

CF01

# Introduction to Monetary Economics and the Malaysian Financial System

8 OCTOBER 2001

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) Using a diagram, explain how the equilibrium price of a product is determined. [8]
- (b) Using the demand and supply curves, explain why the price of mobile phones has decreased substantially over the years. [12]  
(Total:20 marks)

2. (a) The following information is extracted from the *Economic Report 2000/2001*:

Item	RMmillion
Gross Domestic Product (GDP) at current market price	325,161
Net factor payment abroad	-27,146
Taxes	2,000
Subsidies	1,500
Depreciation	300

Based on the above information, calculate the following:

- (i) GDP at factor cost [2]
- (ii) Gross National Product (GNP) at factor cost [2]
- (iii) GNP at market price [2]
- (iv) Net national product at factor cost [2]
- (v) Per capita GDP at market price, assuming the country's population is 20million [2]
- (b) Briefly explain each of the **five** components of the aggregate demand for domestic outputs. [10]  
(Total:20 marks)
3. Money supply in Malaysia is defined into **three** categories, M1, M2 and M3.
- (a) Define M1, M2 and M3. [2]
- (b) State the category of money supply (M1, M2 or M3) that will be affected in the following cases:
- (i) An individual saves RM5,000 with a commercial bank. [2]
- (ii) A business firm's overdraft facility is increased by RM5million. [2]
- (iii) Mr A pays RM100 to a trader for goods purchased. [2]
- (iv) A business firm places RM10million as fixed deposits with a finance company. [2]
- (c) Explain the **four** functions of money. [10]  
(Total:20 marks)

## PART B

### ANSWER THREE (3) QUESTIONS ONLY

4. Bank Negara Malaysia (BNM) is an integral part of the Government's machinery in achieving the macroeconomic and social objectives of the country.
- (a) State the macroeconomic and social objectives of the Government. [5]
  - (b) Briefly explain any **four** major objectives or functions of BNM. [10]
  - (c) Describe the relationship between the macroeconomic and social objectives of the Government and the objectives of BNM. [5]
- (Total:20 marks)
5. (a) In the context of the Malaysian financial system, briefly explain the roles for each of the following:
- (i) Banking system [2]
  - (ii) Commercial banks [4]
  - (iii) Finance companies [2]
  - (iv) Merchant banks [2]
- (b) Briefly explain the rationale of the merger programme initiated by Bank Negara Malaysia for the banking sector. [5]
- (c) Explain how the monetary policy works in an economy. [5]
- (Total:20 marks)
6. In any economy, the financial system acts as a channel for the flow of funds, namely mobilising savings for productive investment.
- (a) Using a diagram, outline the structure of the Malaysian financial system. [10]
  - (b) Describe the flow of funds in an economy. [5]
  - (c) Explain the terms "financial intermediation" and "financial disintermediation". [5]
- (Total:20 marks)
7. Briefly describe the following:
- (a) The difference in loans for project financing based on the *Al-Mudharabah* and *Al-Musyarakah* principles. [8]
  - (b) Major sources and uses of funds for Bank Simpanan Nasional. [6]
  - (c) Principal roles of Malaysian Industrial Development Finance Berhad. [6]
- (Total:20 marks)

- END OF QUESTION PAPER -

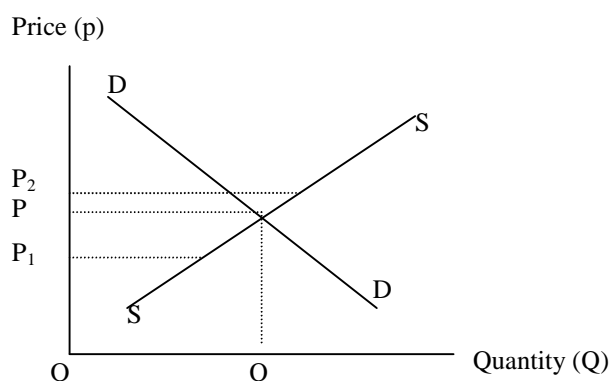
## OUTLINE ANSWERS

### PART A

#### Question 1

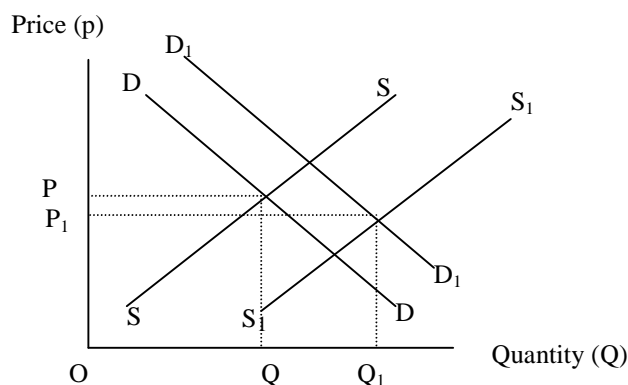
Although candidates could explain how the equilibrium price of a product is determined, many could not apply the concept in the second part of the question.

1. (a) The Equilibrium price of a product is the price at which demand equals to supply or where quantity demanded equals quantity supplied.



In the diagram above, DD and SS are the demand and supply curves respectively. At the price of  $OP_1$ , quantity demanded exceeds quantity supplied. Therefore, price will rise. At the price of  $OP_2$ , quantity supplied is more than quantity demanded. Therefore, price will fall. At the price  $OP$ , quantity demanded is equal to quantity supplied. It is defined as the equilibrium price and  $OQ$  is the equilibrium output.

- (b) When mobile phones were newly introduced, there were not many suppliers. Furthermore, the manufacturing technology used was not advanced. However, the demand for the mobile phones was quite strong. The price of the mobile phones, being determined by demand and supply, was high at that time as shown in the diagram below ( $OP$ ).



DD: Demand for mobile phones during the early 1980s  
 SS: Supply of mobile phones during early 1980s  
 $D_1D_1$ : Demand for mobile phones now  
 $S_1S_1$ : Supply of mobile phones now

The equilibrium price of mobile phones ( $OP$ ) in the early 1980s was about RM6,000. However, over the last 20 years, both demand and supply had increased, but as shown in the diagram above, supply increased faster than the increase in demand due to the advancement in technology to produce the mobile phones. Therefore, the equilibrium price of mobile phones is now at  $OP_1$ , which is very much cheaper compared to the price during the early 1980s.

### Question 2

This question was well answered by most candidates.

2. (a) (i) GDP at factor cost  
= GDP at market price – taxes + subsidy  
= RM(325,161million – 2,000million + 1,500million)  
= RM324,661million
- (ii) GNP at factor cost  
= GDP at factor cost + net factor payment from abroad  
= RM(324,661million – 27,146million)  
= RM297,515 million
- (iii) GNP at market price  
= GNP at factor cost + taxes – subsidy  
= RM(297,515million + 2,000million – 1,500million)  
= RM297,015million
- (iv) Net national product at factor cost  
= GNP at factor cost – Depreciation  
= RM(297,515million – 300million)  
= RM297,215million
- (v) Per capita GDP at market price  
=  $\frac{\text{GDP at market price}}{\text{Population}}$   
=  $\frac{\text{RM325,161million}}{20\text{million}}$   
= RM16,258
- (b) Five components of aggregate demand are:  
(i) Consumption expenditure by private sector  
(ii) Consumption expenditure by public sector  
(iii) Investment expenditure by private sector  
(iv) Investment expenditure by public sector  
(v) Net export

Candidates should briefly explain each of the above and give examples.

### Question 3

This question can be considered a simple question and has been asked in the past examination sittings. Candidates were able to answer this question well.

3. (a) M1: Coins and notes in circulation plus demand deposits held by private sector.
- M2: M1 + private sector holdings of fixed and savings deposits with the commercial banks, net~ negotiable certificates of deposits (NCDs) issued by banks and repurchase agreements.
- M3: M2 + private sector deposits (including repos) placed with the finance companies, merchant banks, discount houses, and Bank Islam, but excluding placement of funds among these institutions.
- (b) (i) M2  
(ii) M1  
(iii) M1  
(iv) M3

- (c) Functions of money:
- (i) Medium of exchange
  - (ii) Unit of account
  - (iii) Store of value
  - (iv) Standard for deferred payment

Candidates should provide explanations for each of the functions.

## PART B

### **Question 4**

The question relating to the macroeconomic and social objectives of the Government was well answered. Although the majority of candidates were able to state the major objectives or functions of Bank Negara Malaysia (BNM), some of them were confused between the 'international reserves of BNM' and the 'statutory reserve requirement'. Only a few candidates understood the relationship between the objectives of the Government and BNM.

4. (a) The macro-economic and social objectives of the Government are:
- promoting economic growth;
  - maintaining a high level of employment;
  - maintaining price stability and a reasonable balance in the country' s international payments position; and
  - eradicating poverty and restructuring of society.
- (b) **Four** major objectives or functions of BNM:
- (i) To issue currency and keep reserves safeguarding the value of the currency;
  - (ii) To act as a banker and financial adviser/agent to the Government;
  - (iii) To promote monetary stability and a sound financial structure; and
  - (iv) To influence the credit situation to the advantage of the country.

Candidates are required to provide a brief explanation for each BNM objective/function.

- (c) Financial stability helps to achieve a higher level of employment and economic growth. A smoother flow of funds will enable a more efficient use of economic resources and, subsequently, increase the total output and income of an economy. Moreover, an adequate supply of money and credit will facilitate the utilisation of economic resources.

Therefore, BNM' s management of the money supply and credit will affect economic growth, employment, the balance of payments and inflation. In addition, BNM also ensures that the payment system within the economy functions efficiently. The payment system, which is based largely on the use of cheques and other means of funds transfer, is an indispensable element of not only domestic and foreign trade, but also the economy as a whole.

### Question 5

Many of the candidates were able to explain the various services offered by each of the financial systems. Whilst this is acceptable, candidates should also emphasis the different roles played by the commercial banks, finance companies and merchant banks.

Not many candidates could answer the question on the merger programme correctly. Most of them elaborated on the merger programme whereas the question had specifically asked for the rationale i.e. to achieve a more effective and competitive banking system. We need to achieve this in view of the impending threat arising from liberalisation and globalisation. At the same time, a strong banking system can help support the financing needs of the economy.

Answers to the question relating to the workings of monetary policy were acceptable. Nevertheless, candidates should take note that there is no necessity to highlight each and every instrument of monetary policy. It would be sufficient to mention that changes in monetary policy would affect the level of bank liquidity, interest rate, and level of deposits and credit. These changes affect consumer and investor decisions and ultimately, the level of economic activity or economic growth.

5. (a) (i) The banking system plays a major role as an intermediary between surplus and deficit units, and between domestic and international units (in the case of commercial banks).

To undertake this role, a variety of financial instruments have been introduced as savings media for the surplus units. At the same time, a varied range of credit and investment facilities is offered to meet the financing requirements of the deficit units.

- (ii) Commercial banks' roles include offering:

- retail and corporate banking services;
- business financing;
- commercial bills discounting;
- standing instructions;
- current (or demand deposit) accounts which provide chequing facilities; and
- miscellaneous services such as the provision of safe deposit boxes.

The role of the bank 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 the only authorised exchange agents and act on behalf of the Central Bank in administering Malaysia' s foreign exchange control system.

- (iii) Finance companies can be considered as important deposit mobilisation mechanisms in our financial system. The total deposits collected by finance companies constitute a substantial amount, second only to that collected by the 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 widely used by the public for savings purposes. Moreover, the bulk of finance company lending is channeled towards the hire-purchase financing of durable consumer goods. Besides this, leasing and housing receive a great amount of funds from finance companies.

- (iv) Merchant banks on the other hand play a distinctly different role in the banking system. They offer comprehensive services to big corporations in our economy. The services are primarily corporate advisory services, funds and investment management, and banking intermediation facilities, aside of some extent of deposit taking and lending. 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 corporate clients.
  
- (b) The merger programme initiated by BNM is aimed at consolidating the domestic banking industry into 10 banking groups to achieve a more effective and competitive banking system. In view of the impending liberalisation and globalisation of the banking sector, the consolidation of domestic banking institutions is inevitably aimed at enhancing their capacity and capabilities.

A fragmented banking system will only increase the vulnerability of the financial system and the economy as a whole. On the other hand a strong and efficient banking system that is resilient will greatly help to support the financing needs of the economy so that the nation can continue to achieve a strong and sustainable growth. As at 31 December 2000, 50 of the 54 domestic banking institutions have been consolidated into 10 banking groups. Effectively, 94% of the total assets of the domestic banking sector have been rationalised and consolidated.

- (c) Monetary policy works through affecting the volume of bank reserves. Further, it 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, and 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**

Candidates' answers for the question on the structure of the financial system lacked depth especially with respect to institutions under the non-bank financial intermediaries as well as the different financial markets.

Candidates had no difficulty answering the question on flow of funds. Some of them illustrated their answers with graphs, which is good. While many candidates were able to define "financial intermediation", many too were unable to define financial disintermediation.

6. (a)

<b>Structure of the Malaysian financial system</b>	
<b>FINANCIAL INSTITUTIONS</b>	<b>FINANCIAL MARKETS</b>
<p><b><u>Banking System</u></b></p> <ul style="list-style-type: none"> <li>• Bank Negara Malaysia</li> <li>• Banking Institutions               <ul style="list-style-type: none"> <li>– Commercial Banks<sup>1</sup></li> <li>– Finance Companies</li> <li>– Merchant Banks</li> </ul> </li> <li>• Others               <ul style="list-style-type: none"> <li>– Discount Houses</li> <li>– Representative Offices of Foreign Banks</li> <li>– Offshore Banks in Labuan IOFC</li> </ul> </li> </ul> <p><b><u>Non-Bank Financial Intermediaries</u></b></p> <ul style="list-style-type: none"> <li>• Provident and Pension Funds</li> <li>• Insurance Companies<sup>2</sup></li> <li>• Development Financial Institution</li> <li>• Savings Institutions               <ul style="list-style-type: none"> <li>– National Savings Bank</li> <li>– Co-operative societies</li> </ul> </li> <li>• Other Non-Bank Financial Intermediaries               <ul style="list-style-type: none"> <li>– Unit Trusts</li> <li>– Pilgrims Fund Board</li> <li>– Housing Credit Institutions</li> <li>– Cagamas Berhad</li> <li>– Credit Guarantee Corporation</li> <li>– Leasing Companies</li> <li>– Factoring Companies</li> <li>– Venture Capital Companies</li> </ul> </li> </ul>	<p><b><u>Money &amp; Foreign Exchange Markets</u></b></p> <ul style="list-style-type: none"> <li>• Money Market</li> <li>• Foreign Exchange Market</li> </ul> <p><b><u>Capital Markets</u></b></p> <ul style="list-style-type: none"> <li>• Equity Market</li> <li>• Bond Market               <ul style="list-style-type: none"> <li>– Public Debt Securities</li> <li>– Private Debt Securities</li> </ul> </li> </ul> <p><b><u>Derivatives Markets</u></b></p> <ul style="list-style-type: none"> <li>• Commodity Futures</li> <li>• KLSE CI Futures</li> <li>• KLIBOR Futures</li> </ul> <p><b><u>Offshore Market</u></b></p> <ul style="list-style-type: none"> <li>• Labuan International Offshore Financial Centre (IOFC)</li> </ul>
<p><sup>1</sup> Including Islamic banks</p> <p><sup>2</sup> Including Takaful</p>	

(b) In a developed economy, a whole range of financial intermediaries would have been established to form a financial system providing a variety of financial instruments as savings and investment media for the surplus units, as well as a varied range of credit and investment facilities to meet the financing requirements of the deficit units. These surplus or deficit units in the economy can be conveniently divided into five major institutional sectors (households, enterprises, government, export, and import). Each sector has different sources and uses of funds from the other sectors and behaves relatively homogeneously as a group.

- (c) Intermediation refers to the activities of financial intermediaries in assisting the indirect flow of funds through the financial system. Financial intermediaries act as ‘middle men’ – pooling the funds of lenders (savers) and passing that money on to end-users (borrowers). Financial intermediaries also trade financial assets such as shares and bonds through specific markets established for this purpose.

Disintermediation on the other hand describes the process of companies arranging their own borrowings and placing their deposits directly in the market, without going through a financial intermediary.

#### **Question 7**

Candidates’ understanding of the various concepts examined in this question has improved as compared to past examination sittings.

7. (a) The main difference between loans for project financing based on the *Al-Mudharabah* and loans based on *Al-Musyarakah* principles lies in whether the borrower himself part-finances the project.

In *Al-Mudharabah*, theoretically, banks provide all the financial requirements with the borrower contributing none 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, the bank, as the financier, will bear all the financial liabilities.

According to the *Al-Musyarakah* principle, the bank usually does not contribute 100 percent 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 the project. However, 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’s main source of funds is the savings deposits collected through its branch network and the post office system. BSN also offers fixed deposits as well savings schemes such as *Save-As-You-Earn* Scheme, *GIRO* Scheme and the *Premium Savings Certificate* Scheme.

BSN’s uses of funds are subjected to the requirement that at least 50% of its investment must be in Government securities (reduced from 70% before 1984, following the downsizing of the Government operations). Following the reduction in the minimum requirement for investment in Government securities, more funds were made available for other investments. Consequently, BSN has diversified its investment in shares and loans.

- (c) Malaysian Industrial Development Finance Berhad (MIDF) is the biggest and oldest development finance institution in Malaysia. 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 mobilising industrial capital in the form of direct equity participation and assisting in 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.