“Global Liquidity and Financial Contagion"

Transcript of the comments by Dr. Sukhdave Singh, Deputy Governor, Bank Negara Malaysia

For me, as a policy maker in an emerging market economy, living next to this pool of global liquidity is like living next to the sea. On a day-to-day basis, the tide comes in, the tide goes out. You learn to live with it. The sea is bountiful and to some borrowers it offers the opportunity of a cool escape from the searing heat of high domestic interest rates. Like the call of sirens to ancient mariners, it lures residents and regulators with its enchanting promise of easy liquidity and growing domestic equity and bond markets. However, this vast sea also holds many dangers. It is affected by fierce forces that can create violent and destructive waves. Even when it is calm, beneath that calm surface there are dangerous currents. To the unwary, who wade in too far, it can drag them to financial ruin, be they businesses, individuals, or governments. Beneath its surface are hidden rocks that can drive even successful economies to the bottom of the sea. The challenge for emerging market policy makers faced with this vast global pool of liquidity is not different from that faced by a fisherman who lives by the sea, and that is, how to benefit from the riches offered by the sea while avoiding the dangers. From that perspective, let me now briefly touch on five ways in which I believe global liquidity conditions can lead to domestic financial instability.

The first of these is the increased global financial integration and the spread of global banking. The financial crisis in the major economies can spread to the rest of the world through the network of financial relationships. Yesterday, we discussed the benefits of having foreign banks setting up as subsidiaries in our markets. In Malaysia, we have had some experience on the benefits of this, and those benefits go beyond what we discussed yesterday. Let me illustrate that point with a couple of examples. In the aftermath of the crisis in Europe, when the European banks were shrinking their balance sheets and pulling back from their overseas lending, someone noted that the European banks had claims of $64 billion on Malaysians, which is equivalent to about 23% of Malaysia’s GDP. The concern was on the impact of a pullback by European Banks on capital flows and the availability of financing to Malaysian companies. What ultimately helped us to alleviate those concerns was showing that two-thirds of these claims were held by locally incorporated subsidiaries of European banks. Therefore, having foreign banks established as subsidiaries helped mitigate financial contagion from what was happening in Europe. Let me give you another example. Post-Lehman, I think this was in 2008. Hong Kong announced that it was offering a blanket guarantee on all deposits in the Hong Kong financial system. This was after Ireland did the same thing. The risk that Malaysia and Singapore faced was of destabilizing outflows and a flight of funds from our banking systems to the banking systems that were protected by such blanket guarantees. Furthermore, if either Malaysia or Singapore were to then announce its blanket guarantee first, it could create destabilising

outflows from the other's banking system. Consequently, Bank Negara Malaysia and the Monetary Authority of Singapore collaborated and synchronised the announcement of their blanket deposit guarantees. This example highlights one aspect of international collaboration; it is not so much about setting the same policies or compromising national policy objectives. Rather, it is about making sure that our policies do not destabilize our neighbouring economies and looking for opportunities where collaboration may lead to a more optimal policy outcome.

The second way that the financial contagion can spread to the domestic economy is through capital flows into domestic asset markets. These create asset bubbles and if the central bank doesn't intervene, the twin attraction of rising asset prices and an appreciating exchange rate is irresistible to foreign portfolio funds.

The third way is through interest differentials. Very low interest rate in advanced economies do not just attract yield-searching foreign funds to the higher yields in the emerging markets, they also create a very strong temptation for residents in emerging markets to borrow from abroad. We saw this type of vulnerability in some Asian economies during the period before the Asian financial crisis and more recently, in the Eastern European economies. It is something that policy makers should be vigilant about.

Then there are global liquidity spillovers into domestic liquidity that put downward pressure on domestic interest rates, leading to excessive borrowing, a decline in savings, increases in asset prices, and increases in leverage, which in turn increase the risks of financial imbalances developing and undermining financial stability. In the current episode of low interest rate, credit has grown very strongly in EMEs, and while this has supported consumption and domestic demand, it has also led to increased household, corporate, and government indebtedness.

Lastly, changes in the current account can be both the source, as well as an outcome, of changes in capital account. The traditional interpretation is that a country has a saving-investment gap and this results in a current account deficit, which then drives it to rely on foreign savings. But my observation is that with global surplus liquidity and large capital inflows, countries can have large capital inflows resulting in excess domestic liquidity and low interest rates. This then spurs domestic consumption and investment booms, leading to higher imports and resulting in current account deficits or lower current account surpluses. Here, the adverse developments in the current account are an outcome of capital inflows.

Given the risks arising from the global liquidity, EMEs would certainly want to avail themselves to all the policy measures we discussed yesterday, including the use of capital flows management

measures to manage disruptive capital flows. I am certainly aware of the “Dutch Disease” literature and the fact that successful economies can perversely be undermined by attracting large capital inflows. While taking these into account, the question I would like to pose and attempt to answer is: “What can EMEs do to beef up their buffers and increase their resilience against the risks arising from integration in the global financial system?” I am going to frame my answers within three broad categories: one, in terms of reducing external vulnerabilities, two, in terms of improving policy frameworks; and three, in terms of strengthening domestic economic fundamentals.

First, in terms of external vulnerabilities, I think storms in the global sea of liquidity are a source of concern, but for policy makers in EMEs, the consequential concern is how seaworthy is our own boat? Can it withstand a stormy sea? In my observation, capital flows often tend to accentuate domestic vulnerabilities and that can create the greatest risk of financial stability. Therefore, in a world of abundance, restraint is a virtue. Like the sirens of Greek mythology, the international banks may go around EMEs telling them how easy it is to get funding. However, like the ancient mariners, governments and corporates in EMEs have to aware of the dangers should they heed these sweet-sounding siren calls. It is a good time to re-finance old debt but it is never a good time to accumulate excessive debt. The temptation is strong, especially when the domestic interest rates are high. Central banks and regulators need to monitor the use of external financing by their residents to avoid an excessive build-up of short-term external debt. At the same time, policy makers need to focus on reducing domestic economic vulnerabilities that make the economy dependent on external savings. This includes persistently high domestic interest rates and current account deficits that are excessive. A related point is the need to be careful about the pace of capital account opening. Having capital controls does impose a cost on international business transactions, but liberalisation should be undertaken gradually. If liberalization does not work out as anticipated, or it creates vulnerabilities that were not foreseen, countries must have the policy space to step back.

Second, having sound and robust domestic policy frameworks are a source of resilience when confronted with a volatile global environment. The prudent conduct of monetary policy to ensure price stability and provide a supportive environment for sustainable growth is a key contribution of central banks. Ensuring that credit growth is not excessive and that it is not channelled into unproductive uses is important to guard against future problems with excessive leverage and bad bank assets. Of course, fiscal policy also needs to be conducted prudently and this is to ensure that that there is fiscal policy space to respond to shocks. It also supports a more sustainable current account balance and it avoids over-dependence on external financing. A very important reason is that it is difficult to have good monetary policy when you do not have good fiscal policy. Having a

sound regulatory framework for the financial system ensures that nothing falls between the cracks. It is also mitigates the excess liquidity leading to a large build-up of vulnerabilities in the financial system that could be highly risky should there be a withdrawal of that liquidity. The final point on policy frameworks is that policy makers must have enough policy instruments. This we discussed yesterday. Let me just touch on three points.

- **Capital flows and capital control related measures**. My view is that capital controls are like quantitative easing (QE). They are not your standard policy instruments like QE is not conventional monetary policy, but it is good to have both of these policy instruments should you get into a difficult situation. As was discussed yesterday, capital controls come in a variety of forms. The mild ones are merely intended to introduce some friction in order to slow down the flows. The more aggressive ones are intended to completely stop either inflows or outflows and these latter types of capital controls are more appropriate when you have more dire economic and financial situations. The type and duration of the measures would very much depend on the situation. Here, I have to agree with the points made by Professor Kevin Gallagher. While the IMF has reluctantly moved its institutional stance on capital flow management measures, it is unfortunate that the old Washington consensus view continues to prevail among many policy makers in the advanced economies, including those in charge of trade policies. EMEs that enter into trade and investment agreements with the advanced economies risk having their policy space severely constrained in terms of their ability to manage capital flows.
- **Foreign exchange reserves.** Reserves are an important policy buffer for economies that are becoming globally financially integrated. However, it is not just the level of reserves that is important but also the sources of their accumulation. There are temporary sources of reserves and there are more permanent sources of reserves. Current account surpluses, FDI and remittances by residents working abroad create more permanent reserves whereas short-term portfolio flows and external borrowings create more temporary reserves. Even if they are high, reserves built from temporary sources can quickly diminish when there is a reversal of global liquidity.
- **Exchange rate.** Among EMEs, a floating exchange rate is probably optimal but it should be managed when there is excessive volatility or risk of overshooting. Combined with adequate foreign exchange reserves, it broadens the policy options when confronted with capital flows. When there are outflows, and the exchange rate is depreciating, increasing interest rates may have limited effectiveness. Also, depending on the duration, such a strategy carries the risk of damaging the rest of your economy. I also believe that higher interest

> rates would not be able to compensate for other weaknesses within the economy that may be driving those capital outflows. In the current environment, where you have zero interest rates and QEs in major economies, central bankers do not want their interest rates to look too attractive for fear of the type of suitors that they would attract. My impression is that in the recent period, central banks and monetary authorities have paid more attention to capital flows, global interest rates and their exchange rates in setting their own monetary policy stance than they did before the current prevalence of QE driven liquidity.

My third and final point on increasing resilience has to do with domestic fundamentals. Firstly, having a diversified, flexible and competitive economy is a key strength in dealing with instability from the external sector, whether it is in the real economy or in the financial system. Secondly, having a strong and resilient financial system is an important source of strength against vulnerabilities rising from living in an integrated world. In the period after the onset of the financial crisis in the advanced economies, many Asian economies have been able to sustain growth because their financial systems were healthy and were able to finance and support domestic economic activity even as growth in the advanced economies disappeared. I do have a caveat to that though. What is a source of strength can easily become a source of weakness if it leads to an excessive build-up of debt and imprudent lending practices. Therefore regulatory and supervisory rigour and vigilance is an on-going necessity. Thirdly, having a deeper and more diversified financial system, while not a panacea, helps to intermediate capital inflows in a less distortionary manner. Therefore, aside from the banking system, it is worth developing the equity and bond markets as viable alternative venues for financing. Again, I say that with caveats. First, a larger and deeper financial system may attract increased capital flows, and consequently, lead to increased volatility of the exchange rate, the mitigation of which may require the central bank to hold a larger amount of foreign exchange reserves. The second caveat is that policy makers should not be too caught up in protecting domestic banks. The concern should be with the quality of financial services that our citizens are getting and the prices that they are paying for those services. Foreign competition may perform a useful function in spurring domestic banks to provide more innovative, more quality financial services at lower prices. However, the process of bringing in foreign competition needs to be managed very carefully to ensure that it does not itself create financial instability or leads to financial activity that does not contribute to economic welfare. Final point, the biggest source of strength for a country is actually its own savers. One way to reduce reliance on risky external borrowings, especially in the context of supporting domestic economic activity, is actually to rely on domestic savings. However, to achieve this requires that savers feel confident that the value of their savings would be preserved. Otherwise, there is no incentive to save, or rather, no incentive to save

domestically. In addition, it is necessary to have a safe and well-distributed banking network to collect those savings and intermediate them to the productive sector of the economy.

With that I conclude. Thank you.

Sukhdave Singh
Central Bank of Malaysia
23 January 2014