Financial Imbalances and Policy Responses in Malaysia

Financial Imbalances

While there have been numerous studies and discussions on financial imbalances, there is no clear or specific definition of financial imbalances. Rather, financial imbalances are often defined by their symptoms or manifestations. These could include over-investment in specific sectors, excessive credit growth, sharp increases in asset prices, or fiscal and current account imbalances. The most typical and frequently identified symptoms are asset price misalignments and excessive credit growth. These imbalances reflect the misallocation of resources and the disintermediation of funds towards speculative activity in asset markets.

As financial imbalances result in a build-up of domestic vulnerabilities and are ultimately unsustainable, they could lead to destabilising adjustments in the economy and pose risks to macroeconomic and financial stability. This phenomenon is not new. Historically, the build-up of financial imbalances has often preceded financial and economic busts[1]. As illustrated by the experience of the advanced economies in the recent financial crisis, the slow build-up of financial imbalances, if left unchecked, can unravel rapidly and in a disorderly manner, leading to financial and economic disruptions, threatening price stability and longer-term economic growth prospects. Of greater relevance to emerging economies, in the post-crisis period, the unprecedented monetary policy accommodativeness in the advanced economies had led to a surge in capital inflows into these economies. These inflows can directly increase asset prices as foreign investors purchase assets, or they can lead to increased liquidity in the financial system, which in turn can intensify pressure on banks to lend, leading to credit booms and asset price bubbles. Such inflows and the consequent downward pressure on the interest rates of recipient countries can significantly influence monetary and financial conditions in small open economies.

Financial imbalances, at their core, are driven by shifts in the risk-taking behaviour of economic agents and a pervasive underestimation of risk exposures. Through the conventional transmission channels of monetary policy, which include the interest rate, credit and asset price channels, a prolonged period of low interest rates may induce investors or savers to take on greater risks. This could occur when valuations and incomes are expected to remain high, or in search of yield given low returns on safe investments. These channels, when interacting with the risk-taking channel, aggravate the risk of financial imbalances[2], as a prolonged period of low interest rates may lead to a fundamental shift in the perception and tolerance of risk.

With the risk-taking channel, a prolonged period of low interest rates results in lower measured risk and an increase in the search for yield. From the perspective of banks, a low interest rate environment eases loan repayment obligations and boosts asset and collateral values, consequently lowering banks' estimates of probabilities of defaults. When improvements observed are misperceived to be permanent in nature, banks become more willing to supply credit on terms that may not necessarily reflect the actual risks associated with the loans. Banks may also actively seek to go beyond conventional loan origination methods and take on riskier investments in order to boost nominal returns. The cumulative effect is a rise in the riskiness of the banks' asset portfolios[3].

The risk-taking channel is also closely linked to liquidity[4]. When there is an increase in liquidity, assets become easier to trade with minimal impact on prices (market liquidity) and funds can be easily sourced (funding liquidity). This increase in liquidity further amplifies risk-taking behaviour as the lower perceived

[1] In a historical account of over 40 financial crises, Kindleberger (2000) describes financial crises as the end result of a process where expectations lead to speculative excesses, facilitated by excessive credit creation. Claessens, Kose and Terrones (2011) find that recessions associated with episodes of financial disruption, notably house price busts, tend to be longer and deeper than other recessions.

[2] The risk-taking channel is different from the credit channel in that it strengthens the financial accelerator with amplification mechanisms *within* the financial sector, namely risk perception and tolerance, as well as liquidity. See Borio and Zhu (2008), and Adrian and Shin (2009) for further details.

[3] This channel is also associated with excessive bank balance sheet expansion through leverage (Adrian and Shin, 2010).

[4] See Borio and Zhu (2008).

risks increases the appetite to participate in the asset markets and to undertake a search for higher returns. For small open economies, liquidity in the financial system can be significantly influenced by external sector inflows. Capital inflows affect asset markets and banks' balance sheets, contributing to higher asset prices and an increase in liquidity with banks[5,6]. Banks are thus able to match credit demand while maintaining low or stable lending rates. In fact, the ample liquidity could increase competition to lend and thereby increase the risk appetite of banks. The combined effects may result in monetary and financial conditions becoming looser even if the policy interest rate remains unchanged. Crucially, the possible reversals of capital inflows and their attendant adverse effects may not be fully taken into account by the banks and their customers.

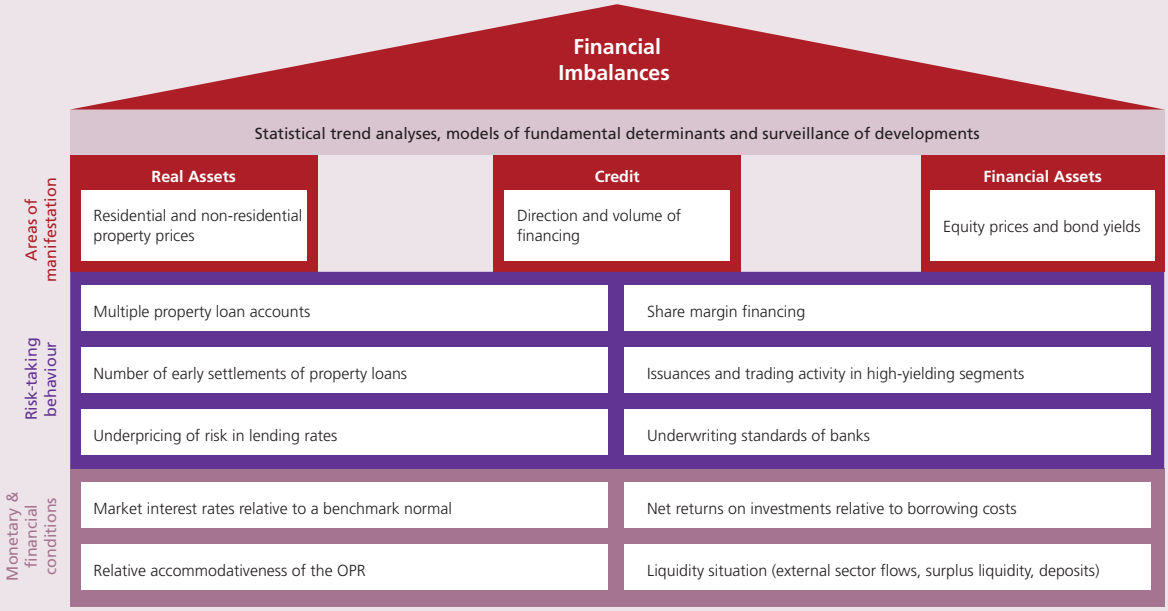
Indicators of Financial Imbalances

In assessing the build-up of financial imbalances in the economy, the Bank conducts surveillance using a wide range of indicators, both in granular and aggregate form. The main focus of surveillance is on (i) the accommodativeness of monetary and financial conditions, (ii) manifestations of increased risk taking, and (iii) signs of excessive credit growth and potential asset price misalignments.

The surveillance of monetary and financial conditions takes into account various price and quantity indicators which set the baseline for risk-taking behaviour. These indicators include borrowing costs and net returns on investments, as well as external sector inflows, surplus liquidity and deposits growth. To gauge risk-taking behaviour, the Bank monitors the risk-taking capacity of banking institutions by assessing their measured risk, and evaluates if shifts in this capacity translate into changes in lending practices. In evaluating credit growth and asset market developments, statistical trend analyses and econometric estimations are carried out. This is complemented by continuous surveillance of economic developments, which help differentiate

Chart 1

A Snapshot of Key Indicators for the Assessment of Financial Imbalances



[5] Persistent current account surpluses also lead to a rise in banks' sources of funds, and potentially, domestic structural surplus liquidity.

[6] Singh (2014) provides a discussion on the direct and indirect effects of global liquidity on Malaysia's monetary and financial conditions. Meanwhile, Bruno and Shin (2014) elaborate specifically on how prolonged loose monetary policy in advanced economies translates into greater risk tolerance by local banks in other countries through the increased leverage of global banks and their cross-border funding of these other banks.

fundamental and cyclical factors, as well as speculative elements. For example, when assessing the housing market, the Bank analyses structural factors such as housing supply, demographic changes and construction costs, which may explain deviations in price trends vis-à-vis income. At the same time, information such as the early settlement of loans and the number of borrowers with multiple loan accounts are also taken into consideration, in order to make an assessment of the level of speculative activity. This comprehensive approach enhances the robustness of assessments[7].

At the aggregate level, the Bank also monitors the financial cycle. The financial cycle captures the evolution of credit and asset prices over time, which reflects changing perceptions of risk and financing constraints[8]. Empirically, peaks in the financial cycle have been shown to be closely associated with financial crises[9]. Additionally, financial cycles also tend to be longer in duration compared to business cycles. Consequently, financial imbalances tend to build up and unwind over a longer period compared to business cycle fluctuations.

Bank Negara Malaysia's Policy Approach to Financial Imbalances

As financial imbalances tend to build up gradually with the potential destabilising effects only emerging at time horizons that are beyond those of conventional monetary policy, it is important to pre-emptively react to early signs of financial imbalances. In this regard, apart from the main focus on the near-term balance of risks to the inflation and growth outlook, the Bank's monetary policy decisions also take into account the potential risks related to financial imbalances[10].

At the same time, the policy approach does not overly rely on any single policy tool, including monetary policy, as adjustments to the policy interest rate would have a broad-based impact across the entire economy. As part of the Bank's broad policy toolkit, policy measures such as macro- and micro-prudential instruments are also considered and deployed to reign in financial imbalances. Coordination with fiscal policy, and the introduction of tax measures, increases the overall effectiveness in dealing with financial imbalances. The decision to use monetary policy or other policy measures, or a combination of these measures, in response to financial imbalances is based on their relative benefits and costs given the assessment of the prevailing situation. When imbalances are assessed to be contained in specific segments of the economy, targeted macro- and micro-prudential as well as fiscal measures may be more effective in curbing excesses while minimising unintended cross-sectional policy spillovers to other segments of the economy[11].

It is important to highlight that while these other measures can complement monetary policy, they are usually not a substitute for having the right level of the policy interest rate. In this regard, three key considerations make a strong case for monetary policy action. First, if prolonged loose monetary conditions are a likely source of financial imbalances, a change in the monetary policy stance may be better than treating the symptoms using other measures, as the cause of distortion is addressed directly. Second, if there are signs of financial imbalances becoming pervasive, driven by widespread underlying risk-taking behaviour, a monetary policy adjustment ought to be considered rather than relying solely on a set of more targeted measures. This is because monetary policy broadly affects the returns on assets and borrowing costs and is less subject to circumvention. In contrast, the use of a variety of other measures on a large scale may lead to distortions and substantial administrative costs. Third, the bluntness of monetary policy is less of a concern if the cost to near-term growth and inflation is low and is outweighed by the likely

[7] The assessments form part of the staff evaluations deliberated upon by the Monetary Policy Committee in determining the balance of risks to growth and inflation. Given the nature of the issues and indicators, however, there is some overlap with the surveillance carried out under the financial stability mandate, which encompasses rigorous assessments on the risks to the financial system. See the Bank's annual publication, Financial Stability and Payment Systems Report for further details.

[8] See Borio (2012).

[9] Drehmann, Borio and Tsatsaronis (2012) find for a sample of seven industrialised countries, that all the financial crises with domestic origin occur at, or close to, peaks of the financial cycle.

[10] For an earlier discussion on the role of monetary policy in addressing financial imbalances, refer to Bank Negara Malaysia (2010).

[11] For broad principles guiding the design, deployment and calibration of macroprudential policies in Malaysia, refer to Ibrahim (2014).

benefit to future growth and inflation. This trade-off tends to be smaller when the business cycle and financial cycle are synchronised.

This approach is reflected in the Bank's policy responses to the potential emergence of financial imbalances in the recent period. After reducing the Overnight Policy Rate (OPR) to a historic low of 2.00% during the financial crisis in the advanced economies in 2008-2009, the Bank progressively reduced this extraordinary monetary accommodation, raising the OPR by a 100 basis points to 3.00% between March 2010 and May 2011. The Bank recognised that keeping the OPR unusually low for an extended period could induce broad-based financial imbalances. This was especially so when asset prices and credit growth had also recovered fairly strongly amid sustained capital inflows arising from the highly accommodative monetary policy stance among advanced economies. Hence, at the earliest possible opportunity, when domestic economic growth was assessed to be more entrenched, the OPR was normalised. However, at the same time, it was recognised that higher interest rates could attract further capital inflows, potentially complicating efforts to avoid a build-up in financial imbalances. In this regard, the Bank's broad policy toolkit, which includes sterilised intervention under a flexible exchange rate regime, and the Statutory Reserve Requirement (SRR), had played an important role in complementing monetary policy. The Bank relies on a wide range of sterilisation instruments for liquidity management. After the initial reduction during the financial crisis in the advanced economies, the Bank raised the SRR by 300 basis points to 4.00% between April and July 2011[12]. This move was aimed at providing longer-term sterilisation of the excess liquidity in the financial system.

A series of macro- and micro-prudential measures were also implemented in stages between 2010 and 2013 to curb financial excesses, which were mainly confined to segments of household lending. These targeted incremental measures have been effective, generally preserving sound lending standards and improving affordability assessments; thus contributing to the significant moderation in the growth of personal loans, particularly among non-banks. Along with fiscal measures, these measures led to reduced speculative activity in the property market[13]. In July 2014, amid firm growth prospects for the economy, and with inflation remaining above its long-run average, the Bank adjusted the degree of monetary accommodation. While the macro- and micro-prudential measures continued to have the desired effects, there remained risks of a broader build-up of financial imbalances. Consequently, the OPR was increased by 25 basis points to 3.25%.

The use of a comprehensive set of measures in tackling financial imbalances reflects the Bank's overall policy philosophy of considering all policy tools available to it and the mix that would most effectively address the issues at hand. Such an approach is necessary given the increasingly complex interactions within and between the financial system and the economy.

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[12] See press statements on the increases in the SRR in March, May and July 2011 to manage the build-up in liquidity which may result in financial imbalances.

[13] For more details on the measures implemented, refer to Chapter 1 of Bank Negara Malaysia's Financial Stability and Payment Systems Report over 2010-2013.

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