
CF01

Introduction To Monetary Economics And The Malaysian Financial System

10 MAY 1999

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| 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) A fall in the fare of Light Rail Transit (LRT) services will cause an increase in the quantity demanded for LRT services, but the demand for LRT services remains.

Using a diagram, explain the difference between “an increase in the quantity demanded” for LRT services and “an increase in the demand” for LRT services. [11]

- (b) List **three** factors which can cause an increase in the demand for LRT services. Explain how each of these factors will lead to an increase in the demand for LRT services. [9]

(Total:20 marks)

2. (a) The aggregate demand for domestic output consists of the following **five** components:

- Consumption expenditures by private sector
- Consumption expenditures by public sector
- Investment expenditures by private sector
- Investment expenditures by public sector
- Net export

(i) Describe, with examples, each of the above components. [10]

(ii) Using a diagram, explain how each of the above components will affect the gross domestic product (GDP). [5]

- (b) With the GDP at market price as the starting point, explain how the net national product at factor cost can be derived. [5]

(Total:20 marks)

3. Liquidity preference is the demand for holding money.

(a) Explain **three** motives for holding money. [6]

(b) How is the liquidity preference curve derived? [6]

(c) Using the liquidity preference curve and money supply, explain how interest rate is determined. [8]

(Total:20 marks)

PART B**ANSWER THREE (3) QUESTIONS ONLY**

4. (a) Bank Negara Malaysia’s monetary policy has been tightened progressively since the onset of the crisis in the domestic financial markets in July 1997.

Outline the tight monetary measures and the rationale for this policy stance. [5]

- (b) However, in early August 1998, Bank Negara Malaysia initiated a series of monetary policy-easing measures. Elaborate the reasons for the reversal in monetary policy stance and also outline the measures undertaken. [15]

(Total:20 marks)

5. (a) The base lending rate (BLR) framework of the banking institutions was revised effective 1 September 1998.

(i) Describe the **old** BLR framework. [2]

(ii) State the **revised** BLR formula for commercial banks and finance companies. [4]

- (iii) Explain **two** major reasons for the revision in the BLR framework. [6]
- (b) Describe how monetary policy works to affect the level of economic activities in a country. [8]
(Total:20 marks)
6. (a) (i) What are the **two** most important banking services unique to the commercial banks? [2]
- (ii) Explain why the commercial banks are considered the most important of all the financial institutions in Malaysia. [6]
- (b) Describe the sourcing of funds by the commercial banks through repurchase agreements (REPOs). [6]
- (c) Elaborate on the fee-based activities of the merchant banks. [6]
(Total:20 marks)
7. Write short notes on the following:
- (a) Project financing based on the Al-Mudharabah and Al-Musyarakah principles. [8]
- (b) Major sources and uses of funds for Bank Simpanan Nasional (BSN). [6]
- (c) Principal roles of the Malaysian Industrial Development Finance Berhad (MIDF). [6]
(Total:20 marks)

OUTLINE ANSWERS

Question 1

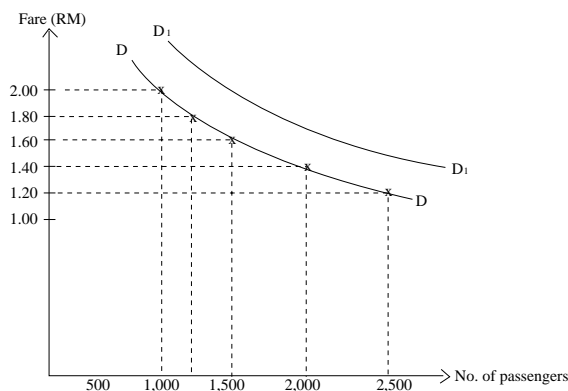
This was one of the most popular questions among candidates.

Most candidates were able to distinguish between “change in demand” and “change in quantity demanded”. However, some of them failed to relate the principles involved to the issue tested, i.e. demand for LRT and quantity demanded for LRT.

- (a) The demand for LRT services is a schedule showing the relationship between price (fare) and quantity demanded (number of passengers) for the services at a particular point in time, for example, one day. An example of the schedule is shown below :

Fare (RM per trip)	Number of passengers per day
2.00	1,000
1.80	1,200
1.60	1,500
1.40	2,000
1.20	2,500

The graph for the above example is shown below:



The graph above illustrates DD as the demand curve for LRT services. If DD shifts to D_1D_1 , then demand for LRT services increases. If the fare for LRT services falls from RM2.00 to RM1.20, then the quantity demanded (number of passengers) increases from 1,000 to 2,500 passengers (DD), but the demand for LRT services remains unchanged.

- (b) Three factors which can cause an increase in the demand for LRT services are as follows:
- (i) **Income**
If the income of people increases, there will be an increase in the demand for LRT services. This means that at all prices more people will want to travel by LRT. This will lead to a shift of the demand curve from DD to D_1D_1 .
 - (ii) **Bus fare**
If there is an increase in the bus fare, then there will be a fall in the number of people taking buses. Some of these people will now find it comparatively cheaper to travel by LRT. This means that there will be an increase in demand for LRT services.
 - (iii) **Price of petrol**
If there is an increase in the price of petrol, people who previously drove to work will find it relatively cheaper to go to work by LRT. This will again mean that there is an increase in the demand for LRT services, leading to a shift of the demand curve to D_1D_1 .

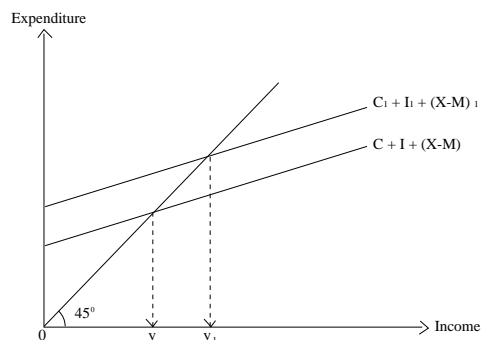
Question 2

- (a) Most candidates answered well in part (i) except for a few candidates who were confused with the investment expenditures by private sector and investment expenditures by public sector. In part (ii) of the question, quite a number of candidates were unable to explain how each of the components affected the gross domestic product (GDP).
- (b) The majority of candidates did well in this question.

(a) (i) The five components of the aggregate demand for domestic output are as follows:

- **Consumption expenditures by the private sector**
This includes all the expenditures spent on final goods by the private sector. For example, expenditures on food and clothing by individuals and business firms.
- **Consumption expenditures by the public sector**
This includes expenditures on final goods by the public sector e.g., salaries given to government servants employed to do day-to-day administration.
- **Investment expenditures by private sector**
Money spent to build factories and open up land for development is considered as investment expenditures. Expenditures on the building of roads and highways by the private sector also fall into this category.
- **Investment expenditures by public sector**
Expenditures by the government on development falls into this category. For example, expenditures on clearing of land and building of highways are investment expenditures. This component has been significantly reduced because of privatisation.
- **Net export**
The value of exports minus the value of imports is referred to as net export demand. In 1998, our exports exceeded imports, thus leading to a favourable external trade balance, i.e., our net export was positive.

(ii) The five components together constitute the Gross Domestic Product (GDP) which is shown in the diagram below:



In the diagram, if private and public consumption expenditures (C), private and public investment expenditures (I) and net export (X-M) are at C, I and (X-M), the Gross Domestic Product is at OY. If the five components increase to C_1 , I_1 and $(X-M)_1$, then the GDP will increase to OY_1 .

(b) Net national product at factor cost can be derived from GDP at market price as shown below:

Gross Domestic Product at market price: -----	XXX
Add Net factor income from abroad : -----	XXX
Gross National Product at market price : -----	XXX
Add Taxes and less subsidies: -----	XXX
Gross National Product at factor cost: -----	XXX
Less Depreciation : -----	XXX
Net national product at factor cost : -----	<u>XXX</u>

Question 3

- (a) **Quite a number of candidates went out of point by explaining the functions of money instead of the motives for holding money.**
- (b) **Most candidates could not explain how the liquidity preference curve is derived.**
- (c) **Most candidates were not able to use the liquidity preference curve and money supply to determine the rate of interest and how changes in money supply can affect equilibrium rate of interest.**

- (a) People prefer to hold their assets in the most liquid form i.e. cash. The demand for holding money is known as liquidity preference and there are three motives for holding money.

(i) Transaction motive

Both private individuals and business firms need to hold cash for spending on daily necessities like food and operating expenditures. The amount of money held for this purpose will depend on the income level. The higher the income of an individual, the more money is held for this purpose.

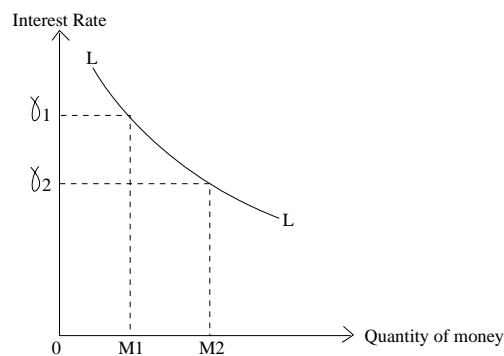
(ii) Precautionary motive

We need to hold money to meet any unexpected expenditure resulting from unexpected events like accidents. For example, we need to hold money to repair our cars which may break down while travelling.

(iii) Speculative motive

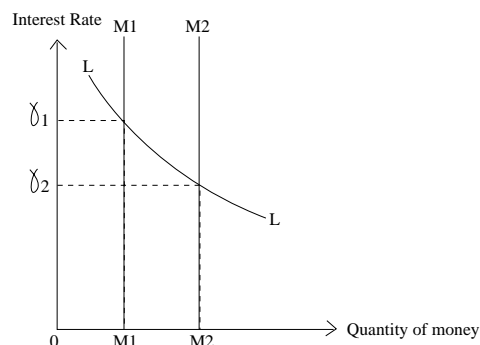
Individuals and business firms will want to hold money so that when the share prices are low, they can utilise their cash to buy shares. The speculative motive for holding money is not only influenced by the share market but also the commodity and foreign exchange markets.

- (b) The liquidity preference curve shows the relationship between the interest rate and amount of money the public will want to hold mainly for the speculative motive as shown below:



In the above diagram, LL is the liquidity preference curve. When the interest rate is high for e.g. r_1 , the opportunity cost of holding money is high and therefore the amount of money that people want to hold is low at OM_1 . At r_2 interest rate, the amount of money people want to hold is OM_2 which is more than OM_1 because the opportunity cost of holding money is lower.

- (c) The liquidity preference curve (LL) and the amount of money available to hold, or simply the supply of money (MM) will determine the rate of interest as shown below:



In the above diagram, LL is the liquidity preference curve and M1M1 is the original money supply curve. The equilibrium rate of interest is γ_1 . If the money supply increases to M2M2 because of monetary expansion undertaken by the financial system, then it will lead to a fall in the interest rate to γ_2 , *ceteris paribus*.

Question 4

- (a) **Very few candidates attempted this question. Those who did, provided a general statement on the instruments available to Bank Negara Malaysia. These general statements therefore, did not satisfy the requirements of the question i.e. the monetary policies that have been undertaken or implemented.**
- (b) **Again, the candidates provided general statements as far as the monetary-easing measures were concerned.**

Candidates are strongly advised to follow closely the monetary measures adopted by Bank Negara Malaysia from time to time. A good source of such information would be Bank Negara Malaysia's annual reports.

- (a) Monetary policy was tightened progressively through a combination of interest rate policy, prudential measures and quantitative restrictions. The 3-month interbank rates were raised from 7.50% in July 1997 to 10% in February 1998. Even before the onset of the financial crisis, prudential guidelines on exposure to properties and stocks and shares were introduced in March 1997. These were pre-emptive measures to ensure that any downward trend in asset prices would not threaten the strength and stability of the financial institutions in particular and the financial system in general. The measures were also aimed at encouraging available financial resources to be channeled for productive activities. While these measures have contained lending to the property and share markets, overall lending growth continued to remain high in subsequent months. Hence, in October 1997, these measures were strengthened further with credit plans which were aimed at slowing down the overall credit growth to levels that are more consistent with the growth in economic activities. At the same time, several prudential regulatory measures were introduced to further strengthen individual banking institutions. These measures include more stringent disclosure requirements, higher general provisions and a shorter period for recognising non-performing loans. The tight monetary policy measures were also essential to contain inflationary pressures arising from the depreciation of the Ringgit. More importantly, these steps were intended to strengthen the foundation on which the prospect for sustainable growth in the medium-term would be enhanced.
- (b) The policy-easing measures were adopted following the emergence of fundamental trends indicating that there was an absence of inflationary pressures. The 3-month intervention rate was reduced from 11% to 10.50% on 3 August 1998 and further to 10% on 10 August 1998. The easing of monetary policy together with earlier measures resulted in lower lending rates. (Earlier Bank Negara Malaysia had implemented measures to reduce the cost of funds to banking institutions in order to enable them to lower their lending rates. Effective 1 May 1998, the permissible daily variation in the average balances that are required to meet the statutory reserve requirement (SRR), was widened to plus/minus 2% of the prescribed SRR rate from the previous band of plus/minus 0.5%. The widening of the SRR rate would accord banking institutions greater flexibility in managing their daily liquidity operations and help reduce the cost of operations. On July 1, 1998, the SRR was reduced from 10% to 8%.)

Further policy-easing measures were undertaken in late August 1998 as latest indicators confirmed the absence of a build-up in demand pressures and the inflation rate showed some degree of moderation. Ringgit rates also remained relatively stable with fluctuations in rates reflecting mainly external developments. Further, monetary growth had moderated primarily due to further declines in outstanding loans as repayments exceeded disbursements. Under these circumstances and given the need to support the recovery process, Bank Negara Malaysia reduced the intervention rate further to 9.50% from 10% while the SRR of commercial banks, finance companies and merchant banks was lowered from 8% to 6% with effect from September 1, 1998. The BLR framework was also revised to allow a faster transmission of changes in monetary policy on interest rate levels.

Additional measures were introduced in September 1998. The adoption of selective exchange controls and a fixed Ringgit accorded greater flexibility for monetary policy initiatives. As part of the measures to contain the severity of the economic contraction experienced by Malaysia and to give priority to support the economic recovery process, monetary policy was eased further. Important considerations in determining the extent of the easing are the medium-term outlook for inflation and the need to ensure that depositors

continue to earn a positive real rate of return. Hence, with effect from September 3, 1998, Bank Negara Malaysia's intervention rate was reduced to 8% from 9.50% and further cuts to 7% was instituted on October 9, 1998 and November 9, 1998. With effect from September 17, 1998, the liquid asset ratio requirement of commercial banks was reduced from 17% to 15% of eligible liabilities (EL). The reduction in the liquid asset ratio requirement had contributed towards reducing the holding cost of liquid assets borne by banking institutions. The SRR ratio was also lowered to 4% of EL on September 15, 1998. In addition, some relaxation to the earlier ceilings on the broad property sector and share market was implemented while the minimum monthly repayment on credit cards was reduced from 15% to 5% of the outstanding balances and the interest rate reduced from 2% to 1.75% per month.

Question 5

- (a) **The majority of candidates were able to describe the old base lending rate (BLR) framework for commercial banks and finance companies. The weakness however was in not knowing the revised framework. As a result, those who failed to state the revised framework also failed to state the reasons for the revision. It must be noted that the 2 major differences between the new and the revised framework are the benchmark used to capture the cost of funds. It was changed from the 3-month weighted average inter-bank rate of the previous month to the 3-month intervention rate whilst the flat administration margin was reduced from 2.50% to 2.25%. The changes were intended to increase the responsiveness of banking to the direction of monetary policy as well as to promote greater operational efficiency among the banking institutions.**
- (b) **Many candidates failed to clearly highlight the link between monetary policy and economic activities.**

- (a) (i) Under the old framework, the maximum BLR which banking institutions was allowed to quote ("computed BLR") was computed based on the 3-month weighted average interbank rate of the previous month and a flat administrative margin of 2.5 percentage points.

(ii) **Commercial Banks**

$$\text{Computed BLR} = [(\text{Intervention rate} \times 0.8) / (1 - \text{SRR})] + 2.25\%$$

Finance companies

$$\text{Computed BLR} = [(\text{Intervention rate}) / (1 - \text{SRR})] + 2.25\%$$

- (iii) It was observed that the old formula in computing BLR was not responsive enough to changes in interest rates. In fact, changes in the computed BLR consistently lagged behind changes in interest rates which reduced the effectiveness of changes in the direction of monetary policy. Hence, to improve the responsiveness of the computed BLR and to ensure an immediate transmission of changes in the direction of monetary policy into the BLR of banking institutions, the computed BLR will be determined based on the BNM intervention rate. Banking institutions are given up to one week to adjust their BLR following changes in the BNM intervention rate.

It was also observed that the level of operational efficiency within the industry had improved since the introduction of the new base lending rate framework in October 1995. This was reflected in the lower average administrative cost for the whole industry. To ensure that borrowers benefit from the higher efficiencies, the flat administrative margin of 2.5 percentage points was reduced by 25 basis points to 2.25 percentage points. The reduction also serves to promote greater operational efficiency among banking institutions.

- (b) Monetary policy works through affecting the volume of bank reserves. Further, monetary policy can also affect bank interest rates and whenever appropriate, directly control the volume of bank credit or the direction of this credit through selective monetary measures. As banks in particular respond to changes in the availability of reserve funds or the variations in interest rates by adjusting their lending and investment portfolios, the monetary measures would also exert an impact on the supply of currency and deposits, the availability of credit, as well as the cost of money and credit in the various markets. These in turn influence the economic decisions of consumers and businesses to spend and save (that is, to consume or invest), which eventually are reflected in the level of economic activity and employment, in price developments and in the performance of the nation's balance of payments.

Question 6

- (a) **The answers given for the 2 major banking services and the importance of commercial banks were generally satisfactory. The only weakness was perhaps the candidates' failure to highlight the most important points, in particular, the commercial banks as the biggest deposit-takers and loan-providers as well as their ability to offer chequing accounts and foreign exchange services that facilitate domestic and international payments.**
- (b) **Many candidates were unable to answer this part of the question correctly.**
- (c) **The answers for this part were generally favourable.**

- (a) (i) The two most important banking services unique to the commercial banks are the provision of current accounts (or demand deposit) and foreign exchange facilities.
- (ii) Commercial banks are considered the most important of all financial institutions as they have been the major deposit-takers and loan-providers. Reflecting this, total assets of commercial banks as a group accounted for 43.6% (or RM486.6 billion) of the total assets of the financial institutions as at the end of 1997.

Besides functioning as an intermediary between surplus and deficit units, commercial banks also offer a large variety of other facilities and services. For instance, only the commercial banks are authorised to offer current account services which provide chequing facilities. The role of the banks in facilitating the payments system is particularly important. Without a prompt, efficient and inexpensive payments system, domestic and foreign economic transactions will be adversely affected, and all economic activities will be badly hindered. Where international payments are concerned, commercial banks are also the only authorised exchange agents and act on behalf of the Central Bank in administering Malaysia's foreign exchange control system. The finance companies, merchant banks or other financial institutions have so far not been given the permission to operate current accounts or deal in foreign currencies (except for Tier-1 institutions for own accounts).

- (b) A REPO is an agreement under which a seller of securities undertakes to repurchase the securities from a buyer at a predetermined price on a specified future date. Therefore, through a REPO, a bank is able to use its holding of marketable securities to raise liquid funds for a specified period of time. In essence, a REPO is no more than a deposit substitute. REPOs were first introduced in 1979 and since then, the purchase of securities under REPOs has grown to become an attractive alternative for corporations with surplus funds because of the liquidity and low credit risk of such transactions.
- (c) Merchant banks primarily complement and supplement the activities of other existing financial institutions. Merchant banks are advisers to and financiers of large companies. They play the role of financial intermediaries specialising in the money and capital markets, offering specialised expertise, especially those which are "fee-based". As they deal primarily with large corporations and cater almost exclusively to the latter's needs, they are often regarded as "wholesale" bankers, as distinct from commercial banks and finance companies which are mostly involved in "retail" banking. The new merchant banks' licenses under BAFIA do not contain the condition stated in the old license (issued under the repealed Banking Act 1973), where at least 30% of a merchant bank's total income should be derived from fee-based activities. Some of the fee-based activities of merchant banks are corporate, financial and advisory services; investment and fund management services and banking intermediation services (such as loan syndication).

Question 7

Most candidates answered the questions correctly and were able to elaborate their answers.

- (a) The difference lies in whether the borrower himself part-finances the project. In *Al-Mudharabah*, theoretically, banks provide all the financial requirements while the borrower does not contribute any at all. Therefore, the bank is considered as the financier. The borrower, on the other hand, acts as the entrepreneur, and runs the project. The bank does not interfere in the management of the project, though it has a right to monitor and supervise the project. Both parties will agree beforehand on the sharing of profits generated from the project. If any loss is incurred, only the bank, as the financier, will bear all the financial liabilities.

According to the *Al-Musyarakah* principle, the bank usually does not contribute 100% of the financial requirement. Instead, both the borrower (entrepreneur) and the bank pool together their financial resources and jointly finance the project. However, the amount of money contributed by each need not be in the same proportion. Both parties including the bank, have the right to take part in the management of project, but the bank need not necessarily assert that right. The ratio of profit-sharing will be predetermined, and this ratio may not be the same as the ratio of their respective financial contributions.

- (b) BSN was established in 1974 to promote and mobilise private savings, especially of the small savers, in order to finance economic development programmes in the country. The main source of funds of BSN is savings deposits collected through its branch network and the post office system. BSN also offers fixed deposits as well as saving schemes such as *Save-As-You-Earn* Scheme, *GIRO* Scheme and the *Premium Savings Certificate* Scheme. The uses of funds by BSN are subjected to the requirement that at least 50% of its investment must be in Government securities (was reduced from 70% prior to 1984, following the downsizing of the Government operations). Following the reduction in minimum requirements for investment in Government securities, more funds were made available for other investments. Consequently, BSN has diversified its investment in shares and loans.
- (c) MIDF is the biggest and oldest development finance institution in Malaysia. It was incorporated as a public company in 1960 to provide term-financing to promote industrialisation in the country. Its principal roles include the extension of financial assistance to private industrial enterprises in the form of medium to long-term loans, factory mortgage loans and hire-purchase and leasing facilities, as well as to mobilise industrial capital in the form of direct equity participation and assistance for the underwriting and floatation of share issues. Through its subsidiary companies, MIDF offers a comprehensive and integrated package of advisory, technical and managerial services to meet corporate financial needs, including the preparation of factory buildings and their sites and issuing of public shares.