decision not to raise interest rates was apt as it provided a much-needed buffer. We moved from being 'behind the curve' to 'ahead of the curve' when other countries began reversing their policies by cutting interest rates.

Fast forward to the current environment, inflation is becoming even more complex with the influence of various factors such as globalisation, demographics and technology bearing on inflation outcomes in ways we do not yet fully understand. Because of these external factors, central banks in some economies have frequently missed their inflation targets over the past decade. These central banks have had to work extra hard to anchor inflation expectations while they continue to miss their targets. This has become a source of sizeable uncertainty and volatility.

In Malaysia's case, keeping a broader view has suited our needs and has given us policy flexibility to respond to economic and financial shocks, as we are not unduly straitjacketed into meeting this explicit inflation target, which, under many circumstances, can prove to be very elusive.

Third, as an open economy with flexible exchange rates, Malaysia is prone to large and volatile swings of capital flows which can lead to exchange rate overshooting. In fact, we just recovered from what was one of the sharpest ringgit depreciation periods since the Asian Financial Crisis. I am sure that this is still fresh in everyone's mind.

We recognised much earlier on that the inflation targeting framework is not well-suited to our domestic conditions as it can compound the risks of unfettered capital flows. Instead, we believed that destabilising capital flows need to be effectively managed to ensure orderly domestic conditions. It did not help that some economies even hosted illegal NDF activities that had grave spillover implications on neighbouring economies. The fact that multilateral institutions are oblivious to these damaging consequences to some of their member countries is very disquieting.

A further point is the dangers that can arise when inflation targeting inappropriately shifts the burden onto monetary policy to solve problems that in reality, require much broader policy responses on the fiscal side. When much needed actions are postponed, it has important consequences for our long term growth potential.

Inflation targeting framework falling under heavy scrutiny

As it turns out, our choice of not conforming to the norm was not in vain. Inflation targeting is now under scrutiny as its merits are debated widely. Many of these discussions centered on the waning effectiveness of the framework and the need for additional policy instruments to make the framework effective.

The sequence of events leading up to the Great Financial Crisis raised the argument that an exclusive focus on achieving the inflation target could cause policymakers to overlook other vulnerabilities, such as credit and asset price bubbles.

Delivering on inflation targets itself has also presented new challenges. Despite almost 10 years of ultra-easy monetary policy, and despite stronger growth and better labour market conditions, some countries are still devoid of inflation. This latest enigma of "missing inflation" has further spurred the search for the next best thing after inflation targeting. It has become increasingly clear that the nature of problems facing policymakers and the underlying heuristics are becoming very complex. What we thought we knew about inflation dynamics has been inadequate and has not factored in many other relevant factors. Inflation dynamics have evolved with structural factors such as the global value chain, demographics, technological advancements and the digitalisation of the economy.

In such a dynamic environment, it is only logical to think that one must be pragmatic, flexible and agile. This is why we focused on inflation anchoring without being tied to a single numerical target. To effectively do this, our monetary policy framework will take into account a broader consideration of factors that could affect the domestic economy and financial system.

It also allowed us some flexibility to monitor how our monetary policy actions could interact with key issues facing the public, such as distributional implications, cost of living, access to financing and financial inclusion. As we understand these interactions better, our responses, including monetary policy decisions, can be more nuanced and effective.

Malaysia's policy approach has remained relevant

Inflation anchoring was not the only thing we did differently. In fact, Malaysia has never shied away from taking the path less travelled. This is not driven by any ideological design but we have always been careful to ensure that policy prescriptions fit our economic, legal and operational circumstances. Some of the policy approaches that have been our practice are only recently being seriously considered by the global community. A good example is capital controls or now more elegantly known as capital flow management measures. Our approaches, while sometimes can be considered as 'different' are premised on several considerations.

First, is that we considered financial stability risks in our monetary policy decisions. While moves to formalise this as part or within the broader context of monetary policy frameworks have been a more recent phenomenon in the aftermath of the recent crisis, Malaysia has always been vigilant against the risks of financial imbalances. We have looked into this aspect for as long as I can remember. In 1992, for instance, the Bank had already introduced administrative limits, or macro and microprudential measures as it is known now, to address the risks of financial imbalances arising from specific sectors of the economy.

Back then, limits on hire purchase loans and guidelines on credit card operations were put in place as complementary measures to the tighter monetary policy stance of the Bank. Even since then, financial stability has remained an important mandate of the Bank. This mandate was reinforced with the introduction of the Central Bank Act in 2009, which established Bank Negara Malaysia as the financial stability authority for Malaysia.

Second, we have always kept our banking system supervisory role in-house, even when the notion of separating the monetary authority from financial supervisory authority was held up as a more effective model in more than a few countries. We now see moves to recombine these functions under the central bank post-Great Financial Crisis. The UK, for instance, had restored the supervisory role back to the central bank after a painful episode with the collapse of Northern Rock in 2007. Authorities were widely blamed for inaction, poor coordination and constraints that held back early interventions.

Third, is the fact that Malaysia has always relied on a broad policy toolkit, even during the early 1990s when we introduced measures to manage capital flows. It was only in 2012 that the IMF updated their institutional view and began recognising the usefulness of capital flow management measures.

More recently, at end-2016, we introduced bold 'market-correcting' and prudential measures to ensure the orderly functioning of the domestic financial market. These measures were seen as 'anti-market forces' at its inception but they have been proven effective in reducing speculative pressures on the ringgit and imbalances in the domestic foreign exchange market. It has in fact further liberalised the market than the situation before the measures were implemented.

Learning from Malaysia's policy experience

There are important lessons behind Malaysia's approach which are relevant to our policymaking, at least from my perspective. These lessons cut across profession and industry. It is not exhaustive. But I would like to raise 5 points.

First, it is important for policymakers to remain agile in their approach to policies. We should not be too rigid in our own ways that we neglect changes in the environment and fail to change with the times. The world as we know it will be transformed with the rapid advancements in technology and communication, big data and the list goes on. If we remain stagnant, we are doomed to fail.

The willingness to renew and redirect policy is critical to successful policymaking. From the outside looking in, the redirection of policy is often perceived to be regressive. In reality, they reflect policies that aim to be more, rather than less, responsive to changing conditions. In the same way that businesses expect governments to relax and adapt policy to capture new opportunities, authorities have a professional duty to redirect policy, however unpopular, to maintain stability and harness our collective growth potential when risks or unintended outcomes become apparent. This requires much more confidence, boldness and courage.

Second, policymakers need to protect and value their autonomy in the conduct of policies and not be constrained by prevailing rules and consensus thinking established by the international community. International organisations have come up with various definitions and primers on how they feel an economy should be managed. Their need for standardisation is understandable because of the need to dispense consistent policy advice across many countries. However, that being said, the domestic policymaker understands best the context of the local situation that the country is facing. There should be no doubt in this.

Third, policymakers must not be afraid of instituting bold policies if they are deemed necessary. This is especially important during times of stress or market failures that risk the orderly functioning of the economy and financial system. Intervention in markets should not be a knee jerk reaction. As a matter of principle, public policies should always first strive to facilitate a self-regulating free market to correct itself. However, when markets fail, it is incumbent upon the regulator to correct market failures. This ought to be the cardinal rule, especially for small and open economies with sizeable financial markets. More often than not, corrective public policy can be unpopular among the masses, but it is important to not lose sight of the bigger picture, for the greater good. Often times, short-term pain is necessary for longer-term gains.

Fourth, clear and transparent communication is crucial. Policies will not be effective if the motivations and understanding between policymakers and the public are not aligned. At the end of 2016, the Bank actively sought out the feedback of industries and market participants that were affected by the financial market development measures we introduced in November 2016.

This became an important source of information for us to continuously fine-tune the implementation of the measures to help those affected to better adapt to the new environment. Being transparent also means that policy intents should be quantified, measured and disclosed.

Finally, policymakers must not formulate public policy in isolation. We must promulgate policy with hard facts, backed by statistics and sound theoretical evidence. Foremost, we should not forget about the lives of people we are trying to help. A strong GDP growth figure will be less meaningful if they do not create good quality jobs, better distribution of incomes and higher standard of living for the people. Formulation of public policies must continue to be based on sound economics and have the ultimate goal of improving the welfare of society.

While we remain cognisant of the broader distributional implications of our policies, issues that are more structural in nature such as low productivity, income inequality and quality jobs creation would also require specific policies that lie beyond the capacity of the central bank alone.

It requires collaboration across many domains, with other policy makers, and with many stakeholders for the betterment of the standard of living and welfare of the general public.

As we know it, the world is fast evolving and we must keep pace. The progress of information and communication technology, has been astounding and its assimilation into our economic and financial system structure will be the catalyst to propel finance as the great social equaliser. But for us to optimise the benefits for all, we need to strike the right balance between regulation and allowing technological innovations to take place in our financial system.

Ultimately, regulations exist to promote a safe, efficient and sound financial system that is competitive and where consumers' interest are protected. Regulatory regimes promote the foundation of trust and confidence that is crucial in any financial system. If people do not trust the system, financial intermediation cannot take place in any shape or form. As the modalities for financial intermediation and payments are transformed by technology, regulation should play an active role in creating a similar environment of trust to ensure overall financial stability.

The boundaries of regulation will evolve to provide the freedom for participants in the Malaysian financial system to innovate and adopt technology to exploit efficiencies and create new and better solutions. Solutions that not only deliver better experience for consumers, but that better align the responsibilities that we all carry as responsible citizens, to lift people out of poverty, provide our fellow Malaysians a decent living standard, eliminate discrimination and protect our environment.

Regulation is never intended to make market players ‘boring'. If they feel that way, it only tells us one thing – that they have become too complacent in their comfort zone and should undertake a reality check. Malaysia’s financial institutions especially must not lay idle as innovations will be relentless in accessing and penetrating the traditional market long enjoyed by the banks. Using the disguise of being tied by regulations is not a valid excuse. We have raised this many times, that the central bank will not hinder innovations in the banking system including those by non-banking institutions. So beware. Those bankers who are complacent and meek might experience the rug being pulled from underneath them.

Conclusion

We hail from different backgrounds and experiences, but all of us here have the influence to impact the Malaysian economy, no matter how big or small. We are duty-bound to play our roles effectively and hold a bigger responsibility to ensure that nobody under our care is left behind as we continue to progress.

On that note, I wish everyone a productive and fulfilling journey in 2018. To those who will be celebrating Chinese New Year, I would like to extend my best wishes. Let us look forward to a better Malaysia.

Thank you.