Box Article 2

Unorthodox Measures for Unconventional Times

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HIGHLIGHTS

- **External spillovers originating from unconventional monetary policy in the advanced economies require policymakers in emerging economies to rethink and reinvent their policy approaches.**
- **Policy flexibility and pragmatism, policy autonomy, and clear and transparent communication are the three principles that should guide policymaking.**
- **Malaysia has adopted these three principles, which have been key in the management of financial market volatility.**

Introduction

A decade of unconventional monetary policy in the advanced economies has created a new dimension of challenges for policymakers in emerging economies. External spillovers originating from these policies come in many shapes and forms; from large cross border capital flows and its impact on domestic monetary and financial market conditions, aggressive yield seeking behaviours by international investors that can create destabilising price dynamics, to sudden shifts in sentiments that can amplify financial market boom-bust cycles. While these spillovers make the operating environment of policies more challenging, it can be further complicated by unique domestic circumstances that emerging economies face.

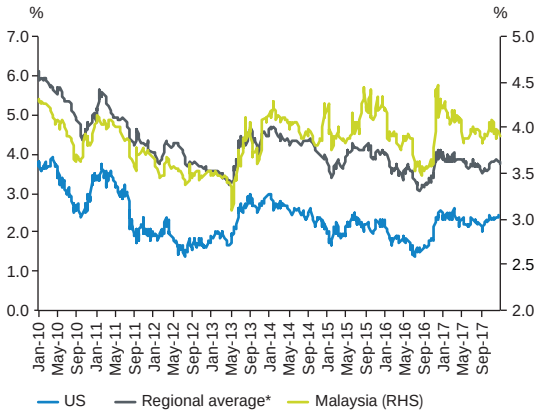
The reality is that emerging economies are constantly exposed to the vagaries of policies in the advanced economies that dictate the global economic and financial market landscape. They remain at the receiving end of these external spillovers which, in turn, have implications on domestic policies. In this new normal, it becomes more important for policymakers in emerging economies to continuously rethink and reinvent policy approaches. In such unconventional times, unorthodox policies may be the new trump card. In Malaysia's case, the series of measures introduced by the Financial Markets Committee (FMC) since late 2016 included some bold measures, aimed at ensuring that the domestic financial market remains resilient and ready to face these external spillovers. This box article will first provide some colour to the environment currently confronting policymakers in emerging economies, before elaborating on the principles, approaches and the efficacy of policy measures from the Malaysian experience.

A. Policymaking in the new normal: Constant spillovers, constant challenges, constant vigilance

Much of these external spillovers have made their way into emerging economies due to the financial globalisation that has taken place over the past few decades. An increasingly open financial system inevitably exposes the country to large cross-border capital flows along with its attendant risks. This became more pronounced following the policies undertaken by the advanced economies in the aftermath of the Global Financial Crisis (GFC) in 2008. Ultra-low interest rates, combined with a large injection of liquidity into the global financial system have led to sizeable capital inflows into emerging economies in the search for higher returns. The more volatile components of these capital flows, which include equity and debt portfolio flows, increased tremendously within a decade, and could reverse at much greater speeds. There are a multitude of policy challenges that arise from this, some of which are:

- **Weaker and less effective domestic policies.** Large capital flows have the ability to influence domestic financial conditions, affecting the effectiveness and independence of domestic monetary policies (Rey, 2015). International investors borrow cheaply from major global financial centres and invest in higher-yielding emerging market financial assets, increasing domestic liquidity and raising asset prices. Domestic banks also now have access to cheaper sources of capital from abroad, easing domestic financing conditions. This can make domestic monetary and financial conditions more accommodative than intended by the policymaker. This can be observed in how long-term sovereign bond yields in the region, which are usually influenced by domestic policy interest rates, have become more strongly correlated with the long-term US sovereign bond yields.

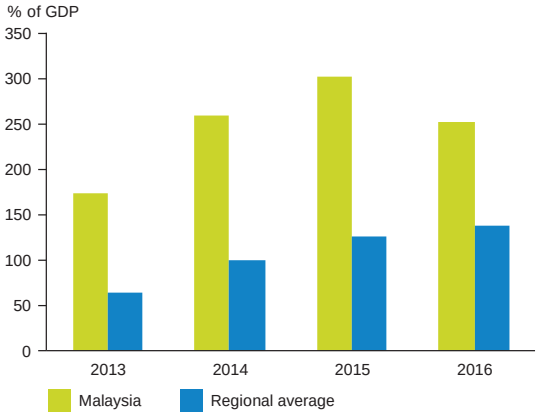
Chart 1: 10-Year Government Bond Yields



*Regional countries include Indonesia, Korea, Philippines, Singapore and Thailand

Source: Bloomberg

Chart 2: Non-Deliverable Forward (NDF) Volume/GDP



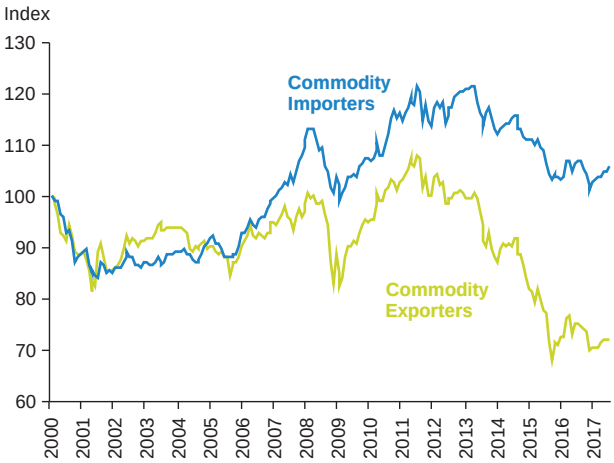
Note: Regional countries include Indonesia, Korea, Chinese Taipei, India and Philippines. NDF volume refers to only regional currencies versus US dollar.

Source: Bloomberg

- **Managing destabilising price dynamics.** The search for higher returns has led to the increasing presence of non-resident investors in financial markets of emerging economies. Among them include global asset managers, who have increasingly encroached on the role of global banks as the intermediator of liquidity (IMF, 2015). The higher participation of non-resident asset managers, whose fund sizes are large and have different risk appetites, have led to increased usage of financial derivatives. This is mainly driven by their desire to hedge or speculate on exchange rate risks, based on their respective risk appetites. A proportion that is primarily driven by returns would find ways to engage in speculative activities, which has coincided with the growing size of the offshore currency non-deliverable forward (NDF) market within the region. Speculators use these NDF contracts to acquire exposure on the movements of regional currencies, causing considerable volatility in both the offshore and onshore foreign exchange (FX) markets. The rising exposure of financial markets in many emerging economies to these types of investors has grown to be one of the main challenges to policymakers, especially to manage these dynamic and potentially disruptive behaviours.

- **Domestic conditions exacerbating the impact of external spillovers.** External spillovers interact differently with the unique domestic conditions faced by emerging economies, complicating the choice of policies to dispense. This can be due to various factors, ranging from the level of financial market development, political and economic situation to the perception of international investors on the country. For example, the large decline in global oil prices in 2015 affected regional commodity exporters more severely compared to its peers. In Malaysia, for example, the misperception that the economy and public finances relied heavily on commodities led to an unwarranted deterioration in investor sentiments and an unwinding of financial assets. The ensuing non-resident capital outflows resulted in a sharper depreciation of the ringgit exchange rate relative to other regional currencies.

Chart 3: Average Performance of Currencies of Commodity Exporters & Importers



Note: Commodity importers are Singapore, Thailand, and Philipinnes while commodity exporters are Malaysia and Indonesia

Source: Bloomberg

B. Towards rethinking and reinventing policy approaches

With these policy challenges in mind, there is a need for emerging economies to rethink and reinvent their policy approaches. The policymaking environment is fast-changing and is growing more complex, possibly evolving beyond the scope of conventional and established policy thinking and tools. Policies also need to be agile and adaptive to the unique domestic circumstances to prevent them from becoming ineffective and irrelevant. Three principles should guide the policy approach:

- **Policy Flexibility and Pragmatism:** Many emerging economies are already practicing a large degree of policy flexibility and have employed a broad array of policy instruments. Yet, the policy scope remains inhibited by consensus thinking and the stigma upon the introduction of certain measures. Policy pragmatism requires policymakers to be bold and timely in introducing new policy tools when it becomes necessary, and not shy away from new and untested ideas that may go against the grain of conventional wisdom. This includes 'market-correcting' measures and the strong reinforcement of existing policies, where needed. These measures may appear penal to market participants but as with any policy that is corrective, the short-term frictions are necessary for the longer-term resilience and development of the economy and financial system.

- **Policy Autonomy:** It is imperative to recognise that every emerging economy faces its own unique circumstances and policy challenges. Hence, policy autonomy is critical to tailor unique policy responses. The international community should not judge policy measures based on pre-subscribed narrow definitions, categorisation and concepts. Instead, policies should be judged based on their outcome and effectiveness in correcting market failures and imbalances. It is especially important for influential international organisations such as the International Monetary Fund (IMF) or Bank for International Settlements (BIS) to create an enabling environment for flexible policies to effectively address unique domestic challenges. The fact is that domestic policymakers have greater understanding and experience in dealing with country-specific circumstances and should be allowed to leverage on this advantage.

- **Clear and Transparent Communication:** Two-way communication is an important pillar of effective policymaking. The implementation of new and untested policies require that policymakers clearly and transparently communicate the motivations and intentions behind the policies to the public. This avoids a situation where the public is quick to react negatively and dismiss policies unfairly. Therefore, constant engagements through various platforms are vital to internalise the concerns and potential difficulties faced by the industry and market participants. These constructive engagements will ensure the effective implementation of policy measures.

C. Malaysia's experience in managing financial market volatility

In late-2016, uncertainties surrounding political developments in the US led to a sharp increase in volatility and risk-aversion in global financial markets. While all regional financial markets were affected by the unwinding of non-resident investments, hence facing exchange rate depreciation pressures, the impact on Malaysia was more pronounced due to factors that were unique to Malaysia.

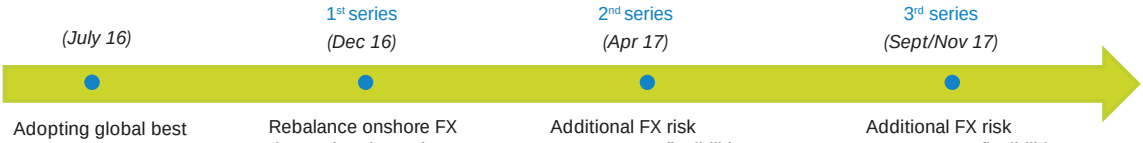
First, there existed imbalances in the demand and supply of FX and ringgit in the domestic FX market. As Malaysia has always exported more than it imported for the past 20 years (current account surplus position), the demand for ringgit was expected to be sustained as exporters convert their FX proceeds into ringgit, alleviating some depreciation pressure during stress periods. However, this demand was not forthcoming during the volatile period and counter-intuitive to the underlying economic activities. Second, there were rising speculative pressures on the ringgit during this period, arising from increased offshore ringgit NDF activities that were being facilitated by non-resident financial institutions and fund managers. Third, the market misperception that Malaysia was still heavily reliant on commodities caused an unwarranted deterioration in investor sentiments, particularly when global oil prices were declining in the first half of 2017. All these factors exacerbated the volatility and depreciation pressure in the ringgit exchange rate to the point that it was no longer in line with Malaysia's fundamentals and risked the orderly functioning of the domestic financial market.

In dealing with these unique challenges, Malaysia implemented a policy strategy that focused mainly on financial market development but included bold 'market-correcting' and prudential measures. Through the FMC, measures were introduced to further liberalise the domestic financial market, including allowing for better market access, hedging flexibilities and the introduction of new financial market instruments. Where a larger degree of firmness was required, such as in addressing the issues of offshore speculative activities, the FMC reinforced the non-facilitation of NDF rule. Export conversion requirements were also put in place to address the imbalances within the domestic FX market, but with sufficient flexibilities accorded to domestic exporters.

The policy combination in the series of measures introduced by the FMC has been crucial to Malaysia's success in managing financial market volatility. As a result, domestic financial market conditions improved substantially. Volatility in the ringgit exchange rate declined and speculative pressures subsided. The outflows from short-term non-resident investors following the measures improved the composition of non-resident holdings in the domestic financial markets towards more stable and sustainable longer-term investors. The improved domestic financial market conditions, which also coincided with Malaysia's stronger-than-expected economic performance, facilitated the appreciation of the ringgit in 2017 to better reflect underlying fundamentals when global financial market conditions improved. More importantly, the orderly functioning of the domestic financial market has continued to support Malaysia's economic growth.

In implementing these policies, there were of course challenges. The measures were initially perceived by the public as 'anti-market forces' and 'disruptive'. In response, the Bank actively engaged the public through various communication platforms, both internationally and domestically. Through regulator-industry platforms, the Bank was able to conduct two-way communications with market participants. This allowed the Bank to internalise the concerns and difficulties faced by them and further fine tune the implementation of the measures accordingly to better facilitate their adjustment to the new environment. These communication strategies proved effective as market perception on the measures improved, giving way to better aligned expectations between the Bank and market participants.

List of FMC Measures Implemented to Foster the Sustainable Development of Malaysia's Financial Markets



Adopting global best practices

- Transaction based KL USD/MYR Reference Rate
- Extension of official closing hour for onshore ringgit market

Rebalance onshore FX demand and supply

- 25% retention of export proceeds in foreign currency
- Trade settlement among residents in ringgit only
- Streamline onshore and offshore foreign currency investment limit

Promote FX risk management onshore

- Active hedging below RM6 million of net open positions
- Active hedging for institutional investors
- Expansion of Appointed Overseas Office framework

Additional FX risk management flexibilities

- Streamline passive and dynamic hedging flexibilities for investors
- Active hedging for corporations

Improve bond market liquidity

- Liberalise regulated short-selling
  - o allow all residents to participate

Promote fair and effective market conduct

- New code of conduct for wholesale financial market
- Principles for a Fair and Effective Financial Market

Additional FX risk management flexibilities

- Allow hedging of RM exposure arising from trading of palm oil derivative contracts on Bursa Malaysia

Improve bond market liquidity

- Introduce regulated Short Selling of Malaysian Government Investment Issues (MGII) and Islamic banks under bilateral binding promise concept

Enhance liquidity intermediation

- Issuance of Bank Negara Interbank Bills (BNIBs) in MYR and USD to onshore licensed banks
- Expand eligible collateral for Monetary Operations

D. Conclusion

Going forward, external spillovers will continue to affect emerging economies in ways that are both expected and unexpected. The state of ongoing uncertainties within global policy, economic, political and financial market developments will lead to periods of heightened volatility. In such a case, it is important for emerging economies to recognise their autonomy in the conduct of policies to address issues that are unique to the domestic environment. Policies can no longer be constrained to conventional tenets of policymaking. Instead, new and untested strategies should be considered. As new risks from external spillovers emerge, Malaysia will continue to introduce new policies in order to preserve macroeconomic and financial stability.

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