The brighter side of capital outflows

MY Say

BY NOR ZAHIDI ALIAS

The recent excitement in the financial fraternity following the outflow of capital from the regional market came as no surprise. As the outflows increased after Donald Trump's victory in the US presidential election, the regional financial markets became the centre of attention. And with the US Federal Reserve positioning itself for more rate hikes in the near term, speculation is rife on the possible ramifications of higher borrowing costs on the regional economies.

While there are some concerns over Malaysia's net bond outflows in five of the past six months, one should not be too fixated on the amount of bond outflows on the aggregate level. History shows that bond outflows after the unpegging of the ringgit in the second half of 2005 and during the global financial crisis (GFC) in 2008-2009 far outweigh this recent episode in magnitude.

During those episodes, foreign holdings as a percentage of outstanding Malaysian bonds, both government and corporates, fell by half and two-thirds respectively (from 10% to 5% in the second half of 2005, and from 21% to 7% in 2008-2009). In absolute terms, total foreign holdings of Malaysian bonds dropped by roughly RM22 billion from July to December, 2005, and by RM84 billion during the GFC. In contrast, the recent bond outflows amounted to about RM43 billion between August 2016 and February this year — only a 17% drop from the peak level of RM246 billion.

Some comfort can also be derived from scrutinising the actual nature of these outflows. First and foremost, on an aggregate basis, foreign holdings of Malaysian government debt securities had dropped to slightly less than 29% of total government bond outstanding as at end-February from almost 35% at the peak of the recent cycle.

> From a macroeconomic perspective, such an incident leads to this important question: what should the desirable level of foreign holdings of a country's debt securities be? I believe that the answer would depend on several factors, such as market depth and exchange rate flexibility.

A quick look at the data on Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (GII) reveals that non-resident holdings of these securities fell to roughly 45% and 8% of their respective outstanding totals from 52% and 13%. At the same time, foreign holdings of total Malaysian bonds (government and corporates) slipped 3.7 percentage points from the peak of the recent cycle last August to RM203 billion at the end of February.

Secondly, the current structure of Malaysian bond holdings makes the market more resilient to capital withdrawals. Specifically, the breakdown of holdings reveals that about 30% of foreign investors who hold Malaysian bonds are in fact central banks and governments, while the rest comprise institutional investors such as pension funds and insurance companies with generally longer investment horizons.

Thirdly, Bank Negara Malaysia's statistics reveal that the bulk of the bond outflows from last November and February this year were indeed associated with a selldown of short-term papers by foreign investors: 70% of the total reduction in foreign holdings of government bonds (or RM15.2 billion) involved papers with maturities of less than three years; foreign holdings of papers with maturities of three to five years accounted for 13%, while those with maturities of five years and more comprised 17%.

These outcomes explain why the spike in bond yields, especially for MGS after the US presidential elections, did not last for long. For example, the yield of the 10-year MGS, which rose to its peak of 4.46% in late November (from 3.65% a day before Trump's victory), slipped to 4.04% by the end of February.

Such a breakdown says something about the volatility of the regional currencies. In short, rapid movements of short-term capital always boost the currencies' volatility and affect regional financial markets. Statistical measures such as regression show that the ringgit's performance is more correlated to the movement of foreign holdings of short-term Malaysian securities than long-term papers. In the recent episode, the ringgit fell by about 9% between August last year and February. During GFC, the ringgit fell about 13% after foreign holdings dropped by two-thirds.

From a macroeconomic perspective, such an incident leads to this important question: what should the desirable level of foreign holdings of a country's debt securities be? I believe that the answer would depend on several factors, such as market depth and exchange rate flexibility. What's pretty obvious, however, is that high foreign holdings of local debt securities come with a price — exchange rate volatility with ramifications for the financial markets. This is especially true if the bulk of the holdings are short term in nature.

Such a view may not surprise financial economists, as history has shown that the problem of short-term capital outflows has induced many countries to undertake various measures to contain their unintended effects. For instance, Chile in the 1990s imposed several measures that ranged from the usage of unremunerated reserve requirements to the limitation of export proceeds in foreign currencies.

Similarly, in Colombia, an implicit tax was imposed in 1993 on foreign borrowings in the form of a non-interest-bearing deposit requirement of roughly 47% of the loan amount on all loans with maturities of 18 months or less. In Brazil, explicit taxes were imposed to control short-term capital inflows in late 1994. Other examples include Spain and Portugal's responses in the early 1990s.

Given such a history, one should not be surprised if the authorities start focusing on luring investments into longer-term papers. In other words, Malaysia's bond market landscape may see some changes in terms of foreign holdings. A slightly lower percentage of foreign holdings may not be detrimental after all, especially for short-term tenures. Such a landscape may prove to be more advantageous, particularly if the volatility in the global financial markets persists in the near term. E

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