

CF01

Introduction to Monetary Economics and the Malaysian Financial System

10 OCTOBER 2005

1. Time allowed : Three (3) hours
2. Total number of questions : Seven (7) questions
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) (i) Define “cross-elasticity of demand” and explain how it is measured. [5]
- (ii) (aa) What are substitute goods? [3]
- (bb) What can you say about the value of cross price elasticity between substitute goods? [4]

- (b) The table below contains data relating to the demand and supply for pizza:

Price (RM)	Quantity Demanded (Units)	Quantity Supplied (Units)
6	100	50
7	90	60
8	80	65
9	70	70
10	60	80
11	50	90

- (i) What is the equilibrium price and quantity in the pizza market? Explain your answer. [4]
- (ii) If the actual price in the pizza market is above the equilibrium price, what would drive the market towards equilibrium? [4]
(Total:20 marks)
2. (a) Ms A deposits RM10,000 with Bank JJ Bhd. Assume that the required reserves are 5% of the checking deposits, and that banks do not hold excess reserves and households do not hold currency.
- Explain in detail the process of money creation in the economy and calculate the size of the money multiplier. Demonstrate your answer using a bank T-account. [14]
- (b) Name and explain **six** qualities of a good medium of exchange. [6]
(Total:20 marks)

3. The table below shows the Balance of Payments (BOP) of Malaysia for year 2004:

	RM'million
A. Goods and services	94,625
Goods	a
Exports	468,874
Imports	365,421
Services	-8,828
Transportation	-16,132
Travel	17,685
Government transactions	-475
Other services	-9,906
B. Income	-26,751
C. Current transfers	-9,907
D. Balance on current account	b
E. Capital and financial account	-5,895
Direct investment	4,800
Portfolio investment	17,575
Other investment	-28,270
F. Errors and omissions	-9,732
G. Overall balance	c
H. Net change in Central Bank international reserves	d

[Extracted from the Malaysian Economic Report 2004/2005]

- (a) Fill in the missing figures in **a**, **b**, **c** and **d** and show how these figures are derived. [6]
- (b) Explain how the net change in Central Bank international reserves (figure **d**) is derived and how it affects the Central Bank's net international reserves. [6]
- (c) (i) In year 2004, was Malaysia in BOP surplus or deficit? [2]
- (ii) Explain how a contractionary fiscal policy can improve the BOP. [6]
- (Total:20 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

4. (a) Describe the following objectives of Bank Negara Malaysia:
- (i) Promoting monetary stability and a sound financial structure [4]
 - (ii) Influencing the credit situation to the advantage of Malaysia [4]
- (b) Explain how the following monetary policy instruments work:
- (i) Direct borrowing and lending in the money market [4]
 - (ii) Open market operations [4]
- (c) Briefly explain the activities of the following types of financial institutions:
- (i) Development financial institutions [2]
 - (ii) Savings institutions [2]
- (Total:20 marks)
5. (a) Explain the main functions of the following:
- (i) Money market [3]
 - (ii) Commercial banks [3]
 - (iii) Merchant banks [3]
- (b) (i) What is monetary policy? [1]
- (ii) State **four** objectives of monetary policy. [4]
- (c) Briefly describe the following Islamic banking principles:
- (i) Al-Wadiah (safe-keeping with guarantee) [3]
 - (ii) Al-Mudharabah (profit sharing) [3]
- (Total:20 marks)
6. (a) State **two** advantages and **two** disadvantages of a company raising funds through the equity market. [4]
- (b) Describe **three** main features of the new monetary interest rate framework introduced by Bank Negara Malaysia (BNM) in April 2004. [6]
- (c) (i) What is inflation? [1]
- (ii) Explain **four** impacts of inflation on the economy. [4]
- (d) Explain how the changes in BNM's overnight policy rate can affect the domestic aggregate demand and the inflation rate. [5]
- (Total:20 marks)

7. (a) Briefly explain the following financial instruments:
- (i) Malaysian Government Securities [2]
 - (ii) Government Investment Certificates [2]
 - (iii) Bank Negara Bills [2]
 - (iv) Corporate bonds [2]
- (b) What are the objectives of the Financial Sector Masterplan 2001-2010? [4]
- (c) Define and briefly explain the following financial markets:
- (i) Capital market [4]
 - (ii) Foreign exchange market [4]
- (Total:20 marks)

- END OF QUESTION PAPER -

OUTLINE ANSWERS

The comments given in the boxes below indicate the areas of weaknesses the examiners have identified and their advice to future candidates.

PART A

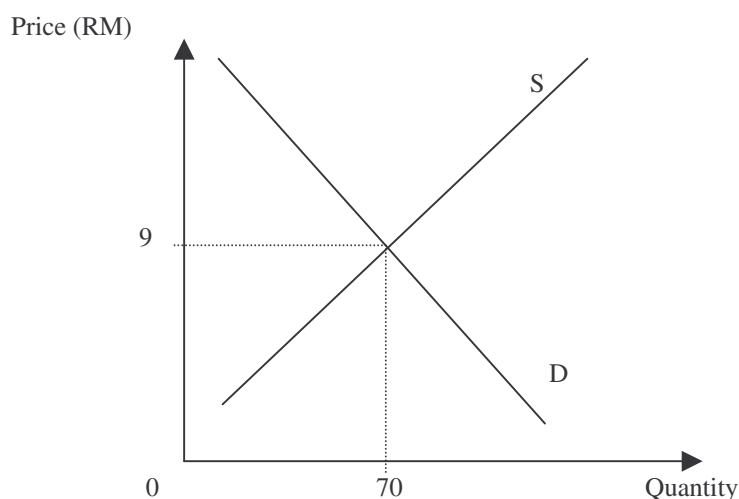
Question 1

- Candidates failed to demonstrate a basic understanding of the principles of equilibrium.
- Candidates should seek to understand rather than memorise the concepts/principles.

1. (a) (i) Cross-elasticity of demand measures how the quantity demanded of one good changes as the price of another good changes. It is calculated as the percentage change in quantity demanded of good X divided by the percentage change in the price of good Y.

$$C_d = \frac{\% \text{ change in demand for good X}}{\% \text{ change in price of good Y}}$$

- (ii) (aa) Substitute goods are goods that can be supplemented or used in place of each other.
- (bb) The cross price elasticity is positive, i.e., an increase in the price of good will lead to an increase in the quantity demanded of the substitute good. For example, when the price of the beverage Milo increases, the sale of Milo may fall because some of the Milo drinkers may switch to another beverage like Ovaltine.
- (b) (i) The equilibrium price is RM9, as this is the price level at which quantity demanded equals the quantity supplied at 70 (the equilibrium quantity).



- (ii) If the actual price were above the equilibrium price of RM9, the market will experience an excess supply of pizza. For instance, at the price of RM10, quantity supplied is greater than the quantity demanded by 20. Such excess supply will put a downward pressure on the price until the equilibrium is reached at RM9.

Question 2

- Candidates were not able to explain the money creation process in detail.
- The money creation process must be shown in detail. Candidates must explain, inter alia, money supply in the economy after each round of money creation and the total money supply that can be created.

2. (a) When Ms A deposits RM10,000, Bank JJ Bhd will have an excess cash reserve of RM9,500. The bank's books of ledger (partial) will look something like this:

Liabilities		Assets	
Deposits Ms A	RM10,000	Cash	RM10,000

Assume that Bank JJ Bhd gives a loan of RM9,500 to Ms B. This is represented only by a book entry and there is no movement of cash as shown in the bank's ledger below:

Liabilities		Assets	
Deposits Ms A	RM10,000	Cash	RM10,000
Deposits Ms B	RM9,500	Loans Ms B	RM9,500

The money supply is now RM19,500. The excess cash reserve is now RM9,025 (RM9500 x 95%). Assume that this excess cash reserve of RM9,025 is lent out to Ms C. Bank JJ Bhd's ledger is shown below:

Liabilities		Assets	
Deposits Ms A	RM10,000	Cash	RM10,000
Deposits Ms B	RM9,500	Loans Ms B	RM9,500
Deposits Ms C	RM9,025	Loans Ms C	RM9,025

The money supply is now RM28,525. The process of credit creation will continue until the total money supply equals to RM200,000.

$$\text{Money multiplier} = 1/\text{cash ratio} = 1/0.05 = 20$$

Therefore, an original deposit of RM10,000 will expand the money supply until RM200,000. In other words, the amount of money created is equal to RM190,000.

Note that RM190,000 is the maximum amount of credit creation. If the bank holds some excess cash reserve or if individuals do not deposit all their money into the bank, the amount of credit creation will be less than RM190,000.

- (b) Give any six of the following qualities:

- Acceptability – has to be accepted as a medium of exchange;
- Durability – it can be kept for a considerable period of time;
- Divisibility – it is readily divisible into smaller units;
- Recognition – it is easily recognisable;
- Uniformity – similar in terms of weight and size;
- Portability – it is easily carried around; and
- Scarcity – it is scarce.

Question 3

- Candidates showed poor understanding of the relationship between the overall balance of payment (BOP) balance and the net change in the central bank's international reserves.
- Candidates must be familiar with the items in the balance of payment (BOP) and the relationship between each item.

3. (a) a = $468,874 - 365,421$ or $(94,625 + 8,828)$ = RM103,453million
b = $(A+B+C) = 94,625 - 26,751 - 9,907$ = RM57,967million
c = $(D+E+F) = 57,967 - 5,895 - 9,732$ = RM42,340million
d = -RM42,340million

- (b) The overall balance of - RM42,340million *c* means that the inflow of funds is more than the outflow of funds as a result of various transactions shown in the BOP. Such an inflow of funds will thereby increase the net international reserves of the Central Bank by the same amount (-RM42,340million) in the net change in Central Bank's international reserves.

Note: A negative sign in net change in Central Bank's international reserves indicates a build-up in reserves.

- (c) (i) Malaysia was in BOP surplus in 2004.
(ii) A contractionary fiscal policy (i.e. decrease in government spending) will reduce income in the economy, thus reducing the level of imports.

PART B

Question 4

- Candidates could not identify the importance of monetary stability and were not able to link monetary stability with financial stability.
- They were unable to elaborate the monetary policy instruments. Candidates also failed to understand that direct borrowing and lending involves cash money whereas open market operations involves financial instruments. Both are conducted in the money market.
- Candidates must be able to link monetary stability with financial stability for effective results. They should also state how to promote financial stability, which is through a strong and effective prudential framework.

4. (a) (i) **Promoting monetary stability and a sound financial structure**

The ultimate objective of monetary policy in most economies increasingly points towards a common goal of attaining monetary or price stability. Price stability is a key prerequisite for sustained economic growth, in the absence of which the mobilisation of resources and the efficient channelling of resources to productive investment would be adversely affected. For more than four decades, the maintenance of price stability has contributed towards the Malaysian economy's structural transformation and its achieving sustainable economic growth.

The other side of the coin to monetary stability is financial stability. This conforms to the view that a sound and stable financial system is necessary for the conduct of monetary policy. Maintaining financial stability, in turn, requires stable monetary conditions so that the balance sheets of corporations and financial institutions are not adversely affected by conditions of macroeconomic stress. Having appropriate policies in place is important to ensure a sound banking system that provides a mechanism for the intermediation process to enable the economy to function efficiently.

An essential element for promoting financial stability is the existence of a strong and effective prudential framework. This will ensure that banking institutions operate in a prudent manner, thereby minimising the risk of bank failures, which could be disruptive with adverse implications on economic activities. Bank Negara Malaysia (BNM), as the lender of last resort, has to ensure that the level of risks assumed by the banking system is kept to a prudent level. BNM is also the sole authority regulating the banking industry in Malaysia.

(ii) **Influencing the credit situation to the advantage of Malaysia**

BNM is also responsible to the Government for influencing the credit situation to help achieve the nation's overall economic objectives. BNM is obliged to ensure that the supply of money and volume of credit are sufficiently elastic to the demands of the domestic economy, without creating undue pressure on resources and prices. It regulates the volume of money and credit generation by the banking system through a range of instruments, including guidelines on lending to priority sectors and selective credit and administrative measures.

The imposition of guidelines on lending to priority sectors and selective administrative measures are meant to target only specific sectors of the economy. The guidelines on lending to the priority sectors are necessary to ensure that the economic and social objectives met are consistent with national objectives. In the case of selective credit measures, such credit controls are imposed to influence the direction of lending activities to specific sectors without affecting the availability of funds in the system and the prevailing level of interest rates.

As these guidelines would have a less desirable impact on the efficiency of distribution of resources in the economy in the longer run, such guidelines are introduced only under compelling circumstances and for limited periods. A case in point were the pre-emptive measures of 1997 to address the imbalances in the resources channelled to the property sector, consumption spending and the purchase of stocks and shares.

(b) (i) **Direct borrowing and lending in the money market**

Direct borrowing and lending in the money market represents one of the methods BNM uses in its money market operations to influence the level of interest rates. Direct lending and borrowing are conducted through principal dealers (PDs). This approach will allow BNM to focus on the need for liquidity in the system as a whole, rather than responding to the needs of each individual institution. Only under special circumstances, in its capacity as lender of last resort, does BNM provide direct access to its rediscount window to individual institutions, including non-principal dealers.

Presently, direct borrowing and lending conducted in the form of money market tenders is the most important instrument in steering the interest rate level and direction. Its role in influencing interest rates is further reinforced by the intervention rate. While the intervention rate will only be announced whenever there is a change in the policy stance, money market tendering is conducted on a daily basis.

BNM actively deals in market operations through the PDs, who then deal with the rest of the money market players. The market players will submit their bids/offer through the PDs. BNM normally focuses its operations in the shorter tenor of one month or less, and occasionally in three-month maturity. Such operations are conducted on a clean basis, without requiring any collateral.

(ii) **Open market operations (OMO)**

OMO are transacted mainly via the sale and purchase of Government securities and other papers either directly or through repurchase agreements (repo)/reverse repo. The scope for active OMO however has been constrained by the limited availability of Government papers (Government securities, Treasury bills and Government Investment Issues). Government papers are thinly traded as they have mainly been held by a captive market to meet statutory investment requirements.

At the same time, the diminishing supply of the papers, reflects the Government's improved financial position since 1993 and the downsizing of its operations. With the limited supply of papers, OMO have been largely used to provide a discount window facility to banking institutions as a last resort in times of liquidity needs.

In addition to the Government papers, other papers eligible for rediscounting at the window facility includes Cagamas bonds/notes and BNM bills and selected private debt securities. BNM has the option of conducting OMO either through direct transactions or through repurchase agreements. As in the case of direct lending/borrowing, BNM only deals with the PDs.

(c) (i) **Development financial institutions (DFIs)**

Established by the Government to promote development programmes in the agricultural, industrial and international trade and export sectors, the DFIs continue to play a complementary role to the banking institutions in the intermediation process. They maintain their role as niche providers of specialist capital financing for projects which require medium to long-term financing in the agriculture, industrial and manufacturing sectors. DFIs have traditionally relied heavily on borrowings to fund asset growth as they are not licensed to mobilise deposits from the public. These institutions have access to resources at concessionary rates from the Government and foreign and international institutions.

(ii) **Savings institutions**

Savings institutions complement banking institutions in their role as major deposit-taking institutions. These savings institutions play a particularly important role in the promoting and mobilising savings among the middle and lower-income groups, especially in areas, which banking institutions do not adequately serve. Savings institutions source funds mainly from deposits largely to extend loans and investments.

Question 5

- There were no examiner's comments for this question.

5. (a) (i) The money market comprises the interbank market, where the lending and borrowing of short-term funds take place; and the market for short-term money market papers, consisting of Malaysian Government Securities (MGS), Treasury Bills (TBs), Cagamas bonds and notes, Bankers' Acceptances (BAs), Negotiable Instruments of Deposit (NIDs), Repurchase agreements, Government Investment Certificates and Bank Negara Malaysia bills. The money market's primary function is to reconcile interests of two groups:

- institutions and individuals with temporary surplus funds who want to lend these funds and earn some returns; and
- institutions and individuals who need funds immediately for short periods.

(ii) Commercial banks enjoy the widest scope of permissible activities. Apart from the prohibition to engage in wholesale and retail trade, and some restrictions on investment in immovable property and shares, commercial banks are able to engage in a full range of banking services. Traditionally, the main functions of commercial banks are to provide:

- retail banking services such as the acceptance of deposits, granting of loans and advances, and financial guarantees;
- trade financing facilities such as letters of credit, discounting of trade bills, shipping guarantees, trust receipts and bankers' acceptances;
- treasury services;
- cross border payment services; and
- custody services such as safe deposits and share custody.

Commercial banks are also authorised to deal in foreign exchange i.e. to buy, sell, borrow and lend in foreign currencies, and are also the only financial institutions allowed to provide current account facilities.

(iii) Merchant banks were specifically formed to service the needs of the corporate sector and to complement the facilities offered by commercial banks which focus mainly on providing short-term credit for working capital and trade financing. As such, the operations of merchant banks hinge mainly on providing advisory and management services to corporations as well.

Specifically, merchant banks play a role in the short-term money market and capital raising activities including financing, specialising in syndication, corporate finance and management advisory services, arranging for the issue and listing of shares, as well as investment portfolio management.

Apart from engaging in fee-based activities, merchant banks also extend credit to the economy. As the business of the merchant banking industry focuses mainly on the corporate sector, it operates mostly on a wholesale basis and is largely involved in project-based financing.

- (b) (i) Monetary policy is policy focusing on controlling the nation's money supply and credit. It is aimed at controlling inflation by influencing aggregate demand.
- (ii) The four objectives of monetary policy:
- **To maintain price stability** – the constant fluctuation of prices and goods can be disruptive to the economy. Prices are only allowed to fluctuate within a certain acceptable range in order to maintain economic stability. Price stability is the key prerequisite for sustained economic growth for in its absence, mobilisation of resources and efficient channeling of resources to productive investment can be adversely affected.
 - **To achieve a higher level of economic growth** – this can be achieved when major macro-economic issues like unemployment and inflation are well controlled.
 - **To control the demand and employment** – there must be a balance between aggregate demand and the level of employment, in order to achieve a stable economy.
 - **To maximise employment of resources** – all factors of production should be fully employed for maximum benefits to the economy.

- (c) (i) Al-Wadiah (safe-keeping with guarantee)

This concept refers to deposits that have been deposited with another person, who is not the owner, for safekeeping. As Wadiah is a trust, the depository becomes the guarantee and therefore it guarantees repayment of the whole amount of deposits or any part thereof, outstanding in the account of the depositors when demanded. The depositors are not entitled to any part of the profits but the depository may provide returns as a gift (Al-Hibah) as a token of appreciation.

- (ii) Al-Mudharabah (profit sharing)

Islamic banks also offer investment accounts to their customers based on principle of Al-Mudharabah (profit sharing according to pre-determined agreed upon ratios). Under this arrangement the bank will use deposits for investment purposes and share profits gained with customers according to predetermined agreed upon ratios. At the same time, if losses occur, the losses are borne only by the bank.

Question 6

- Candidates were not able to state the disadvantages of raising funds through the equity market.
- They were also not aware of the revised interest rate framework.
- Candidates showed poor understanding of the impact of inflation on the economy. They also had poor knowledge of the Overnight Policy Rate and could not explain how it is used to manage inflation.

6. (a) Give any two of the following advantages:

- Access to additional capital
- Increased liquidity of capital through the listing of the company
- Enhancement of corporate image
- Attracting and keeping key personnel

Give any two of the following disadvantages:

- Dilution of control of the existing owners
- Additional responsibilities on directors
- Greater disclosure of information
- Cost – more expensive to run a public company than a private company, such as the costs of investor relations, share registry, share certificates, listing fees and the cost of annual reports.

(b) Three main features of the new interest rate framework.

- **The Overnight Policy Rate (OPR)**

The OPR will be the indicator of the monetary policy stance. The OPR will have a dual role – as a signalling device to indicate the monetary policy stance and as a target rate for the day-to-day liquidity operations of the central bank. Any change in the monetary policy stance would be signalled by a change in the OPR. It will serve as the primary reference rate in determining other market rates. To reflect the unchanged stance of monetary policy, the OPR will be set at the current interbank overnight rate of 2.70%.

- **Overnight rate as the sole operating target**

Monetary operations of Bank Negara Malaysia (BNM) will target the overnight interbank rate. Liquidity management will aim at ensuring the appropriate level of liquidity that would influence the overnight interbank rate to move close to the OPR. Liquidity operations will also be conducted at other maturities but without targeting a specific interest rate level. Therefore, interbank interest rates at other maturities would be market determined, reflecting overall demand and supply conditions in the money market as well as interest rate expectations.

- **Introduction of Overnight Operating Corridor and Standing Facilities**

To minimise excessive volatility in the overnight rate, BNM will specify a corridor around the OPR. The corridor is set at ± 25 basis points around the OPR. Day-to-day liquidity operations will aim to hold the overnight rate close to the announced OPR. A standing facility is introduced to ensure that the overnight interbank rate fluctuates within this corridor by providing a lending facility at the upper limit of the operating band and a deposit facility at the lower limit of the operating band. Market participants will transact among interbank institutions at a rate within the operating band to meet their short-term liquidity needs before utilising the standing facility.

Residual overnight liquidity surplus or shortage positions will be met by the standing facilities from the central bank. With the OPR set at 2.70%, the upper limit will be 2.95% and lower limit will be 2.45%. The standing facilities are available to all interbank institutions at their request.

- (c) (i) Inflation is a rise in the general level of prices. Inflation causes money to lose its purchasing power because more money is needed to purchase the same volume of goods and services.
- (ii) Inflation distorts all price signals that makes for the efficient functioning of an economic system. The higher the inflation rate, the greater the distortions. Persistent increase in prices have a number of adverse economic and social consequences. Fixed-income earners may see their standard of living decline; the disparity between the rich and poor may increase; the distribution of national income between wages and profits will change; higher inflation relative to our trading partners will cause our industries to become less competitive or will cause the exchange rate to fall.

But one effect which is especially important is its impact on saving and investment decisions because sustainable growth in an economy can be retarded. Business investment decisions are also distorted, as long-term investment looks less profitable than short-term speculation. For the financial markets, inflation erodes the real-return from fixed-interest

- (d) Monetary policy operates through short-term interest rates to achieve its ultimate objective of growth with price stability. Liquidity management and its signalling impact will influence the level and direction of interest rates. BNM conveys its policy intention to the market through its overnight policy rate (OPR).

A change in the OPR will trigger a chain of events that affects the whole range of market rates. More specifically, changes in BNM's OPR will have a direct impact on lending rates, which will affect the cost of funds in the system. This in turn will affect the private sector's financial assets, liabilities position and asset prices. It will also affect decisions to consume or save, and invest which involve both domestic and external goods and services.

These factors will ultimately influence aggregate demand and prices. Generally, the objective is to ensure aggregate demand is in line with potential output to contain inflationary pressures. Price stability will lead to efficient resource allocation and improved investment sentiment. It will provide an incentive to save and hence enhance economic welfare. More importantly, price stability will foster sustainable long-term economic growth.

Question 7

- Candidates were not able to state the objectives of the Financial Sector Masterplan 2001- 2010. They also showed poor understanding of the financial markets.

7. (a) (i) **Malaysian Government Securities (MGS)**

These are long-term debt securities issued by the Government with an original maturity of more than one year. Financial institutions and pension funds largely hold MGS. Financial institutions need to hold MGS for compliance purposes, while pension funds, such as the EPF, are investing to comply with statutory requirements and at the same time provide a secured return to contributors in the long run.

(ii) **Government Investment Certificates**

These are issued by the Government based on Islamic principles and are also regarded as liquid assets. Islamic banks can invest in the certificates to comply with the stipulated liquidity requirements as well as to park their temporarily idle funds.

(iii) **Bank Negara Bills (BNB)**

This is a short-term paper issued by BNM to mop up excess liquidity in its open market operations and to provide financial institutions with an alternative instrument in meeting their liquidity and reserve requirements on their investment portfolios. BNBs are short-term debt securities with maturity of 91, 182 and 364 days.

(iv) **Corporate bonds**

They are intermediate and long-term obligations issued by large corporations to finance plant and equipment investment. Typically, corporate bonds pay interest twice a year and repay the principal amount at maturity. There are many variations, like the convertible bonds where the holders are allowed to convert the debt into equity. The corporate bond market is smaller than the stock market.

- (b) The objectives of the Financial Sector Masterplan (FSMP) released by Bank Negara Malaysia in March 2001, is to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy throughout the economic cycle. It has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation. The development of domestic institutions that form the core of an efficient, effective and stable financial sector is an important part of this process.

(c) (i) **Capital market**

The capital market comprises a primary securities market, in which new issues of government and corporate securities are offered both to the public and financial institutions, and the secondary market, in which existing government and corporate securities are transacted. This is where medium to long-term funds are mobilised. This means instruments with maturity of more than one year. It is also used to finance long-term investments and capital expenditure for both private and public sectors. The funds raised can be either interest-bearing debt or equity. Interest-bearing debts are commercial papers and bonds, which are short term and issued by companies directly to the investors. Equity comes in the form of public issues, right issues and convertible shares.

(ii) **Foreign exchange market**

The foreign exchange market is where the exchange of currencies takes place, i.e. buying and selling of currencies. For example, when individuals, businesses and the government in one country want to trade, borrow or lend in another country, they must convert their currency into the currency of the country they are dealing with. The exchange rate is the price of one country's currency in terms of another. Market forces determine the exchange rate that prevails for consumers and investors. However, governments through their central banks do intervene in the foreign exchange markets to promote or safeguard their national policy objectives. International currencies are traded in foreign exchange markets around the world through computer networks between traders in commercial banks in many countries. The transactions in the foreign exchange market determine the rates at which international currencies are exchanged. These exchange rates affect the cost of acquiring foreign financial assets or foreign goods and services. Foreign exchange market transactions are over-the-counter, i.e. there is no single physical location where traders gather to exchange currencies, as there is for many domestic stocks and bonds.