Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves

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Introduction

External debt of emerging market economies (EMEs) has risen significantly in the aftermath of the global financial crisis (GFC). This was facilitated by supportive global liquidity conditions (IMF, 2018) driven partly by the highly accommodative monetary policy stance in the advanced economies (AEs). Since 2013, however, more entrenched growth, particularly in the US, has led to monetary policy normalisation and increasingly tighter global financial conditions. These developments have resulted in a re-orientation of global capital flows and depreciation of EMEs' currencies, raising concerns on external financing vulnerabilities of the EMEs.

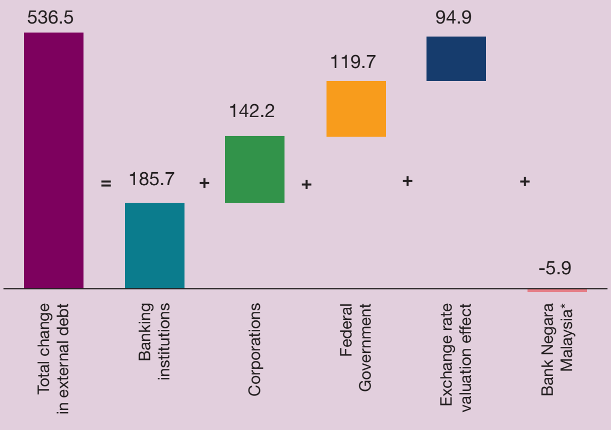
Malaysia has also experienced an increase in external debt. Malaysia's external debt is higher relative to the EMEs[1] median peer countries. This article examines the underlying drivers of Malaysia's external debt and mitigating factors that contain the risks emanating from external shocks. A medium-term projection and stress testing of Malaysia's external debt further underpin the sustainability and robustness of the country's external debt. This article also features an information box on the adequacy of reserves to facilitate international transactions which further strengthens Malaysia's external position.

Malaysia's external debt stood at 64.7% of GDP

Post GFC, Malaysia's external debt has risen from RM388.3 billion or 54.5% of GDP as at end-2009 to RM924.9 billion or 64.7% of GDP as at end-2018. The higher external debt is mostly accounted for by banks, corporations and the Federal Government. In aggregate, these institutions contribute about 83.4% of the rise in external debt (Chart 1). By instrument, the increase in external debt reflects higher non-resident (NR) holdings of domestic debt securities, interbank borrowings, intercompany loans, NR deposits and bonds and notes issued internationally (Chart 2).

Chart 1: Contribution to Total Change in External Debt by Institution from end-2009 to end-2018 (RM billion)

Banks, corporations and the Federal Government account for 83.4% of the rise in external debt

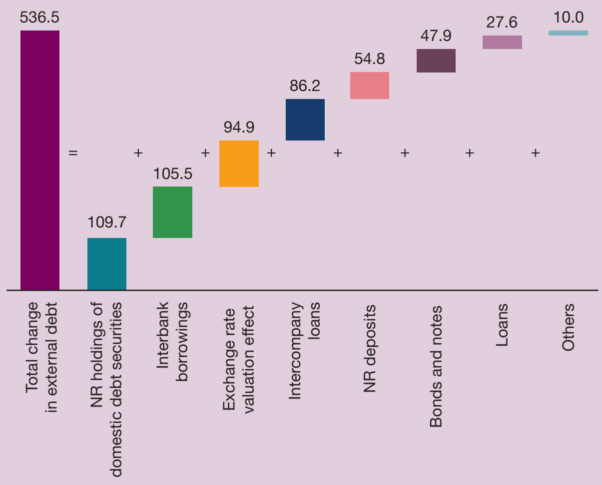


* The decline reflects largely liquidation of NR holdings of Bank Negara Monetary Notes

Source: Bank Negara Malaysia

Chart 2: Contribution to Total Change in External Debt by Instrument from end-2009 to end-2018 (RM billion)

The rise in external debt spreads across debt instruments



Source: Bank Negara Malaysia

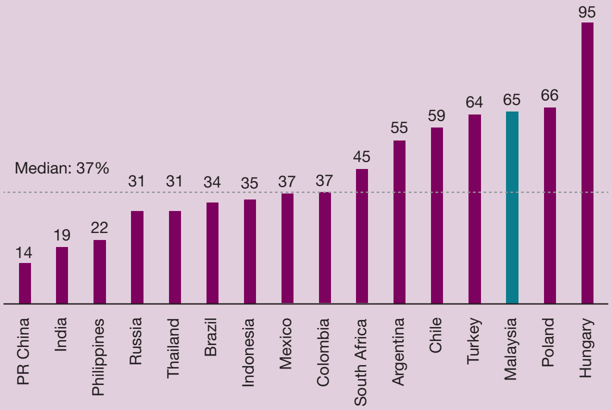
[1] Median of peer countries of Malaysia, i.e. Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Philippines, Poland, PR China, Russia, South Africa, Thailand and Turkey. This composition of countries applies throughout this article.

The relatively higher external debt (Chart 3) has attracted focus on Malaysia's external position. The IMF in its 2018 Article IV Consultation report argues that Malaysia's external financing vulnerabilities are higher than its median peer countries. Meanwhile, Moody's Investors Service in its 2017 report assesses that a large share of short-term and foreign-currency denominated portion in Malaysia's total external debt posed rollover and exchange rate risks. These analyses, however, mostly focus on headline external debt figures without further analysing the underlying drivers and mitigating factors against debt-related vulnerabilities.

Malaysia has been able to withstand external shocks considerably well. These include the episodes of large capital outflows triggered by the US Federal Reserve's Taper Tantrum in 2013, followed by a collapse in commodity export prices towards the end of 2014. Since 2015, the US Federal Reserve has increased its policy rate nine times, equivalent to 225 basis points. In addition, ringgit depreciated by about 50% from RM2.9675 per US dollar in May 2013 to the trough of RM4.4995 per US dollar in January 2017. Despite these shocks, domestic banks and corporations continued to be able to meet their external obligations and to access new borrowings. Underpinned by healthy debt servicing capacity, these entities experienced a relatively small increase in the cost of foreign currency (FCY) borrowings (Chart 4).

Chart 3: External Debt across EMEs (% of GDP)

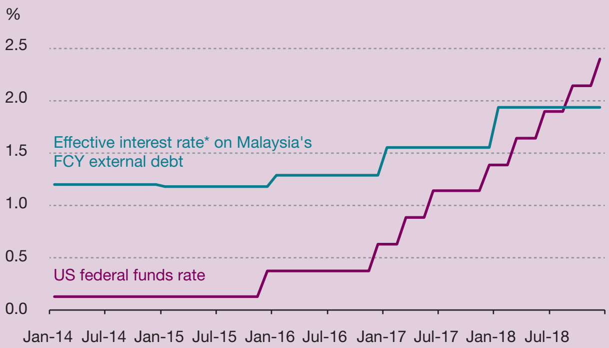
Malaysia's external debt relative to the size of the economy is higher than the EMEs median



Source: Bank Negara Malaysia, the IMF and World Bank

Chart 4: Interest Rate on Malaysia's FCY External Debt and US Federal Funds Rate

Smaller increase in interest rate on Malaysia's FCY external debt compared to the rise in US interest rate



* Derived from the actual interest payments on FCY external debt divided by the average FCY external debt outstanding during the year

Source: Bank Negara Malaysia and US Federal Reserve Board

Part I: Underlying drivers of Malaysia's external debt and factors reinforcing resilience against external shocks

This section examines factors driving Malaysia's external debt by institutions, namely; (A) Banks; (B) Corporations; and (C) The Federal Government. As assessed in the following sections, the nature of Malaysia's external debt accumulation in itself presents a considerable mitigation against attendant risks.

A. Underlying drivers of banking institutions' external debt: Large presence of foreign banks in Malaysia and extensive regional footprint of domestic banks

Banks' external debt[2] is notably higher than that of the emerging Asia Pacific peers[3] (Chart 5).This reflects the sizeable presence of foreign banks in Malaysia (Chart 6), including those operating in the Labuan International Business and Financial Centre (LIBFC) and the sizeable regional operations of domestic banking groups (DBGs) (Chart 7).

[2] Banks' external debt in this context includes external debt of banks in Labuan International Business and Financial Centre.
[3] Refer to all economies in the Asia Pacific region excluding Australia, Hong Kong SAR, Japan, New Zealand and Singapore.

Chart 5: Cross-country Comparison of Banks' External Debt

Banks' external debt, while higher than emerging Asia Pacific peers, is comparable to its rating peers

Note: Data for peer countries as at end-3Q 2018 except for Australia, India, Israel and Thailand, which refer to end-2Q 2018 figures. Banking system rating peers are based on S&P Banking Industry Country Risk Assesment methodology. Malaysia is in group 4 along with Israel, Mexico, Spain, New Zealand, Saudi Arabia, Estonia and Iceland

Source: Bank Negara Malaysia, Haver Analytics, World Bank's Quarterly External Debt Statistics Database and IMF World Economic Outlook

External debt of foreign banks primarily reflects intragroup placements from parent institutions, which render the debt less susceptible to sudden withdrawal shocks

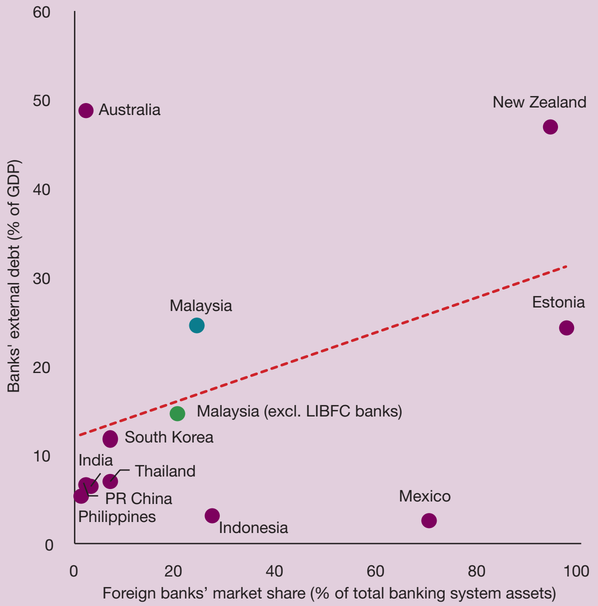
About 41% of banks' external debt is attributable to banks operating in LIBFC, predominantly in the form of intragroup placements from foreign[4] parent banks and regional offices (83% of total LIBFC banks' external debt) (Chart 9). Given LIBFC's position as an international financial centre, banks in LIBFC typically operate as booking centres for transactions arranged and managed by the head office. Funds received by LIBFC banks are substantially lent out to non-resident clients (also known as 'out-out' transactions), which comprise 60% of LIBFC banks' total assets. A sizeable portion of these funds is also placed with related parties in the interbank market. Liquidity, funding and foreign exchange (FX) risks associated with these exposures are assessed to be low as these transactions are 'back-to-back' in nature, i.e. the amount, tenure and currency of the funding received from related entities typically match that of the transaction with the ultimate beneficiary of such funds. Therefore, banks are less susceptible to sudden funding reversals before the associated assets mature and also to potential volatility in the FX market.

Another 20% of banks' external debt is driven by the sizeable presence of locally-incorporated foreign banks (LIFBs) in Malaysia (Chart 9). LIFBs leverage on the stronger credit rating of their internationally-active parent banks to source cheaper and longer-term FCY funding from abroad. Such funds are then utilised primarily in three ways: (i) Manage any immediate liquidity mismatches in the FCY balance sheet; (ii) Extend FCY lending in the domestic interbank market; and/or (iii) Pursue short-term ringgit investments in highly liquid and low credit risk assets such as placements with Bank Negara Malaysia or holdings of Malaysian Government Securities. For smaller LIFBs that serve niche segments or clientele, parent placements serve as an important source of funding. Such banks also operate a 'back-to-back' model, thereby limiting potential risks.

[4] As DBGs are resident entities, their transactions and exposures to affiliates in LIBFC are not deemed as external exposures.

Chart 6: Banks' External Debt and Market Share of Foreign Banks

Size of banking system external debt is generally commensurate with presence of foreign banks



Note: Foreign banks' market share data refers to proportion of total banking sector assets held by foreign banks

Source: Bank Negara Malaysia, Bloomberg, Global Financial Development Database, Haver Analytics and IMF World Economic Outlook

Chart 7: Total Foreign Claims of Domestic Banks (% of GDP)

Domestic banking groups have sizeable overseas presence

Note: Refers to total foreign claims of domestic banks in all currencies. Data for peer countries as at end-3Q 2018

Source: Bank Negara Malaysia, BIS International Banking Statistics, Bloomberg, Haver Analytics and IMF World Economic Outlook

Domestic banking groups with regional operations typically adopt centralised liquidity management, with external borrowings broadly matched with external assets

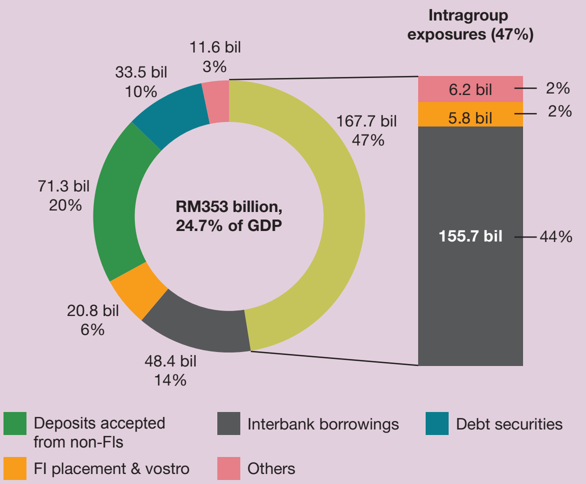
The remaining 39% of banks' external debt is attributable to domestic banking groups (DBGs) (Chart 9), particularly those with extensive regional operations. These DBGs typically adopt centralised liquidity management[5] (CLM) in order to optimise funding cost advantages across various overseas operations within the group. More specifically, excess liquidity from overseas branches and subsidiaries as well as medium- to long-term funding raised in international wholesale and capital markets are pooled at the head office in Malaysia, and strategically channelled back to related offices. The composition of DBGs' external debt reflects such activities, with 53% of the external debt consisting of interbank borrowings and debt securities issuances. In the first half of 2018, several DBGs notably tapped overseas wholesale funding markets to capitalise on more favourable market conditions.[6] DBGs also sought to reinforce FCY liquidity buffers amid rising uncertainties in the domestic and international markets following the 14th Malaysian General Election and uncertainties over the pace of US Federal Reserve's monetary policy normalisation. This led to a significantly higher-than-average growth in banks' external debt for the year (2018: 11.5%; 2014-17 CAGR: 6.0%). These funds were largely placed in the domestic interbank market and in ringgit or FCY short-term investments, with borrowings observed to be broadly matched with assets in terms of amount, currency and tenure, thereby limiting the risks arising from tenure or currency mismatches. As market uncertainties subsided in the later part of 2018, such precautionary borrowings were significantly unwound. This resulted in a decline in DBGs' interbank borrowings by RM15.2 billion or 27%. This trend is expected to continue as market conditions improve further.

5 For further information on the CLM practices of Malaysian banks, please refer to the information box on page 33 of Bank Negara Malaysia Financial Stability and Payment Systems Report 2017.

6 The implied cost of raising FCY funds abroad and swapping it into ringgit is cheaper than marginal cost of raising ringgit funds from domestic sources.

Chart 8: Banks' External Debt by Type of Exposure and Instrument (RM billion, % share)

47% of banks' external debt is intragroup exposures which are less susceptible to sudden withdrawal shocks

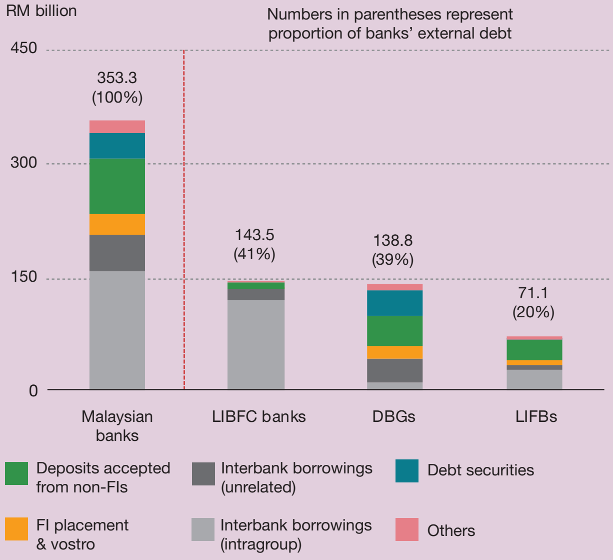


Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

Chart 9: Banks' External Debt by Type of Banks and Instruments

41% of banks' external debt is attributable to foreign banks operating in LIBFC



Source: Bank Negara Malaysia

Domestic banking system is self-sufficient in supporting intermediation needs with no undue reliance on external and cross-currency funding

While onshore banks[7] cumulatively account for 59% of banks' total external debt, no signs of undue reliance on external or cross-currency funding are being observed. The domestic banking system continues to be self-sufficient in supporting domestic intermediation needs with financing activities of onshore banks primarily funded by stable sources in the form of non-bank deposits and medium- to long-term funds (Chart 10). Onshore banks' external debt accounts for less than 8% of total domestic banking system funding liabilities, while non-residents account for only 6.1% of total domestic banking system deposits.

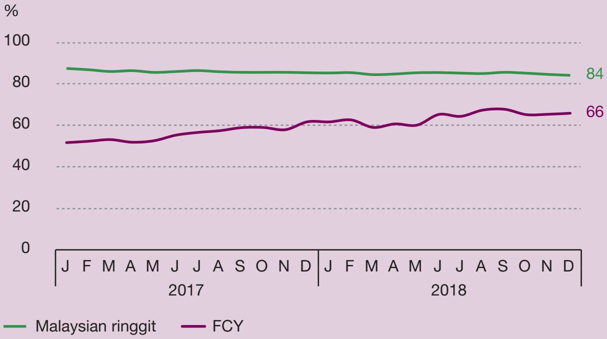
Sound risk management practices mitigate risks associated with external debt

Current macro- and micro-stress tests conducted by Bank Negara Malaysia and individual banking institutions, respectively, also assess the capacity of onshore banks to withstand adverse liquidity and funding shocks, including assessing the adequacy of FCY liquidity buffers. Of note, onshore banks hold substantial FCY liquid asset buffers[8] amounting to RM135.8 billion, bolstering their capacity to mitigate the impact of sudden external funding withdrawal shocks. Such liquid FCY assets are able to cover 54% of total FCY short-term external debt and more than two times the proportion of FCY external debt that is considered more susceptible to sudden withdrawal shocks (also referred to as external 'debt-at-risk'[9]), respectively. This is further supported by banks' risk management practices which include: (i) Prudent internal limits observed for funding and liquidity positions, market risk exposures and mismatch positions; (ii) Minimising open positions through financial derivative hedging instruments; and (iii) Contingency plans in meeting FCY obligations.[10] In line with such practices, onshore banks have maintained relatively low and stable levels of FX net open position across significant currencies (Chart 11).

[7] The term 'domestic banking system' and 'onshore banks' shall be used interchangeably in this article, both refer to DBGs and LIFBs.
[8] FCY liquid assets comprise cash and cash equivalents, interbank placements and unencumbered debt securities.
[9] Banks' external 'debt-at-risk' comprise unstable exposures such as interbank borrowings and short-term loans from unrelated counterparties. As at end-2018, FCY external 'debt-at-risk' amounted to RM64.2 billion or 18.2% of banks' total external debt.
[10] For further information on FCY liquidity management practices of banks, refer to Bank Negara Malaysia Financial Stability and Payment Systems Report 2018, Chapter 1: Risk Developments and Assessment of Financial Stability in 2018.

Chart 10: Banking System – Malaysian Ringgit and FCY Loan-to-Fund Ratios

Banks maintain sufficient stable funds to support intermediation activities

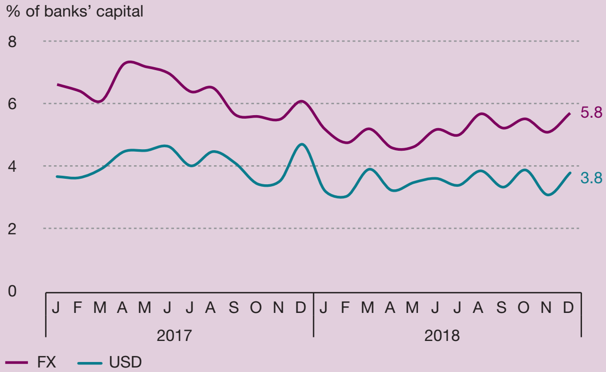


Note: Funds comprise deposits accepted from non-banks and all debt instruments

Source: Bank Negara Malaysia

Chart 11: Banking System - FX and USD Net Open Positions

Overall FX and USD net open positions of banks remain low



Source: Bank Negara Malaysia

B. Underlying drivers of corporate external debt: Significant presence of foreign MNCs

External debt of multinational corporations (MNCs) is predominantly in the form of intercompany loans. These loans are generally on flexible and concessionary terms

As a highly open economy with attractive growth prospects and business-friendly operating environment, Malaysia is the beneficiary of substantial and consistent inflows of foreign direct investment (FDI). Since 2001, growth of FDI stock averaged 10% per annum and the outstanding position stood at 44.1% of GDP as at end-2018. Due to the nature of business strategy and operations, FDI investors, primarily MNCs, rely heavily on their parent companies for funding (Eiteman et al, 1991). Chart 12 corroborates this relationship across a group of selected economies.

Notably, for Malaysia, close to half of corporate external debt is accounted for by MNCs (Chart 13). Three quarters of this debt consists of intercompany borrowings, reflecting extension of financing from parent/affiliate companies overseas to their subsidiaries/affiliates operating in Malaysia (Chart 13). These loans are generally on flexible or no contractual fixed repayment schedules and zero or very low interest rates that are well below the prevailing market interest rates (Bank Negara Malaysia, 2015). Despite the ongoing global financial tightening and rising external interest rate environment, the effective interest rate on Malaysia's FCY intercompany loans has remained very low (Chart 14). These favourable terms largely mitigate the corporates' risk exposure to a sharp rise in interest rates and thereby sustain their debt repayment capability.

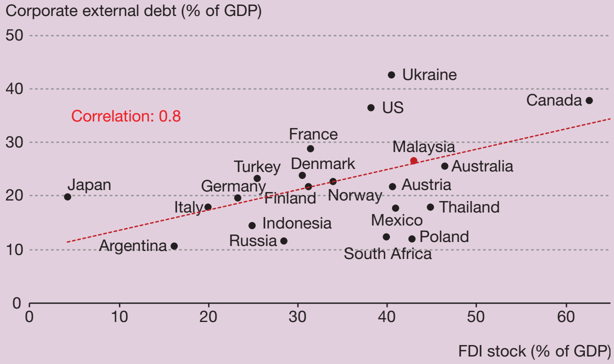
Public corporations account for about one third of the corporate external debt (Chart 13). A significant share of this is held by the national petroleum company which has a solid financial position as affirmed by major international credit rating agencies. A few other public corporations with external borrowings also have FCY earnings that mitigate currency mismatch. Thus, the strong repayment capability of these public corporations attenuates potential risks emanating from their external debt.

More than sufficient FCY earnings and assets to naturally hedge FCY risk of corporate external debt

Exporters account for more than half of corporates with external borrowings (Chart 15). Essentially, with the export proceeds, exporters are naturally hedged. After accounting for imports, net foreign-currency earnings from trade are more than sufficient to meet total corporate FCY external debt servicing obligations (Chart 16), even during periods of large ringgit depreciations. Moreover, Malaysia's diversified export structure across products and markets cushions export earnings against sharp external demand deteriorations. In addition, the sustained current account surplus since 1998 has contributed to the accumulation of RM931 billion of corporations' FCY external assets. This is more than double the corporate FCY external borrowings (Chart 17) thus further reinforcing corporates' repayment capacity.

Chart 12: FDI and Corporate External Debt across Selected Economies

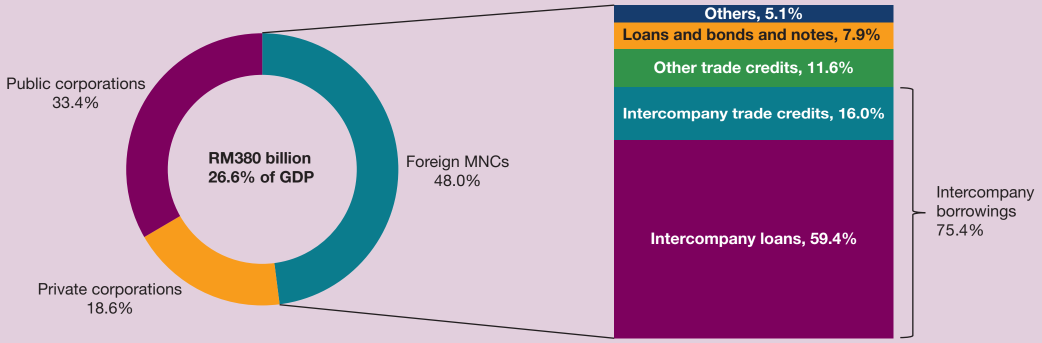
Positive correlation between FDI stock and corporate external debt



Source: Bank Negara Malaysia, World Bank's Quarterly External Debt Statistics Database and United Nations Conference on Trade and Development (UNCTAD)

Chart 13: Profile of Malaysia's Corporate External Debt by Institution (% share)

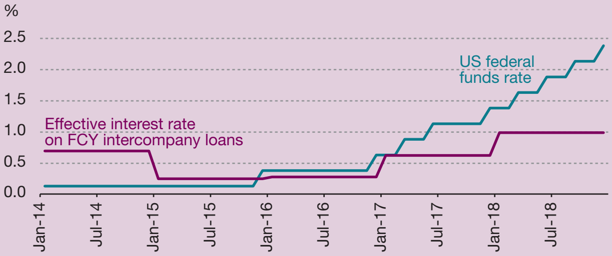
MNCs account for the bulk of Malaysia's corporate external debt



Source: Bank Negara Malaysia

Chart 14: Interest Rate on Malaysia's FCY Intercompany Loans and US Federal Funds Rate

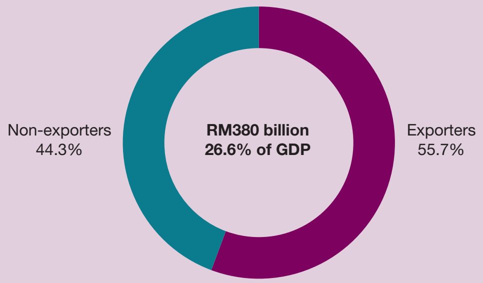
Interest rate on Malaysia's FCY intercompany loans remains very low and stable despite higher US federal funds rate



Source: Bank Negara Malaysia and US Federal Reserve Board

Chart 15: Corporate External Debt in Malaysia by Borrower (% share)

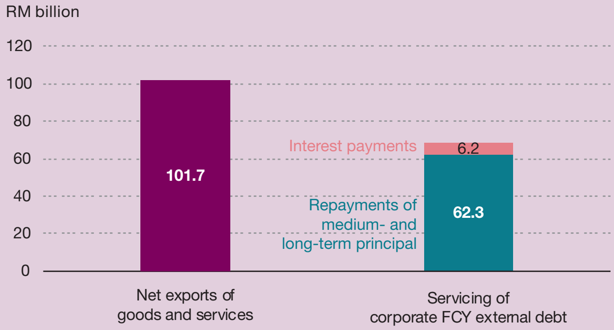
Exporters account for more than half of Malaysia's corporate external debt exposure



Source: Bank Negara Malaysia

Chart 16: Corporate FCY External Debt Servicing and Net Exports

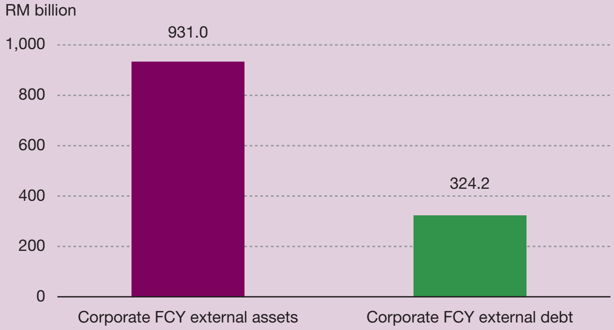
Net exports are sufficient to cover the servicing of corporate FCY external debt



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 17: Corporate FCY External Assets and FCY External Debt

Corporate FCY external assets far exceed its FCY external debt



Source: Bank Negara Malaysia

Prudential safeguards further enhance corporate borrowers' repayment capacity

Malaysia has always maintained a balanced need to ensure adequate prudential safeguards while creating a conducive business environment that enhances the competitiveness and flexibility of the economy. This is clearly outlined in Bank Negara Malaysia's Foreign Exchange Administration (FEA) framework designed to support the country's monetary and financial stability as well as ensuring external sector resilience. In this regard, corporate external borrowings from non-related parties require Bank Negara Malaysia's approval to, among others, ascertain that the debt is supported by FCY earnings or sufficiently hedged and that the borrowings are utilised to finance productive investments. This prudential measure is critical in ensuring that corporate offshore borrowings are self-sustaining and do not pose a material risk to the economy. Of note, the favourable profile of corporate external borrowings as deliberated in the preceding section reflects to some extent the prudent stance of Bank Negara Malaysia. This is corroborated by Bank Negara Malaysia's survey of approved corporate borrowings from 2015 to 2018 which indicates that three quarters of corporate's foreign-currency external borrowings are hedged, either naturally or through financial derivatives. Overall, given these mitigating factors, risks surrounding corporate FCY external debt are largely contained.

C. Underlying driver of ringgit-denominated external debt: Deep and liquid domestic debt market

Malaysia has been highly successful in developing its domestic debt market. In Asia, Malaysia's debt market relative to its economic size is the third largest[11] after Japan and South Korea. The country's deep, liquid and investor-friendly bond market attracts a high level of non-resident participation, primarily in the MGS market. This partly reflects non-resident investors' confidence in the country's economic prospects. Consequently, the share of domestic-currency external borrowings is comparatively high at almost one-third of external debt (Chart 18). This directly reduces the exchange rate mismatch of Malaysia's external debt.

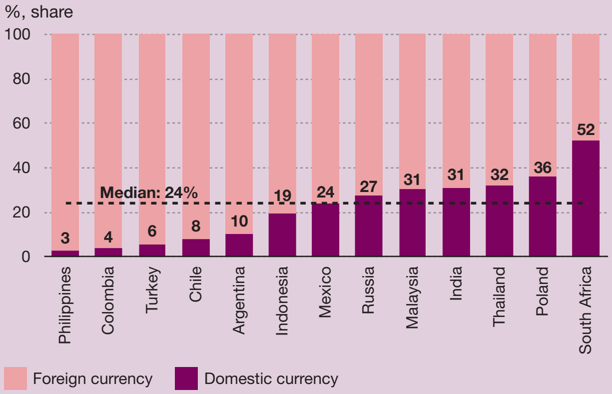
Large and sophisticated domestic institutional investor base attenuates rollover risk

The stability of Malaysia's domestic debt market is observed during episodes of large capital outflows, namely the Taper Tantrum and commodity price shocks in 2013 and 2014-2015, respectively. Between 2015 and 2018 as the US Federal Reserve began normalising its policy rate, the 5-year MGS remained broadly stable (Chart 19). Ample capacity accorded by the large and diverse domestic institutional investor base (Chart 20) facilitated smooth absorption during periods of heightened risk aversion towards EMEs' securities, thus containing rollover risk.

[11] Size of local currency bond market as a % of GDP as at end-3Q 2018 (Malaysia: 96.7%; South Korea: 127.0%; and Japan: 207.6%) (Source: Asia Bond Monitor, Asian Development Bank, November 2018).

Chart 18: External Debt by Currency across EMEs

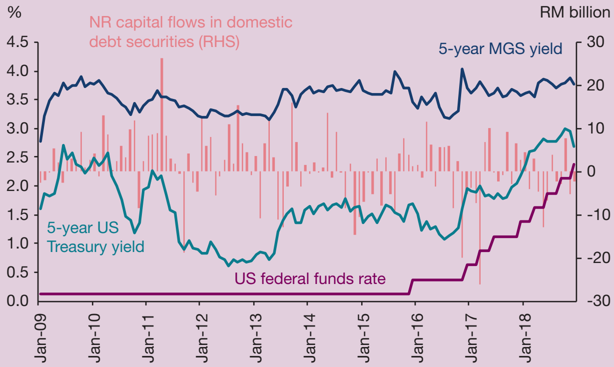
Malaysia has a higher proportion of domestic currency external debt than the EMEs median



Source: Bank Negara Malaysia, World Bank's Quarterly External Debt Statistics Database and Bank Indonesia

Chart 19: US Interest Rate, Malaysia's Debt Market Flows and MGS Yield

Despite higher US interest rate and NR capital outflows in Malaysia's debt market, MGS yield remains steady



Source: Bank Negara Malaysia, US Department of the Treasury and US Federal Reserve Board

Chart 20: Domestic Institutional Investor Base (Asset Size % of GDP as at end-2017) across EMEs

Malaysia's institutional investor base is larger compared to the EMEs Median

Source: IMF's October 2018 Global Financial Stability Report and Bank Negara Malaysia

Part II: Assessing medium-term sustainability of Malaysia's external debt

The preceding sections provide support that given its nature and composition, Malaysia's external debt position remains manageable and resilient to shocks in the near term. Looking ahead, the challenging international financial conditions necessitate a thorough assessment of debt resilience against stronger and more persistent shocks. This section provides an assessment on Malaysia's external debt sustainability and resilience over the medium-term horizon.

Macroeconomic background

The strong macroeconomic fundamentals provide for a firm starting point for the ensuing analysis. Under the baseline, the external debt is projected to be lower over the medium term at 56.2% of GDP by end-2023 (Chart 21), supported by continued current account surplus and sustained economic growth. Despite being narrower, relative to the 10-year historical average (2009-2018), the current account surplus which mirrors the excess savings of the economy, will facilitate the repayment of external debt. Sustained economic performance will contribute to the country's ability to meet its external debt obligations (Table 1). These are more than sufficient to offset the impact of higher global interest rates.

Table 1: Assumptions of the External Debt Projection and Stress Testing

Large and persistent shocks are built in to simulate the external debt stress testing

Variables	2009-2018 average	2019-2023 average	
		Baseline	Shock
Real GDP growth (%)	4.7	4.9	2.5
Non-interest current account[1] (% of GDP)	7.1	3.2	-1.1
Exchange rate (RM per USD)	3.6498	4.1385	4.8617
Interest rate (%)	1.9	3.2	3.9

[1] Current account excluding interest payments to non-residents

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Rigorous stress testing on external debt determinants

The following sections elaborate on a set of simulations on the impact of large and persistent adverse shocks to the determinants of external debt dynamics. This exercise, however, does not take into account mitigating factors and shock absorbers, which will be explored in the subsequent section.

In the first stage of the stress testing, a varying degree of selected shocks are applied to individual variables of external debt determinants while holding other variables constant:

1) **Current account and growth shocks:** A one-standard deviation[12] of negative permanent shock is applied throughout the simulation horizon (Table 2). Under this shock, the current account will turn into deficit for the first time since 1998. Meanwhile, growth is simulated to decelerate sharply to an average of 2.5% over the next five years. Historically, the slowest pace of 5-year average GDP growth of 2.7% was registered between 1998 and 2002, when growth was dragged by the Asian Financial Crisis and the bursting of the dot-com bubble. Based on these considerations, the level of imputed shock is assessed to be rigorous and realistic.
2) **External interest rate shock:** A three-standard deviation magnitude of adverse permanent shock is built in throughout the horizon. Note that a larger shock has to be imputed in the simulation as to contrast against the very low and stable effective external interest rate[13] in the past 10 years. The shock is considered to be considerably exacting given the highly accommodative global monetary policy and structure of Malaysia's external debt which comprises a significant portion of intercompany external debt.

[12] 10-year standard deviation, utilising annual data from 2009 to 2018.
[13] Derived from the actual interest payments on external debt divided by the average external debt outstanding during the year.

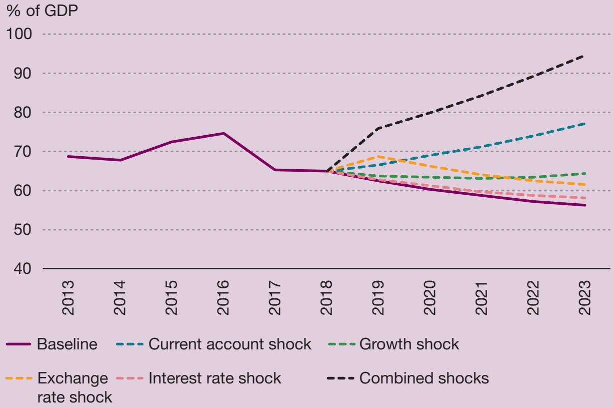
Economic Developments in 2018

3) **Exchange rate shock:** A one-time two-standard deviation of depreciation shock is applied in 2019, resulting in the ringgit to be at its new weakest level of RM4.8617 to the US dollar. Historically, this depreciation shock is quite close in terms of magnitude with the episode of large ringgit depreciation experienced in 2015 following the collapse of commodity prices.

In the second stage of the stress testing, the impact of the combined shocks is simulated.

Chart 21: Projection and Stress Testing of Malaysia's External Debt (2019 – 2023)

External debt (% of GDP) is projected to decline over the medium term



Source: Bank Negara Malaysia

Under large and persistent adverse shocks, external debt will rise above the baseline projection, albeit by varying degrees

Under the first stage of the stress testing, the most significant impact from applying the individual shocks is observed in the case of the current account shock (Chart 21). A deficit in the current account of the balance of payments results in increased external financing requirement, thus higher external debt. Meanwhile, the interest rate shock is found to have a limited impact on external debt. The large exchange rate depreciation in 2019 will increase external debt to 68.6% of GDP, before declining to 61.2% of GDP by end-2023. This decline is driven by continued current account surplus and sustained economic performance which facilitate the repayment of external debt. In the worst case scenario of all the shocks happening simultaneously, the combined shocks result in external debt rising to 94.4% of GDP by the end of the simulation horizon.

Mitigating factors reinforce the resilience of Malaysia's external debt against shocks

The simulation exercise established the various scenarios for the evolution of the country's external debt over the next five years. Importantly, the stress test exercise does not take into account the mitigating factors and in-built stabilisers which would substantially mitigate the risks surrounding Malaysia's external debt (Table 2). Considering these factors, there are two major implications on the sustainability of external debt. Firstly, the external debt will continue to remain manageable given its profile, nature and composition as deliberated in Part I. This includes large banking intragroup placements which are less susceptible to withdrawal shocks, sizeable corporate intercompany loans which are generally on flexible and concessionary terms and a considerable amount of ringgit-denominated external debt. Secondly, Malaysia's external buffers, particularly the value of external assets will rise faster than the increase in external debt. The current account will also improve under the exchange rate depreciation shock. This underscores the role of exchange rate flexibility as the first line of defence against shocks. Given that most of these factors are structural in nature, they will continue to accord Malaysia with resilience against potential shocks, over the medium term.

Table 2: Mitigating Factors and Shock Absorbers Fortifying the Robustness of Malaysia's External Debt

Mitigating factors and shock absorbers accord Malaysia with resilience against potential shocks

Potential Shocks	Mitigating Factors and Shock Absorbers
Exchange rate depreciation	• About one-third of external debt is ringgit denominated, thereby not affected by exchange rate depreciation;
	• Exports, current account and growth to benefit from a ringgit depreciation, thus enhancing debt dynamics; and
	• As a net FCY creditor, the increase in value of FCY external assets will far outweigh the increase in FCY external debt or FCY external liabilities.
Global financial conditions tightening	• More than half of external debt is skewed towards medium- and long-term tenures;
	• Close to half of banks' external debt consists of intragroup exposures which are less susceptible to sudden withdrawal shocks;
	• More than one-third of corporate external debt consists of intercompany loans which are generally on flexible and concessionary terms; and
	• Large domestic institutional investor base has ample capacity and buying interest to absorb the outflows and ensure orderly market conditions.
Domestic and global growth slowdowns	• Diversified economic structure and sources of growth, mitigating sector-specific shocks; and
	• Diversified export sector across products and markets, mitigating product-specific and region-specific shocks.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Information Box: Adequacy of Bank Negara Malaysia's International Reserves

The Bank's international reserves further reinforce the strength of Malaysia's external sector. The primary driver of international reserves is to act as a liquidity buffer in ensuring orderly adjustment in the exchange rate particularly during periods of large and volatile capital flows. With the rise in sophistication of reserve adequacy assessment, conventional indicators including the ratio of reserves to short-term external debt must evolve to take into account other liquidity avenues available.

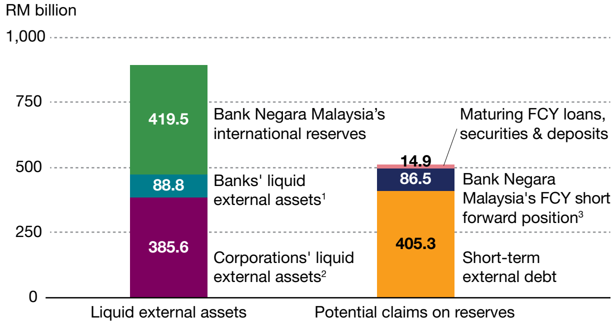
The international reserves are not the primary means in meeting external obligations. The long-standing policy of decentralisation of international reserves has enabled resident banks and corporations to accumulate sizeable external assets which stood at RM1.3 trillion as at end-2018. This is equivalent to about three-quarters of Malaysia's RM1.7 trillion external assets. These assets, particularly the liquid portion, can be drawn upon immediately to meet resident entities' external debt obligations without creating a claim on international reserves. It is important to note that the resident banks and corporations' liquid external assets are more than sufficient to cover the short-term external debt (Chart 1). This further underscores the country's prudent and responsible external debt management which ensures resident entities' external debt is self-sustaining. In addition, the availability of wide ranging financial instruments, including hedging derivatives in domestic market allows the domestic entities to manage their external exposures more effectively, without relying on international reserves.

The potential claims on international reserves are not limited to the short-term external debt. For comprehensiveness, it also includes Bank Negara Malaysia's FCY short position in the forward market and potential short-term net drains of maturing FCY loans, securities and deposits. Even accounting for these potential claims, the total liquid external assets stood at a comfortable level to facilitate international transactions (Chart 1).

While the international reserves provide a buffer to facilitate liquidity needs, a number of bilateral and regional cooperation initiatives stand ready to be called upon to provide additional safety net as and when needed.

Chart 1: Liquid External Assets and Potential Claims on International Reserves

Liquid external assets are 1.8 times higher than potential claims on reserves



[1] Consist of deposits and interbank placements, bonds and notes and money market instruments
[2] Consist of portfolio investments and currency and deposits
[3] Including the forward leg of currency swaps

Source: Bank Negara Malaysia

This includes the bilateral currency swap arrangements with PR China, Japan and South Korea, Chiang Mai Initiative Multilateralisations (CMIM), ASEAN Swap Arrangement and Executives' Meeting of Asia-Pacific Central Banks (EMEAP) repo lines, totalling USD28.4 billion or equivalent to RM117.5 billion.

Conclusion

Although Malaysia's external debt is relatively higher in comparison to the EMEs median peer countries, it is manageable, has proven to be resilient to adverse shocks and is likely to remain so even when the shocks are magnified. This development is driven by the country-centric factors, including the high presence of foreign banks and MNCs, extensive regional network of domestic banks and a highly developed domestic debt market. The nature and profile of Malaysia's external debt accumulation in themselves have accorded natural risk attenuating factors, enabling the economy to absorb large external shocks.

Looking ahead, the sustainable evolution of external debt is important given the more challenging outlook for the global economy and international financial conditions. In this regard, the projection of external debt provides clarity that Malaysia's external debt will remain manageable over the medium term. This prognosis is supported by rigorous stress testing on external debt, which re-affirms the robustness of Malaysia's external debt sustainability under large and persistent adverse shocks.

The international reserves position provides another layer of strength to the external sector position. Importantly, Bank Negara Malaysia's international reserves are not the primary means in meeting external obligations. Resident banks and corporations' liquid external assets are more than sufficient to cover the short-term external debt. These liquid assets can be drawn upon immediately to meet resident entities' external debt obligations without creating a claim on international reserves. Beyond this, the availability of a number of bilateral and regional cooperation initiatives can be called upon to provide additional safety net as and when needed by the country.

In essence, the prudent management of Malaysia's external debt, reinforced by relevant prudential requirements, has accorded Malaysia with considerable resilience to face potential adverse shocks. This assessment on the country's external debt has taken into account the nature and composition of debt as well as the availability of external buffers, and further stress tested against various and more severe external shocks that could hit the economy. While this is reassuring, it is recognised that the nature of the shocks could shift and are highly dynamic. Vigilance, as always, remains paramount.

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