Building Buffers: Roles and Functions of Bank Negara Malaysia's International Reserves

Introduction

International reserves constitute part of a country's external financial assets held against the rest of the world. The International Monetary Fund (IMF) defines international reserve assets as "External assets that are readily available to and controlled by central banks or monetary authorities[1] for meeting balance of payments[2] (BOP) financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes".[3] This distinguishes international reserves from other domestic savings or funds, as it is narrowly defined and meant for specific purposes.

Bank Negara Malaysia's (BNM) international reserves play a critical role in Malaysia's macroeconomic management. In particular, it helps the economy withstand large and volatile capital outflows, thereby preserving macroeconomic and financial stability, and maintaining orderly financial market conditions and public confidence. This article outlines the reasons for reserve accumulations and deployments, and briefly describes the management of BNM's international reserves. It also addresses common misconceptions surrounding BNM's international reserves.

How do countries accumulate international reserves and why do they hold them?

Countries, particularly emerging market economies[4], accumulate international reserves primarily from cross-border trade and investment inflows. These activities generate foreign currency inflows and increase demand for the domestic currency in the foreign exchange market. The central bank conducts foreign exchange market operations as and when necessary, to ensure sufficient liquidity and orderly functioning of the foreign exchange market. This operation results in reserve accumulations or drawdowns as a by-product. The magnitude of foreign exchange market interventions and size of international reserve holdings vary across countries depending on the country's foreign exchange obligations, susceptibility to capital outflows and type of exchange rate regime.

Learning from previous crises, the self-insurance or precautionary motive has been more prevalent among emerging market economies. This was demonstrated during the 2013 Taper Tantrum[5], when ample international reserve buffers enabled affected emerging market economies to withstand capital outflows from domestic financial markets without adverse implications to the economy. In the aftermath of the Asian Financial Crisis, many emerging market economies have also made significant progress to further develop and deepen their domestic financial markets in order to reduce reliance on external financing.

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1 In most countries, the major part of international reserves are foreign currency holdings and foreign currency deposits and securities held by central banks or monetary authorities.
2 The balance of payments encompasses international trade and financial/investment transactions between residents of a country with the rest of the world.
3 Other related purposes include maintaining confidence in the domestic currency and economy, and serving as a basis for foreign borrowing (Source: International Monetary Fund (2013). "International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template").
4 Composed of 156 developing countries as identified by the IMF.
5 Estrada, G., Park D., Ramayandi A. (2015). "Taper Tantrum and Emerging Equity Market Slumps". Asian Development Bank (ADB).

Table 1: Motivations in Accumulating and Holding International Reserves

• **Precautionary motive to ensure ability to meet external obligations, particularly during large capital outflows**	Economies generally hold international reserves to meet external obligations. In the event of an economic or financial shock, large capital outflows may significantly reduce foreign currency liquidity in the domestic financial market, which is critical to ensure the demand for foreign currencies can be fulfilled efficiently. This could disrupt the ability of the country to meet its external obligations smoothly, as it faces difficulty in sourcing foreign currencies. An adequate level of international reserves provides assurance to external creditors and non-resident investors of the country's ability to meet its obligations, even during adverse market conditions, with the deployment of international reserves to ensure sufficient foreign currency liquidity in the domestic financial market. The Bank for International Settlements estimated that more than half of international reserve accumulations between 2000 and 2016 were driven by the precautionary motive.[6]
• **Facilitate smooth and orderly domestic foreign currency market functioning**	International reserves act as a buffer in allowing the central bank to conduct foreign exchange market interventions when necessary to maintain orderly domestic foreign exchange market conditions and avoid excessive exchange rate volatility. This is particularly important during periods of foreign exchange market stress. Excessive volatility in the foreign exchange market increases businesses' foreign exchange transactions and hedging costs. This can adversely affect trade and investment decisions. Holding adequate international reserves therefore provides confidence to market participants that the central bank is able to minimise excessive volatility in the exchange rate, thus avoiding panic in the foreign exchange market due to herd behaviour among foreign currency traders.
• **Mercantilist/export competitiveness**	Intervening in the foreign exchange market may also dampen a sustained appreciation pressure on a country's exchange rate. By doing so, it maintains an undervalued exchange rate that preserves export competitiveness. Through foreign exchange purchases, the central bank absorbs inflows of foreign currencies, builds up international reserves and suppresses the value of its domestic currency. This country may sustain large current account and trade surpluses at the expense of its trade partners' current account and trade deficits. This may invite actions especially by countries experiencing prolonged current account and trade deficits. It may even incentivise the affected countries to weaken their domestic currencies and implement protectionist policies in the form of tariff or non-tariff measures to shield their domestic industries against unfair foreign competition. Malaysia does not subscribe to the practice of preserving or gaining export competitiveness via international reserve build-ups as it is unsustainable and can lead to repercussions, including retaliatory measures from trade partners.
• **Tool to peg the currency under fixed exchange rate regime**	Exchange rate fluctuations may induce uncertainties and risk aversion that lead to weak consumption and investment decisions and activities. For example, a volatile and uncertain exchange rate may discourage long-term investments due to the difficulty in assessing an appropriate time to convert into foreign currencies for investment purposes. Countries may thus decide to use their international reserves to ensure exchange rate stability, including by pegging their domestic currency to a particular foreign currency or a basket of foreign currencies. International reserves may be accumulated or deployed as a result of foreign exchange market interventions aimed at stabilising exchange rate movements. With limited or no room for appreciation or depreciation in the exchange rate, countries with fixed or crawling exchange rate regimes would require a bigger international reserves buffer to defend a specific exchange rate target level during periods of large capital outflows.

[6] Arslan Y., Cantu C. (2019). "The Size of Foreign Exchange Reserves". Bank for International Settlements (BIS).

BNM's international reserves holdings: Motivations and management

Under the Central Bank of Malaysia Act 2009 (CBA 2009), BNM is entrusted to hold and manage international reserves for the purpose of ensuring financial and monetary stability, as well as maintaining public confidence.[7] Given Malaysia's deep trade and financial integration[8] with the global economy, international reserve holdings are vital as a tool that can be deployed to insulate the domestic economy against sudden capital flow reversals. In this regard, international reserves held by BNM are primarily for precautionary purposes to facilitate international trade and financial transactions, and to ensure orderly foreign exchange market conditions, especially during periods of economic or financial distress.

The management of international reserves by BNM is subject to a strict governance and risk management framework established pursuant to the CBA 2009. The framework sets out specific guidelines for managing the international reserves, including the permissible assets, investment limits and investment benchmarks that are approved by BNM's Board of Directors. The allocation of international reserve investments ensures sufficient foreign exchange liquidity while meeting the long-term objective for capital preservation, risks and returns.[9] This entails holding a well-diversified portfolio that can withstand adverse global market conditions. The Reserve Management Committee oversees the investment strategies and reviews risks emanating from the global economic and financial markets outlook. The risk management framework helps ensure the sustainability and adequacy of BNM's international reserves to meet Malaysia's external obligations.

Debunking misconceptions surrounding international reserves

This section of the article aims to respond to common misconceptions surrounding BNM's international reserves.

Misconception 1:
Malaysia's international reserves are too low.

Based on a wide range of internationally accepted benchmarks (Chart 1), BNM's international reserves as at end-2020 remained sufficient, and was neither too low nor too high. Given Malaysia's high degree of trade and financial openness, having sufficient international reserves is important to mitigate the impact of sharp reversal of capital flows.

Reserve accumulations have moved in tandem with potential foreign exchange liquidity needs of the economy. BNM's international reserves meet the reserves adequacy thresholds but do not significantly exceed these benchmarks. The international reserves are therefore adequate and not excessive[10].

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7 Section 5(2) Central Bank of Malaysia Act 2009.

8 As measured by trade and financial openness. As at end-2020, Malaysia's trade openness (sum of export and import of goods and services divided by GDP) stood at 117% of GDP while financial openness (sum of external financial assets and liabilities divided by GDP) stood at 266% of GDP.

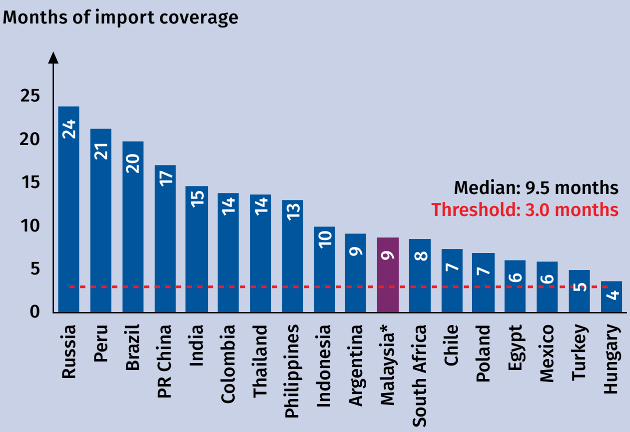
9 "Risk Management and Internal Control". BNM Annual Report 2019.

10 Accumulating large international reserves involves opportunity costs whereby excessive foreign currency funds are invested in highly liquid and more conservative reserve assets. In addition, aggressive reserve accumulations could undermine the role of the floating exchange rate and may be interpreted by trade partners as pursuing the export competitiveness motive. This could lead to several repercussions including under-investment in the domestic sector, over-reliance on the export sector and retaliatory measures from trade partners as discussed in the previous section.

Chart 1: International Reserves Adequacy Indicators[1]

International reserves coverage of imports (months)

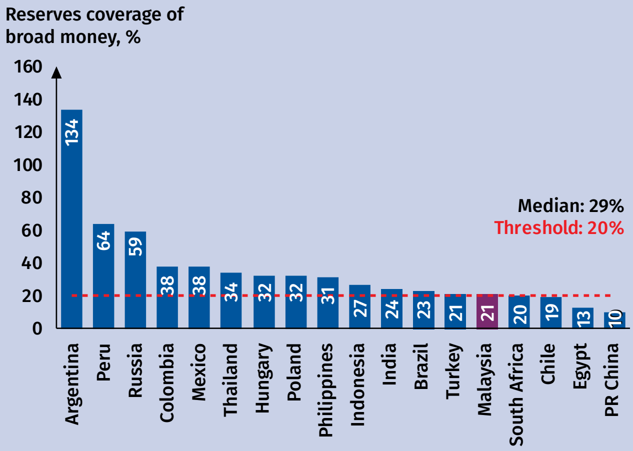
Measures a country's ability to finance its import payments if other net flows are halted.



* Malaysia uses retained imports as its benchmark.

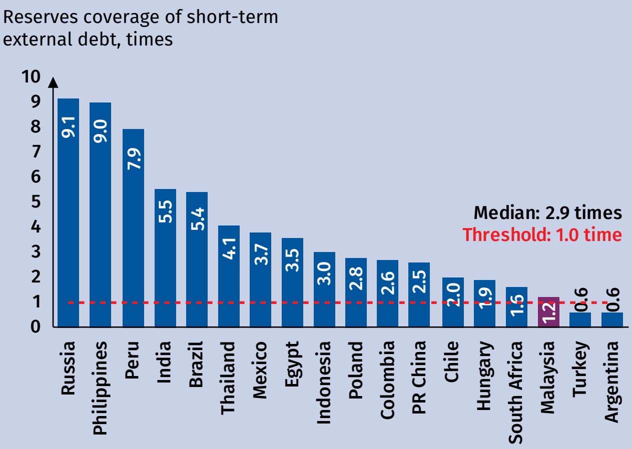
International reserves coverage of broad money (percent)

Measures a country's ability to withstand capital flight if other net flows are halted.



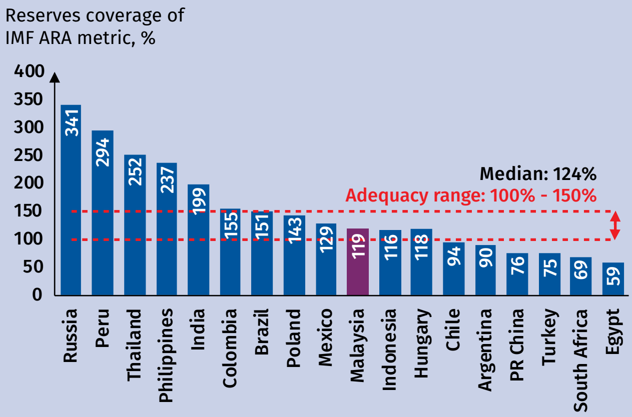
International reserves coverage against short-term external debt (times)

Measures a country's ability to meet its external debt obligations maturing in the next 12 months if other net flows are halted.



International reserves coverage of IMF's Assessing Reserve Adequacy (ARA) metric (percent)

Assesses a country's potential foreign currency liquidity needs taking into account its level of exports, broad money, short-term external debt and other liabilities.



[1] As at end-2020, except for country-level data in international reserves coverage against short-term external debt for Argentina, Colombia, Egypt, Philippines, Poland, PR China, Russia, Thailand and Turkey, which are as at end-September 2020.

Source: International Monetary Fund, CEIC Data, national authorities and Bank Negara Malaysia

Misconception 2:

International reserves could be used to finance the Government's fiscal deficit and pay off part of Government debt.

As a highly open economy, Malaysia is exposed to sudden and sizeable two-way capital flows. BNM is entrusted to ensure that the impact of these capital flows is well-managed, in order to preserve orderly foreign exchange markets and stable macroeconomic conditions. BNM's international reserves are at a level commensurate with Malaysia's external liabilities. Depleting BNM's international reserves for other purposes would affect Malaysia's ability to withstand and respond to external shocks, thereby exposing the country to significant risks during periods of stress.

The country's experience with past episodes of large and volatile capital flows, as recently as 2015, underscore the criticality of holding sufficient amount of international reserves. Malaysia has experienced several such episodes of large capital flow reversals. For example, during the 2008-2009 Global Financial Crisis and 2014-2015 oil price shock episodes, portfolio outflows amounted to USD26.0 billion (3Q 2008 – 1Q 2009) and USD13.7 billion (3Q 2014 – 3Q 2015), respectively. During these episodes, BNM deployed its international reserves to mitigate the significant withdrawal of foreign currency liquidity and ensure orderly functioning of the domestic foreign exchange market. This successfully prevented excessive ringgit exchange rate fluctuations that would have harmed the Malaysian economy. This demonstrates the importance of holding adequate level of international reserves to minimise any adverse impact from sizeable capital withdrawals to the economy. It also underscores that BNM's international reserves are needed for its intended objectives and should not be utilised for other purposes, including financing the Government's fiscal deficit or paying off Government debt. Financing fiscal spending using international reserves is viewed negatively by financial market investors and analysts as it signals potential for further depletion of international reserves.

Misconception 3:

BNM uses the reserves to target a specific level of ringgit exchange rate.

BNM does not target any specific ringgit exchange rate level. Malaysia maintains a flexible exchange rate policy where the level of the ringgit exchange rate is market-determined.[11] This allows the exchange rate to play an important role in the economy, particularly to respond to and absorb the impact of external shocks effectively (see Chart 2). As outlined in the preceding sections of this feature article, BNM's aim is to maintain orderly functioning of the domestic foreign exchange market. Hence, BNM's foreign exchange intervention operations are meant to prevent disorderly foreign exchange market conditions and avoid excessive exchange rate volatility by ensuring sufficient liquidity in the domestic foreign exchange market. It is important to note that these foreign exchange intervention operations are conducted during periods of ringgit appreciation and depreciation. The two-way foreign exchange interventions underscore that BNM does not target any specific exchange rate.

Ongoing efforts to further strengthen Malaysia's external resilience

The progressive liberalisation of the Foreign Exchange Policy[12] has resulted in the accumulation of external assets by corporates and banks amounting to USD365.5 billion as at end-2020, up from USD62.6 billion as at end-2001. These external assets can be used by domestic entities to meet their external obligations, without creating a claim on international reserves.

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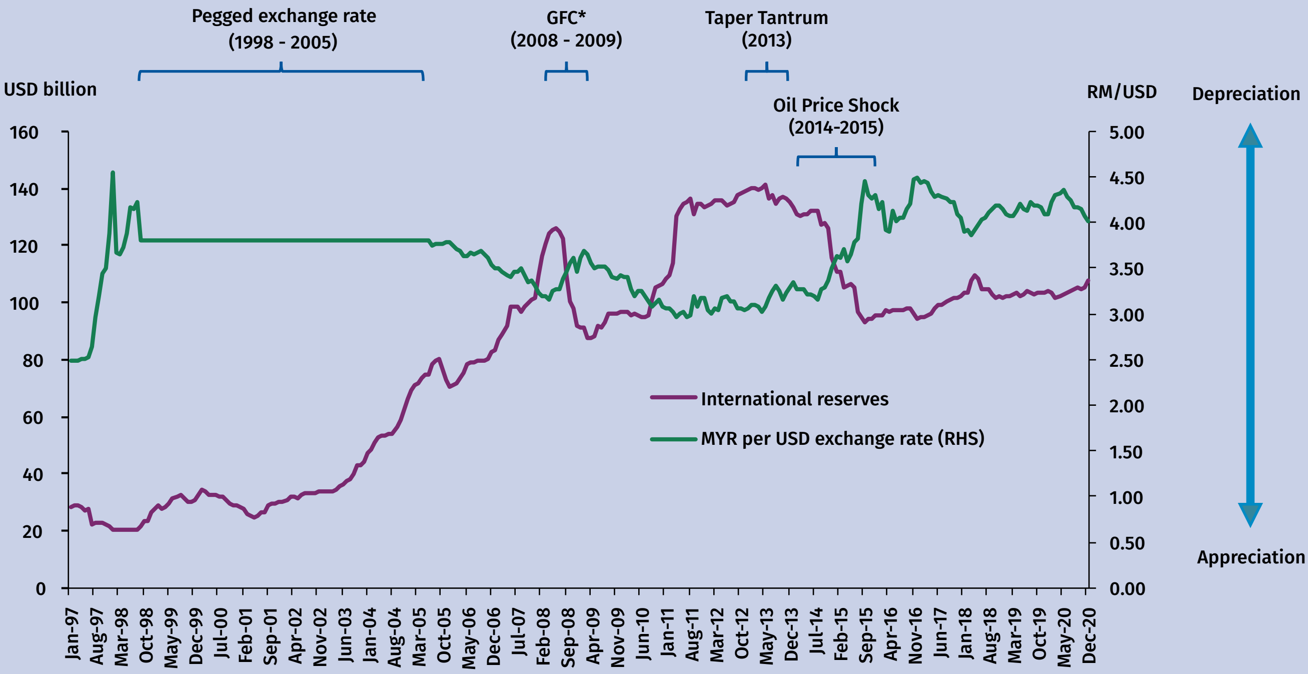
[11] The IMF classifies the ringgit exchange rate under the floating arrangement, which is defined as "largely market determined, without an ascertainable or predictable path for the rate". In addition, this classification acknowledges that countries with a floating exchange rate arrangement do engage in foreign exchange interventions, specifically to maintain orderly foreign exchange market functioning. Under this definition, foreign exchange interventions are not aimed to target a specific level of the exchange rate.

[12] A set of prudential measures related to the foreign exchange market to promote monetary and financial stability conducive to the sustainable growth of the economy and safeguarding the balance of payments position.

Chart 2: International Reserve Levels and RM/USD Exchange Rate



* Refers to the 2008-2009 Global Financial Crisis

Source : Bank Negara Malaysia

To further strengthen Malaysia's external resilience, BNM has continued to pursue initiatives to deepen the domestic financial market and to promote more active management of foreign exchange risks by corporates, banks and households. This includes enhancing the domestic foreign exchange market access and facilitating the development and offering of efficient foreign exchange hedging products and instruments to protect against exchange rate fluctuations. These measures enhance Malaysia's flexible exchange rate to serve its purpose as the first line of defence in facilitating adjustments in the economy in response to shocks. In addition, these initiatives have helped increase the average monthly turnover of foreign exchange swaps, forwards and options from USD67.3 billion in 2012 to USD171.9 billion in 2020.

Continued efforts to advance international cooperation and ease of access to global and regional financial safety nets complement the country's action to boost economic and financial resilience. A notable example is the Chiang Mai Initiative Multilateralization, a regional multilateral currency swap agreement between ASEAN, PR China, Japan and South Korea, which aims to address balance of payment and short-term foreign exchange liquidity needs. These initiatives can serve a supplementary role to support existing international reserves.

Conclusion

BNM's international reserves remain adequate, but not excessive, to meet the potential foreign currency needs of the economy during periods of shocks. This is to ensure that international trade and financial transactions are not disrupted during periods of market stress. BNM's foreign market interventions are consistent with Malaysia's flexible exchange rate regime to allow the necessary macroeconomic adjustments to take place in response to external shocks. In addition, the wide-ranging availability of exchange rate hedging instruments allow businesses and individuals to protect themselves against exchange rate fluctuations. Malaysia's participation in the regional and global international financial safety nets provides another layer of buffer against foreign currency liquidity shocks. Therefore, given the important role of international reserves, it is critical that they are utilised prudently and appropriately.

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