CF01

Introduction To Monetary Economics And The Malaysian Financial System

11 OCTOBER 1999

1.	Time allowed	: Three (3) hours
2.	Total number of questions	: Seven (7) questions on 2 pages
3.	Number of questions to be answered	: Five (5) questions Part A: Two (2) questions [20 marks each] Part B: Three (3) questions [20 marks each]
4.	Candidates must obtain a minimum of 30 marks in Part B as well as pass the paper as a whole.	
5.	Begin each answer to a new question on a fresh page.	
6.	Answer **all** questions in **English**.	

PART A

ANSWER TWO (2) QUESTIONS ONLY

1. (a) Using examples, define and explain the following:

   (i) price elasticity of demand [5]

   (ii) income elasticity of demand for normal goods and inferior goods [5]

   (b) Using examples, list and explain **four** factors which affect the price elasticity of demand. [10]

   (Total:20 marks)

2. (a) What is the difference between "cost-push inflation" and "demand-pull inflation"? [10]

   (b) Explain briefly the use of monetary and fiscal policies in controlling inflation. [10]

   (Total:20 marks)

3. The following is the balance of payments of Malaysia for 1998 (extracted from the *Malaysian Economic Report 1998/99*):

	RMmillion
Merchandise account balance	**A**
Exports (f.o.b.)	280,248
Imports (f.o.b.)	237,524
Services account balance	-19,486
Balance on goods and services	**C**
Transfers (net)	-3,173
Balance on current account	**E**
Balance on long-term capital	**F**
Basic balance	33,948
Private capital (net)	-31,798
Errors and omissions	24,613
Overall balance (surplus +/deficit -)	**J**
Allocations of Special Drawing Rights	0
International Monetary Fund (IMF) resources	0
Net change in Central Bank international reserves	-26,763
Central Bank net international reserves	85,886

   (a) Explain the difference between "merchandise account balance" and "services account balance". [5]

   (b) Fill in the missing figures in **A**, **C**, **E**, **F** and **J**. [10]

   (c) Explain how the net change in Central Bank international reserves of – RM26,763 million is arrived at. How does it affect the Central Bank net international reserves? [5]

   (Total:20 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

4. Elaborate on the following **four** major functions of Bank Negara Malaysia:

   (a) Bank for currency issue [5]

   (b) Keeper of international reserves [5]

   (c) Banker and financial advisor to the government [5]

   (d) Promoting monetary stability and influencing the credit situation to the advantage of the country [5]

   (Total:20 marks)

5. The table below shows the movement of Bank Negara Malaysia's (BNM) 3-month intervention rates in 1998. Based on this table, answer the questions that follow:

Changes to BNM Intervention Rate and Statutory Reserve Requirement (SRR) Ratio				
1998	**Liquidity Position**	**Date**	**Intervention Rate**	**SRR Ratio**
January-February	Tightening	End 1997	8.70	13.50
		9 January	9.00	
		20 January	10.00	
		6 February	11.00	
Mid-February -July	Stable	16 February		10.00
		1 July		8.00
August-December	Easing	3 August	10.50	
		10 August	10.00	
		27 August	9.50	
		1 September		6.00
		3 September	8.00	
		16 September		4.00
		5 October	7.50	
		9 November	7.00	

   (a) State the interest rate directions during the above **three** periods in 1998. [2]

   (b) Describe the reasons for the movements of interest rates in 1998. [8]

   (c) Explain how a high interest rate environment affects the level of economic activities. [10]

   (Total:20 marks)

6. The sharp fall in loans growth of the banking institutions from 26% in 1997 to 1.3% in 1998 was accompanied by a decline in Malaysia's real Gross Domestic Product from **7.5%** in 1997 to **-7.5%** in 1998.

   (a) What are the supply and demand factors that caused the decline in loans growth? [10]

   (b) Explain the measures implemented by the government and Bank Negara Malaysia to deal with the sharp decline in loans growth. [10]

   (Total:20 marks)

7. Write short notes on the activities of the following financial institutions:

   (a) Bank Islam Malaysia Berhad [5]

   (b) finance companies [5]

   (c) merchant banks [5]

   (d) development finance institutions [5]

   (Total:20 marks)

OUTLINE ANSWERS

PART A

Question 1

Although most candidates were able to explain the concepts of "price elasticity of demand" and "income elasticity of demand", many were unable to apply the concept to further illustrate their understanding. Instead of explaining income elasticity of normal and inferior goods, many explained degree of elasticity with positive or negative income elasticity. Many candidates explained factors affecting "demand" rather than "elasticity of demand" when asked to explain factors affecting "price elasticity of demand".

(a) (i) Price elasticity of demand is defined as the responsiveness of change in quantity demanded due to changes in price. It can also be defined mathematically as the proportionate change in quantity demanded divided by the proportionate change in price.

If a 10% increase in the price of apples resulted in a 20% decrease in the quantity demanded for apples, then the price elasticity of apples is -2. Ignoring the negative sign, the demand for apples is said to be elastic since the elasticity coefficient 2 is greater than 1. If, on the other hand, a 10% increase in price leads to a 5% fall in quantity demanded, the price elasticity is -0.5 and the demand is said to be inelastic since the coefficient is less than 1. If the coefficient is infinite, demand is said to be perfectly elastic and if the coefficient is zero demand is said to be perfectly inelastic.

(ii) Income elasticity of demand is the responsiveness of change in quantity demanded due to changes in income. Mathematically, it is equal to percentage change in quantity demanded divided by percentage change in income. For normal goods, there is a direct relationship between income and quantity demanded, i.e. an increase in income leads to an increase in quantity demanded, and therefore income elasticity is positive, e.g. 1.6 (income elastic) or 0.5 (income inelastic). For inferior goods, the relationship between quantity demanded and income is inverse, i.e. an increase in income leads to a decrease in quantity demanded and therefore income elasticity is negative, e.g. – 1.6 (income elastic) or – 0.5 (income inelastic).

(b) The four factors that can affect the price elasticity of demand are:

(i) **Price itself**
Normally at low prices demand is inelastic. This is because when prices are low consumers will not feel the effect of a price increase. At high price, demand is price elastic because consumers will feel the effect of a price increase. For example, demand for cars may have been price inelastic in the 1980s as car prices were still cheap but now demand for cars is price elastic because car prices are expensive.

(ii) **Degree of substitution**
If a product has a close substitute then demand is price elastic because consumers can always shift to buy a close substitute if the price of a competing product increases. Demand will be price inelastic if there are no close substitutes. For example, demand for ESSO petrol is very elastic because there are close substitutes in terms of other brands while demand for petrol is inelastic because there are no close substitutes for petrol.

(iii) **Proportion of income spent**
If a small proportion of income is spent on the goods then demand is inelastic while demand will be elastic if a large proportion of income is spent on the goods.

(iv) **Habitual consumption**
Habitual consumption goods will be price inelastic because no matter what the price is consumers will still buy the goods, e.g. cigarettes and alcoholic drinks.

Question 2

Candidates were unable to clearly identify the difference between "cost push" and "demand-pull" inflation. Explanations given were too vague and causes of each type of inflation were not explained. Some candidates had poor knowledge of the basic use of fiscal and monetary policies in controlling inflation.

(a) Inflation is a period of persistent rising prices. The initial cause of inflation can be attributed to "push and/or the pull" factors. **Cost-push inflation** refers to a rise in the cost of production, for example an increase in wages without a corresponding increase in productivity. In order to meet the rising cost, manufacturers increase the prices of goods resulting in an increase in profits. Trade unions begin to negotiate for higher wages. Employers raise prices again to meet increasing cost. This will set the inflationary spiral in motion.

Demand-pull inflation starts with an increase in aggregate demand in the economy, e.g. the government's fiscal expansion. This fiscal expansion will result in an increase in private consumption which in turn will increase the aggregate demand in the economy. If aggregate supply does not increase then it will lead to increase in prices. The next effect is an increase in profits. Trade unions then might negotiate for higher wages. The inflationary spiral is again set in motion. However, in reality it may be difficult to identify the initial causes of inflation.

(b) Since inflation is caused by excess aggregate demand over aggregate supply, it is therefore necessary to control aggregate demand by the use of monetary and fiscal policy as explained below:

Monetary Policy

Monetarists believed that inflation is a monetary phenomenon caused by too much money chasing too few goods. To control inflation it is therefore necessary to control money supply. The monetary authority (Central Bank) can reduce money supply by using various instruments. For example, in Malaysia, Bank Negara Malaysia may increase the Statutory Reserve Ratio. This increase will lead to a reduction in money supply. The reduction in money supply will lead to a reduction in consumer and investment expenditure and thus exert a downward pressure on prices.

Fiscal Policy

The use of tight fiscal policy to control inflation was the result of the work of Lord Keynes. It was argued that to cut down aggregate demand during inflation, it is necessary to reduce consumer spending by raising taxes and/or reducing government spending, resulting in a budget surplus. The effect of higher taxes is a decrease in disposable income, which in turn will result in a fall in consumer spending. This will exert a downward pressure in prices. However, today most governments use a combination of fiscal and monetary policies to control inflation. In addition to these monetary and fiscal policies, the government also supplements the effort by price and income policies.

Question 3

Generally, the question on balance of payments was quite well answered. However, only a few candidates were able to explain how the net change in Central Bank international reserves is arrived at and how it will affect the Central Bank net international reserves.

(a) **Merchandise account balance** is also known as balance of trade which is the difference between visible exports and visible imports. If it is positive, then the balance of trade is favourable and vice versa. The **services account balance** is the difference between invisible exports and invisible imports. Examples of invisible exports and imports are freight and insurance. These two balances make up the major components of the current account of the balance of payments.

(b) A = 280,248 – 237,524 = RM42,724 million

C = 42,724 – 19,486 = RM23,238 million

E = 23,238 – 3,173 = RM20,065 million

F = 33,948 – 20,065 = RM13,883 million

J = 33,948 – 31,798 + 24,613= RM26,763 million

(c) The overall balance of RM26,763 million (J) means that the inflow of funds is more than the outflow of funds as a result of various transactions as indicated in the balance of payments. This inflow of funds will increase the net international reserves of the Central Bank as shown by the entry of – RM26,763 million in the net change in Central Bank's international reserves. The Central Bank's net international reserves for 1998 will therefore increase by RM26,763 million from the balance of 1997.

PART B

Question 4

Despite a straightforward question, many candidates were unable to elaborate on the major functions of Bank Negara Malaysia (BNM). Candidates had insufficient and inadequate understanding of this basic topic as answers lacked facts and depth. On the specific functions of BNM, the weakest explanation was for function 2 – "Keeper of international reserves", whereby many candidates were confused with the word "reserves" and elaborated instead on the Statutory Reserve Requirement (SRR) of the banking institutions.

(a) **Bank for Currency Issue**

Part III of the Central Bank of Malaysia Ordinance 1958 (CBO) provides for Bank Negara Malaysia (BNM) to be the sole currency issuing authority in the country. BNM commenced to issue its own currency on 12 June 1967, thereby replacing the Currency Board as the sole currency issuing authority in Malaysia. The par value of the Malaysian Ringgit was defined as equivalent to 0.290299 grammes of fine gold. The currency was then required under Part IV of the CBO to have a minimum cover of 80.59% in gold and foreign exchange. In practice, however, BNM maintains an external asset cover well above 100% of its currency liability. This practice reflects the Government's policy to maintain full gold and foreign exchange backing for the Malaysian Ringgit.

(b) **Keeper of International Reserves**

Holdings of the country's official external reserves are centralised at BNM. BNM's international reserves comprise gold, foreign exchange, reserve position with the International Monetary Fund and holdings of Special Drawing Rights. The nation's external reserves have increased progressively from only RM10.3 billion in 1980 to a high of RM113.2 billion in May 1998. The rising external reserves of the Central Bank in the 1990s can be attributed to several factors including a big surplus in the current account of the balance of payments and large inflows of private long-term capital. To safeguard the external value of the Ringgit, the CBO 1958 provides for the maintenance of a minimum external reserves backing of 80.59% against the currency issue. In practice, however, the Ringgit is being fully backed by external reserves. With the BNM's external reserves level standing at RM113.2 billion in May 1998, and currency in circulation amounting to RM21.158 billion, the external Ringgit backing was at more than 500%.

(c) **Government Banker and Financial Advisor**

BNM acts as a banker, fiscal agent and financial advisor to the Government. Close cooperation between the Government and BNM is also evident from the centralisation of Government deposits with the Bank. With this arrangement, Government receipts, arising mainly from the new issues of Government securities, tax revenue and dividend payments are placed with BNM and managed by the Bank depending on the liquidity situation of the system. The arrangement proves to be an effective monetary policy instrument, enabling BNM to manage liquidity at source and also ensuring that the Government's expenditure patterns take cognisance of BNM's prevailing actions to manage liquidity in the banking system. This arrangement also acts as an additional safety valve to ensure that the Government does not resort unnecessarily to deficit financing. BNM's responsibilities as fiscal agent of the Government include acting on behalf of the Government in its public loan programme, including raising internal and external loans for the Government and managing the Government's public debt.

(d) **Responsibility for Monetary Policy**
As the nation's monetary authority, BNM is responsible for promoting monetary stability and maintaining a sound financial structure to influence the credit situation to help achieve the nation's overall economic ob jectives. BNM is obliged to ensure that the supply of money and the volume of credit are sufficiently elas tic to the demands in the domestic economy, without creating undue pressure on resources. It regulates the volume of money and credit generation by the banking system through a range of instruments, including quantitative and qualitative controls. To enhance the stability of the financial system, BNM is responsible for managing the banking system in a manner that would ward-off the possibility of systemic failure and as such, maintain public onfidence in the banking system.

Question 5

Candidates did not have a basic understanding of the recent economic developments and the concepts of liquidity and supply and demand. Candidates generally failed to cite the actual reasons for the different interest rate movements during 1998. The majority of the candidates were unsure of the different monetary stance BNM adopted in 1998 which in turn was driven largely by developments in the financial markets and the real economic situation. Candidates' arguments on effects of high interest rates on economic activity were generally satisfactory although unorganised.

(a) **Interest rate directions**
On the whole, interest rate developments in 1998 can be divided into three periods. Prior to February 1998, interest rates were on an upward trend. Between February and July 1998, interest rates were stable, while thereafter, interest rates took a downward trend.

(b) **Reasons for the upward and downward movements of interest rates**
In 1998, the movements of interest rates was primarily influenced by the level of liquidity, which was in turn affected by financial market expectations, as well as the shift in the monetary policy stance.

In the first two months of the year, interest rates continued their uptrend as a policy of monetary restraint was adopted from September 1997 to contain inflationary pressures arising from the ringgit depreciation. At the same time, following increased uncertainties in the domestic financial market, there was a flight of deposits – from smaller to bigger financial institutions and from domestic to foreign banks causing an uneven distri bution of liquidity and distortions in the term structure of interest rates. The outflow of foreign short-term funds also contributed to a progressive tightening of liquidity in the banking system.

On the other hand, to improve the distribution of liquidity as well as to reduce the cost of funds for banking institutions (and hence lower the lending rates to their customers), the SRR was reduced twice on February 16 and July 1. On both occasions the liquidity for the system as a whole remained unchanged, resulting in the 3-month interbank rates remaining firm at around 11.00%.

After July, however, interest rates became more stable following the monetary measures undertaken between February and July 1998. There were also emerging signs that inflationary pressures had moderated. These developments enabled BNM to ease monetary policy to complement the ***relaxed*** fiscal policy to revive the economy. In August, the 3-month intervention rate was adjusted downwards in three steps to 9.50%. Since September, when selective exchange controls were introduced, further monetary easing was pursued. The intervention rate was reduced to 7.00% over three successive reductions, while the SRR was reduced in two steps to 4%.

(c) **Effects of high interest rates on economic activity**
High interest rates can influence the economic decisions of consumers and businesses to spend and save (that is, to consume or invest). A higher lending rate would discourage consumption by the private sector. For instance, consumers will spend less on purchase of motor vehicles or consumer durables as they will incur higher interest charges. It will at the same time discourage businesses from borrowing. As a result, investment activity slows down. As the private sector spends less on consumption and investment, they will save more. As deposit rates would also increase, banks and finance companies would be able to generate more savings.

The deceleration in consumption and investment spending reflected slower domestic demand which would ultimately result in slower economic growth. As demand falls, industries producing consumer and investment goods will also be affected. Industries producing motor vehicles for instance will reduce production following lower or falling (depending on the extent of interest rate increases) demand for motor vehicles triggered by high borrowing cost. Industries producing construction-related materials would also reduce production as a result of weaker demand as people postpone their intention to buy houses.

As the economy slows down, demand for labour is expected to ease or fall. Unemployment could also increase. This would result in falling wages and income. However, the combination of a slower domestic demand and economic growth, lower wages and income could help to reduce inflationary pressures.

Higher interest rates could also help to improve the country's balance of payments position. As consumption and investment spending slows down, demand for investment goods or intermediate goods from overseas would also fall. On the other hand, if the world demand for a country's products remains strong, exports could increase. A combination of lower imports and higher exports would result in the merchandise balance registering a bigger surplus and bringing in more foreign exchange earnings.

Question 6

Very few candidates attempted this question, possibly due to the lack of understanding of the basic concept of supply and demand. Shallow knowledge on the recent economic developments that have caused a sharp fall in loan demand and supply in 1998 could also have prohibited candidates from attempting this question.

(a) **Supply and demand factors that caused the decline in loans growth**

On the supply side, there are at least four factors that can be identified. Firstly, in early 1998, a small number of banking institutions, severely affected by a withdrawal of deposits, faced funding problems, that adversely affected the disbursement of their loan commitments. Secondly, concerned over the health of their financial position, banks became more cautious. Just when working capital requirements rose in tandem with the higher cost of inputs due to the ringgit depreciation, banks tightened lending activities and even withdrew credit lines to long-term customers. Thirdly, uncertainties surrounding the economic environment, domestically and externally, caused banks to be more concerned with the viability of projects so that they imposed stricter conditions on loan approvals. Fourthly, the on-going merger exercise among the finance companies led to the slowdown in their loans growth.

The demand for loans, on the other hand, is a derived demand which depends on the performance of the economy. As investor and consumer sentiments deteriorated amidst the prolonged financial crisis, activities in the real sector of the economy contracted. The negative wealth effect due to asset price deflation and the rising inflation rate in the first half of 1998 led to more cautious consumer sentiment and private spending. At the same time, the high interest rates increased the debt burden of borrowers, both individuals and companies. As there was a lack of demand, inventory levels of companies increased and capacity utilisation was lower, leading to a fall in the demand for loans for new investments.

(b) **Measures implemented by BNM to address declining loan growth**

BNM took several steps to address declining loans growth. To alleviate the uneven distribution of liquidity, BNM injected liquidity (RM34 billion) into the banking system in 1998. Although external pressures prevented an earlier reduction in interest rates, BNM implemented other measures to reduce the cost of funds to banks and to improve the distribution of liquidity. The SRR was reduced from 13.5% to 4% in September 1998. Several other policy initiatives were also taken to ensure an efficient intermediation process. This comprised the revision of the framework for the computation of the BLR, announcement of information on BNM's daily operations in the money market and the implementation of the new liquidity framework. Subsequently, when inflation moderated, interest rates were eased. Following greater monetary independence accorded by the selective exchange controls, BNM reduced interest rates and the SRR. The average BLR of the commercial banks now averaged only 7.25% which is 225 basis points below the pre-crisis level.

The Government is also using a combination of measures, including expansionary fiscal and monetary policies to promote economic growth, coupled with structural reform in the financial sector, and selective

exchange controls and fixing of the exchange rate to provide an environment of stability to foster business activities. Increasingly, convincing signs are emerging and both the consumers' and investors' confidence is returning. Stock prices have improved since its lowest level in September 1998, while economic activities have picked up. This has been translated into an increasing demand for loans, as reflected by the increase in total loans approved by the banking system. If the current trend continues, the economy will achieve a positive real GDP growth for 1999.

Question 7

As in previous sittings, most candidates did well when required to provide factual answers on the activities of various financial institutions. However many were unable to elaborate on the activities of Bank Islam, finance companies, merchant banks and development finance institutions satisfactorily.

(a) **Bank Islam Malaysia Berhad (BIMB)**

BIMB was established in 1993 to offer banking services such as accepting deposits, granting credit facilities, provision of safekeeping facilities and funds transfer based on the Islamic principles of banking and credit conforming with the Syariah. The Bank accepts savings and demand deposits from members of the public under the principles of Wadiah, term deposits in the form of general investment deposits and special investment deposits under the principles of Mudharabah. The Bank uses the funds mobilised to grant financing facilities such as project financing under the principles of Mudharabah and Musyarakah, lease financing under the principles of Al-Ijarah and Al-Takjiri, hire-purchase financing under the principles of Al-Bai Bithaman Ajil, trade financing (including bill financing and letter of credit) under such principles such as Murabahah, Musyarakah and Wakalah, guarantees under the principles of Al-Kafalah and benevolent loans under the principles of Qard Hassan.

(b) **Finance Companies**

Finance companies can be considered as an important deposit mobilisation mechanism in our financial system. Total deposits collected by finance companies are most substantial, second only to commercial banks. Finance companies, however, do not contribute much to our country's payments system as deposits in finance companies cannot be used for payment purposes. Instead, finance companies are used widely by the public for savings purposes. Moreover, the bulk of a finance company's lending is channelled towards the hire-purchase financing of durable consumer goods. Besides, leasing and housing receive a great amount of funds from finance companies.

(c) **Merchant Banks**

Merchant banks play a distinctly different role in the banking system. They offer comprehensive services to big corporations in our economy. Besides some extent of deposit-taking and lending activities, merchant banks primarily offer corporate advisory services, funds and investment management, and also banking intermediation facilities. The most important feature of merchant banks is that they do not retail their services to the general public and ordinary individuals. On the contrary, their services are wholesale, catering exclusively to the needs of clients.

(d) **Development Finance Institutions**

Development finance institutions are specialised financial institutions, established by the Government to promote investments in the manufacturing and agriculture sectors. Some of the institutions have a distinct agricultural emphasis, while others operate primarily in the commercial and industrial sectors of the economy. Their functions include the extension of financial assistance in the form of medium and long-term loans, participation in equity capital, underwriting and the provision of guarantees for loans. In addition, they help in the identification of new projects, participate in their promotion, and where appropriate, provide ancillary financial, technical and managerial advice. The role played by development finance institutions normally tends to complement those of other major financial institutions. They specialise in medium and long-term capital financing as well as a range of financial services not normally provided by the commercial banks and finance companies.