

DP01

Monetary Economics and the Malaysian Financial System

7 APRIL 2003

1. Time allowed : Three (3) hours
2. Total number of questions : Six (6) questions
3. Number of questions to be answered : Four (4) questions
Part A : Compulsory question [40 marks]
Part B : Three (3) questions [20 marks each]
4. Candidates must obtain a minimum of 20 marks in Part A 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**.
7. Blank pages are provided at the end of the question paper for rough work.

PART A

COMPULSORY QUESTION

1. (a) (i) Briefly explain **three** challenges of the Malaysian financial system in the 21st century. [3]
- (ii) List **two** participants and **four** financial instruments in a developed financial system. [3]
- (iii) Define the term “financial intermediation” and briefly explain the markets that financial intermediaries operate in. [3]
- (b) (i) Name **four** types of instruments traded in the capital market. [4]
- (ii) Highlight **three** objectives of the Capital Market Masterplan 2001. [3]
- (c) List **three** characteristics of venture capital investments. [3]
- (d) Briefly explain the following:
- (i) Financial deepening [2]
- (ii) Bank failure [2]
- (iii) Money multiplier [2]
- (e) (i) Briefly explain the stance of monetary policy in Malaysia during the period 2000-2001. [4]
- (ii) State **three** advantages of a pegged exchange rate during a financial crisis. [3]
- (iii) Briefly explain the selective exchange control measures implemented in Malaysia during the Asian financial crisis in 1997. [3]
- (f) Describe the monetary transmission mechanism in an open economy using a schematic diagram. [5]

(Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) (i) List **three** sources and **three** uses of funds of commercial banks in Malaysia. [3]
- (ii) Highlight **two** banking services offered by commercial banks that may overlap and compete with those services rendered by the merchant banks. [2]
- (b) (i) Briefly explain the importance of asset and liability management practices of financial institutions in Malaysia. [3]
- (ii) Name **two** factors that influenced the trend of non-performing loans (NPLs) in the Malaysian banking system during 2001 and early 2002. [2]
- (c) (i) List **three** functions of development finance institutions in industrial development in Malaysia. [3]
- (ii) Highlight **three** recommendations for the promotion of development finance institutions in the Financial Sector Masterplan. [3]

- (d) Based on a statutory reserve ratio (SRR) of 4%, a total of RM30billion of finance companies reserves are kept with the Central Bank.
Calculate the reserves released to finance companies following a cut of the SRR to 2%. [2]
- (e) List **four** potential indicators for measuring the productivity of the banking system. [2]
(Total:20 marks)
3. (a) (i) What are the objectives of Bank Negara Malaysia (BNM)? [4]
(ii) To meet its objectives, BNM is vested with comprehensive legal powers under the various Acts and Ordinances to regulate and supervise the financial system.
List **four** of these Acts or Ordinances. [4]
- (b) (i) Briefly explain the dilemma of a central bank in setting the money supply and interest rates. [4]
(ii) Briefly explain whether interest rate targets help central banks to soften the impact of economic downturns. [3]
- (c) Briefly explain the present framework of the base lending rate of commercial banks and finance companies in Malaysia. [2]
- (d) Briefly explain how a central bank uses its monetary policy tools to decrease money supply by RM100million, given a money multiplier of 10 and a monetary base of RM500million. [3]
(Total:20 marks)
4. (a) (i) Briefly define the monetary aggregates M1, M2 and M3. [3]
(ii) Briefly explain the shift from monetary aggregates to interest rates as intermediate targets of monetary policy. [2]
- (b) Briefly explain **two** factors that determine the level of money supply in the Malaysian economy. [4]
- (c) Briefly explain why policymakers are concerned with excessive fluctuations in interest rates or exchange rates. [3]
- (d) (i) Briefly explain **two** determinants of the level of money stock in an economy. [4]
(ii) What is the size of the money multiplier if the currency-deposit ratio is 0.25 and the reserve-deposit ratio is 15%? [2]
(iii) What is the size of the currency-deposit ratio and the excess reserves when the money multiplier reaches a maximum? [2]
(Total:20 marks)
5. (a) (i) List **four** objectives of monetary policy in a developing economy. [4]
(ii) What are **two** obstacles that can hinder monetary policy tools in achieving its goals for a country? [3]
- (b) Briefly explain the channels for the transmission of monetary policy in the financial system. [4]
- (c) (i) Briefly explain **one** monetary instrument used by Bank Negara Malaysia in recent years for implementing monetary policy. [3]
(ii) Briefly highlight the impact of the monetary instrument in (c)(i) on economic activities. [3]
- (d) Briefly explain the use of immediate targets by central banks to improve monetary policy decisions. [3]
(Total:20 marks)

6. (a) Briefly explain the roles of the International Monetary Fund during the Asian financial crisis in 1997. [5]
- (b) Briefly explain the fixed exchange rate system and the flexible rate exchange system. [5]
- (c) Briefly explain why countries with deterioration in export earnings may consider a devaluation of their domestic currency. [4]
- (d) (i) Explain why short-term capital flows are volatile in nature. [2]
- (ii) When is a surplus position recorded in the balance of payments? [2]
- (iii) An American firm donates RM20million worth of art to Muzium Negara. Explain the recording of this transaction in the balance of payments. [2]
- (Total:20 marks)

OUTLINE ANSWERS

PART A

Question 1

Generally, candidates have a fair understanding of the concepts and principles examined. However, many had difficulties in expressing their ideas clearly.

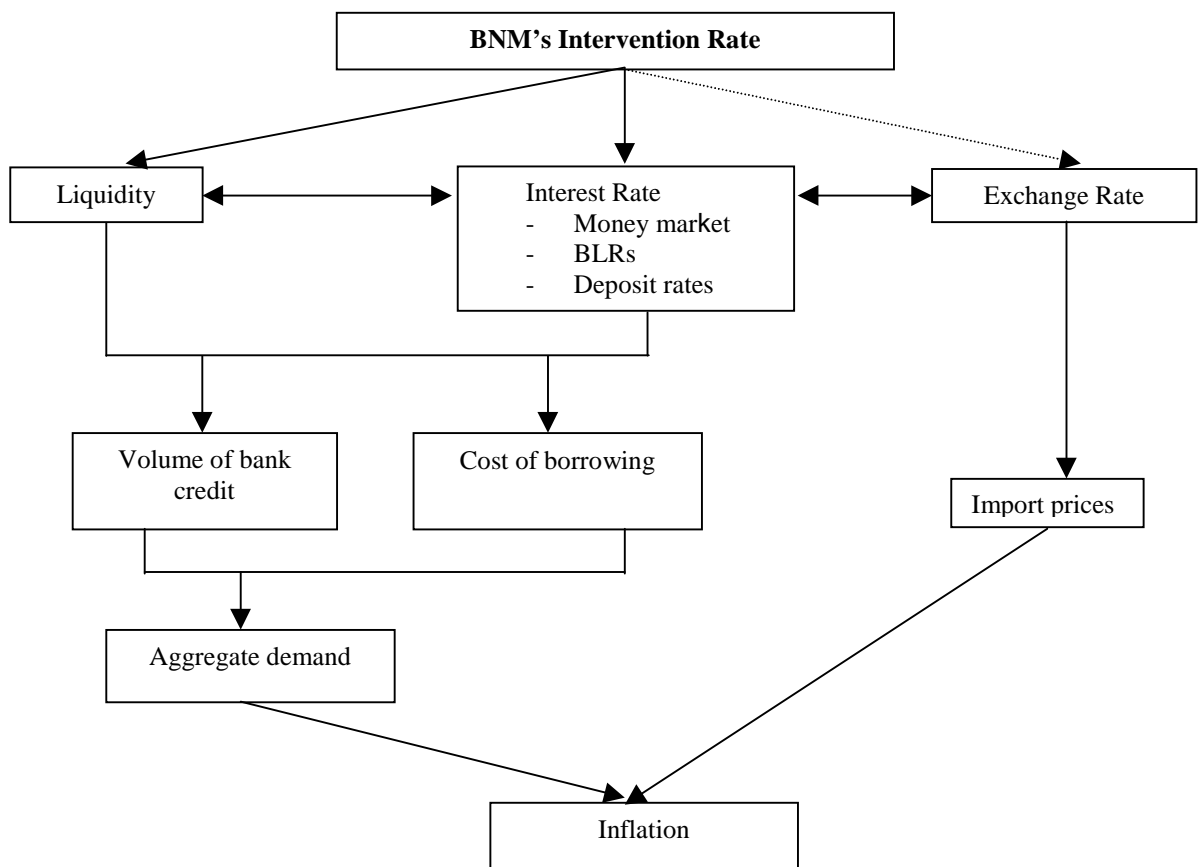
1. (a) (i) The Malaysian financial system faces several challenges in the 21st century (choose any **three**):
- The rapid intensification of globalisation in recent years has significantly affected the structure and operations of financial institutions. There is a need for financial and structural reforms to prepare the domestic banking sector for greater competition arising from liberalisation and globalisation. The financial system needs to focus on enhancing efficiency and competitiveness and product development and skills enhancement.
 - A well-functioning and efficient financial system is vital in ensuring effective and efficient conduct of monetary policy. The need to tap information technology will increasingly be important to meet more sophisticated demand.
 - Banking sector needs large amount of capital investments to remain competitive and be able to assume greater risks.
 - Need to address issues related to security, regulatory framework and protection of consumers' personal data. These new areas will pose greater challenges in the supervisory and regulatory framework.
 - The financial system must adapt to meet the changing requirements for financing new economic activities. In particular, new areas of growth have different characteristics, which may limit their access to the traditional form of the bank-based financing. The capital market will play an important role in financing the growth of new growth areas and businesses.
- (ii) The participants in a developed financial system: (choose any **two**)
- Households, enterprises, government, central bank, commercial banks, finance companies, merchant banks, discount houses, industrial finance institutions, savings institutions, provident funds, insurance companies, unit trusts and others.
- The financial instruments are: (choose any **four**)
- Currency, deposits, loans, bonds, unit trusts, share capital, insurance premiums, loans and investments.
- (iii) Financial intermediation refers to the flow of funds between the depositors and the borrowers that is fulfilled through the efforts of a financial intermediary. The transaction is effected through indirect financing. In the process, the banks lending to the borrowers channel funds from depositors. The bank will assume the credit risk of the borrowers in return for an interest.
- Financial intermediaries operate in following markets:
- Savings market – where they operate as borrowers, while meeting the demand for financial assets by surplus units.
 - Credit market – where financial intermediaries supply the financial resources required by the deficit units. They will provide various financial instruments as a conduit to supply funds to the deficit units.
 - Money and foreign exchange markets, the capital market and the financial futures and options market – where they transact their own instruments not only directly with the economic units in an economy, but also among themselves.

- (b) (i) The instruments traded in the capital market are:
- Government securities (including MGS, Khazanah bonds, and Malaysia Savings bonds)
 - Private sector shares (ordinary shares and new issues of shares)
 - Debt securities (including straight bonds, convertible bonds, bonds with warrants, Islamic bonds, Cagamas bonds)
 - Short-term securities (commercial papers and Cagamas notes)
- (ii) The objectives of the Capital Market Masterplan 2001 are (choose any **three**):
- To be the preferred fund-raising centre for Malaysian companies
 - To promote an effective investment management industry and a more conducive environment for investors
 - To enhance the competitive position and efficiency of market institutions
 - To develop a strong and competitive environment for intermediation services
 - To ensure a stronger and more facilitative regulatory regime
 - To establish Malaysia as an international Islamic capital market centre
- (c) The main characteristics of venture capital (VC) financing (choose any **three**):
- A long time-frame of a 3 to 7-year investment
 - Hands-on investment involving a partnership with management to provide support and advice based on the expertise; experience and contacts of venture capitalists as a means of adding value to their investment
 - Finance of new and rapidly growing companies
 - Purchase of equity securities
 - Assistance in developing new products or services
 - Adding value to the company through active participation
 - Returns harvested are primarily in the form of capital gains at the end of the investment period rather than through on-going dividend returns
 - Higher risks are taken with the expectation of higher returns
- (d) (i) Financial deepening refers to the evolution of the financial system from a simple structure to a sophisticated institution. The Malaysian financial system has undergone radical changes, from a relatively simple structure of the mid-1950s, comprising mainly the foreign commercial banks, provident, pension and insurance funds, post office savings banks and a few insignificant financial intermediaries.
- (ii) Bank failure refers to an event whereby a bank is unable to pay its depositors in full. A bank fails when it is unable to meet its obligation to its depositors. Banks use depositor's funds to provide loans and to purchase other assets. Some of the bank's borrowers may find themselves unable to repay their loans or the assets of the bank may decline in value for some reasons. In these circumstances, the bank may not be able to pay off its depositors.
- (iii) Money multiplier is the number of times money supply will change in response to a given change of the monetary. For example, given a monetary base of RM300 million and a money multiplier of 5, the money supply is RM1,500 million.
- (e) (i) The stance monetary policy in Malaysia during 2000-2001 was directed at supporting economic recovery and to maintain domestic and external stability. The focus was to create a conducive environment that will support economic recovery while preserving price stability. The policy stance will ensure that there are adequate funds at reasonable cost to support private sector activity. Interest rates will be kept competitive to promote investments in the real sector, and also to provide a positive real rate of return on savings. This would be maintained as long as there are no build up in inflation.

- (ii) The advantages of a pegged exchange rate during a financial crisis (choose any **three**):
- Relative stability in the foreign exchange market.
 - Avoid the day-to-day management of the exchange rate.
 - The fixed exchange rate provided more certainty for businesses to make business and pricing decisions.
 - The fixing of the Ringgit against the US dollar resulted in some independence in setting the level of interest rate.
 - It avoids a trade-off between an accommodative monetary policy to avoid a contraction of the economy, and the need to check further deterioration in the Ringgit exchange rate.
- (iii) Selective exchange controls were introduced on 1 September 1998 to insulate the Malaysian economy from potential risks of external developments. The selective controls were directed at containing speculation on the Ringgit and also to stabilise short-term capital flows, and the repatriation of profits and other forms of income from investments in Malaysia. As part of the exchange control measures, the exchange rate of the Ringgit against the USD was fixed at RM3.80 on 2 September 1998.

(f) Monetary transmission mechanism in an open economy using a schematic diagram.

Monetary Policy Transmission Mechanism



PART B

Question 2

Candidates' understanding of NPLs, role of DFIs, and the indicators for measuring the productivity of the banking system was poor, as reflected in their answers.

2. (a) (i) The sources and uses of funds of commercial banks in Malaysia:
- Sources of funds (choose any **three**) – capital and reserves, deposits (demand, fixed and savings), negotiable instruments of deposits (NIDs) issued, amount due to financial institutions in Malaysia and abroad, bankers acceptances and other liabilities.
- Uses of funds (choose any **three**) – cash, balances with BNM, SRR with BNM, call money, NIDS held, Malaysian securities, loans and advances, fixed assets and other assets.
- (ii) **Two** banking services of commercial banks that may overlap and compete with those services rendered by the merchant banks.
- Authorised to offer fixed deposits to corporations, associations and clubs.
 - Raise funds by issuing NIDS.
- (b) (i) The asset and liability management practices of financial institutions in Malaysia play important roles in addressing the risks and management of liabilities. Asset management addresses the exposure of the banks to liquidity risks by lending money to other banks through the inter-bank market. The role of liability management is to manage liquidity as the bank's liabilities are usually of shorter-term compare with their assets.
- (ii) Factors that influenced the trend of NPLs during 2000-2001 (choose any **two**):
- Increase in lending to the economic sectors
 - Economic performance
 - Corporate debt restructuring
- (c) (i) The functions of development finance institutions (DFIs) are (choose any **three**):
- Extension of financial assistance in the form of medium and long-term loans
 - Participation in equity capital, underwriting
 - Acting as issuing house for public share issues
 - Provision of guarantees for loans
 - Identifications of new projects
 - Ancillary financial, technical and managerial advice
- (ii) **Three** recent policies recommended promoting the growth of DFIs:
- Measures to build the capabilities of DFIs
 - Improve supervisory framework
 - Encouraging DFIs as lead advisers, consultants and management providers
- (d) (i) RM15billion
- (ii) The potential indicators for measuring the productivity of the banking system (choose any **four**):
- Average assets per employee
 - Staff cost per employee
 - Cost incurred per RM of revenue earned
 - Cost incurred per RM of net interest income
 - Overhead to staff cost ratio
 - Pre-tax profits/average assets
 - Pre-tax profit per employee
 - Pre-tax profit per RM of shareholders funds

Question 3

Generally, the question was well answered. However, some candidates did not fully understand the concepts of the expansion and contraction of money supply and were also not able to explain whether interest rates targets help central banks to soften the impact of economic downturn.

3. (a) (i) Objectives of the Central Bank:
- to issue currency and keep reserve while safeguarding the value of the currency
 - to act as a banker and financial adviser or agent to the Government
 - to promote monetary stability and a sound financial structure
 - to influence the credit situation to the advantage of the country
- (ii) The legal infrastructure vested with the Central Bank to supervise and regulate the financial system are (choose any **four**):
- The Central bank of Malaysia Act 1958 (revised 1994)
 - The Banking and Financial Institutions Act 1989 (BAFIA)
 - The Exchange Control Act 1953
 - The Islamic Banking Act 1983
 - The Insurance Act 1996
 - The Takaful Act 1984
 - The Loan Ordinance 1959
 - Emergency (Essential Powers Act 199 and the Essential (Protection of Depositors) Regulations 1986
 - The Treasury Bills Act 1946 (revised 1977)
 - The Government Investment Act 1983
- (b) (i) The Central Bank faces a dilemma because the Central Bank can either control the level of money supply or interest. The Central Bank cannot be expected to control both the level of money supply and interest rate at the same time. When the Central Bank controls money supply, then interest rate becomes volatile and vice-versa. If the Central Bank chooses interest rate as its intermediate target, then it will loose control on money supply. Money supply will increase or decline depending whether the Central Bank is acting to prevent interest rate from falling below or rising above its target.
- (ii) Interest rate targets may not be useful for this purpose if the targets are not adjusted frequently. Other measures are equally important including reclassification of loans as non-performing loans; fiscal stimulation purchase and an accumulative monetary policy through reducing interest rates.
- (c) Essentially, the formula computation for the ceiling BLR is now based on the prevailing BNM 3-month intervention rate instead of the previous month's average LIBOR. The current computed BLR formula is:
- Computed BLR = adjusted BNM intervention rate + fixed administrative change of 2.25%
- Commercial banks =
$$\frac{[\text{BNM intervention rate} \times 80\%]}{1-\text{SRR}} + 2.25\%$$
- Finance companies =
$$\frac{[\text{BNM intervention rate}]}{1-\text{SRR}} + 2.25\%$$
- (d) The Central Bank could conduct open market sales of bonds of RM100million. It could also increase discount rate to reduce borrowed reserves by RM100million or to increase reserve requirements in order to reduce the money multiplier.

Question 4

Candidates showed average understanding of the concepts examined, but were not so well versed with the determinants of the level of money stock in an economy. They also could not explain the shift from monetary aggregates to interest rates as intermediate targets of monetary policy.

4. (a) (i) The categories of money supply can be summarised as follows:
- | | | |
|----|---|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| M1 | = | coin and currency notes + demand deposits |
| M2 | = | M1 + quasi money |
| M3 | = | M2 + broad quasi money (savings deposits + fixed deposits + NIDS issued + Repos) of private sector at finance companies, merchant banks, discount houses and Bank Islam Berhad) |
- (ii) Prior to 1987, monetary targeting had focused on M1. With the financial liberalisation and innovation, this has rendered M1 less liable for policy targeting and the shift in focus to M3. However, the large swings in the monetary targets reduced the viability of M3 as an intermediate target.
- (b) Factors that determined the level of money supply (choose **two**):
- Net Government Operations
Financing of the Government's overall deficit by the banking system will have the overall same effect as the banking system's loan to the non-bank private sector. There is no difference between these two operations – both of them work through bank reserves to inject greater liquidity into the private sector. The expansionary and contractionary impact on money supply arising from the bank financing of the Government expenditure will be reflected in the average difference over time between the level of Government deposits with the banking system (i.e. the Government lending to the system) and the holdings of Government debt by the banking system, mainly in the Government papers (that is bank lending to the Government). If on average, Government deposits with the banking system is larger than the holding of Government debt by the banking system, then the public sector's financial operations have imparted a contractionary impact on money supply and vice versa.
 - Bank Credit to Private Sector
Loans by the banking system to the private sector are major source of liquidity. Every loan will create a deposit and therefore, expand money supply. The limit tend credit to which banks may extend credit will depend on the size of the statutory reserves at the Central Bank. In the Malaysian economy over the past years, credit to private sector has always been expansionary and has even exceeded that of money supply (M3). On the other hand, a restrictive monetary policy will slow down lending to the private sector.
 - External Sector
This is another major determinant of money supply. Any excess of foreign exchange receipts over payments will raise money supply and vice-versa. In the event of a large flow of external funds into the domestic economy than outflows, the Central Bank and the banking system will be receiving foreign currency. This will increase domestic deposits and therefore, money supply in the economy. In other words, a surplus balance of payments position will result in an inflow of fund and vice-versa when there is a deficit.
- (c) Interest rates affect savings and investment decisions. Therefore, any fluctuations in interest rates may reduce savings and investment on account of uncertainty. Similarly, fluctuations in exchange rate might discourage businesses from making new expansion.
- (d) (i) Money can only be created if banking institutions can increase their holdings of domestic assets, which are normally constituted by loans to the private sector and to the public sector, by increasing their own liabilities in the form of demand and/or fixed deposits. There is no creation of money when currency in the hands of the public is substituted for deposits with a bank and vice-versa, since such an operation modifies only the composition of the stock money and not its account.

Since it is unlikely that all depositors will request encashment of all their deposits at the same time, banks will hold as reserves only a fraction of the amount of their deposit liabilities, that is, the amount they consider appropriate to satisfy demands by the public and the amount they are legally required to hold. It follows that an increase of cash (reserves) in the banking system can support the expansion of banking system assets and liabilities equal to a multiple of credit accretion. Thus, there is said to exist in a fractional reserve system, a money and credit multiplier.

- (ii) The size of the multiplier is $(0.1 + 0.25) / (0.25 + 0.15) = 3.1$
- (iii) The size of the currency-deposit ratio and the excess reserves when the money multiplier reaches a maximum is equal to **zero**.

Question 5

Candidates had weak understanding of the obstacles that can hinder the effectiveness of monetary policy tools.

5. (a) (i) The objectives of monetary policy in a developing economy
- Price stability
 - Strong sustainable output growth
 - Low level of unemployment
 - A satisfactory balance of payments position
- (ii) Factors that hinder the effectiveness of monetary policy:
- *Information lags*, or the inability to observe changes in the GDP, inflation, or other economic variables instantaneously. Delays in receiving information about the state in the economy can lead to major policy errors.
 - *Impact lags*, or the time required for monetary policy changes to affect output, employment or inflation.
- (b) Channel for transmission of monetary policy:
- The Central Bank began to use market-oriented instruments such as the open market operations to conduct monetary policy in the early 1980s. Measures included the introduction of the principal dealer system, issue of MGS with maturities of up to 10 years by auction through the principal dealers, and participation of selected finance companies in the interbank market.
 - Another channel is through interbank rates. Implicit in the action by the Central Bank to effect monetary changes is the assumption that interbank rates are an important signalling device to the market of monetary policy intentions.
 - Selective control of credit extension that are targeted at certain sectors
 - The imposition of selective exchange controls on capital flows including a pegged exchange rate, so that the central bank can focus on monetary policy to address macroeconomic issues.
- (c) (i) Monetary instruments used by BNM (choose **one**):

The Statutory Reserve Ratio (SRR)

BNM has used the SRR as a monetary instrument to conduct monetary policy. The SRR is one of the oldest monetary instruments deployed by BNM to control liquidity situation in the banking system. All banking institutions are required to maintain a certain percentage of their reserves with BNM. The SRR is defined in terms of a bank's eligible liabilities (EL) and it comprises deposits and net interbank borrowings. The SRR affects the level of deposits and loans that a bank can support given the size of its reserves. The SRR ratio will lower the level of reserves of the banks and as the impact of contraction of loans and vice-versa. The reserves earn no interest rates. This has the effect of passing the costs on to customers through higher rates of lending. The SRR also serves as a safety net for the protection of depositors.

The Liquidity Requirement (LR)

The LR is another important monetary tool of BNM. The ratio, which is akin to the SRR, is expressed as a percentage of the eligible liabilities base of the banking institutions. It operates in a similar manner as the SRR, that is, an increase in the LR will reduce the amount of deposits and loans a given supply of reserves can support and vice-versa.

Under the New Liquidity Framework, the compliance requirement is set equal to a specified percentage of the banking institutions deposit base. It incorporates the requirement that, for example, a commercial bank must be able to withstand the withdrawal of up to 5% of its deposit base over one week period or 7% of its deposit base over a month.

(ii) **The Statutory Reserve Ratio (SRR)**

Impact: Affects all sectors that borrow funds from the banking system. An increase in the SRR will tighten liquidity and increase the costs of funds to the banking institutions. This triggers fairly prompt adjustments in the lending rates across-the-board. The announcement effects of the SRR adjustments are very powerful in influencing the psychology of economic agents and market participants in making their economic decisions.

The Liquidity Requirement (LR)

Impact: An increase of the SRR ratio will provide less scope for a bank to liquidate its liquid assets to support an expansion of bank loans. It affects the provision of credit to desired areas such as the development of Government papers and Cagamas bonds. As a monetary instrument, it influences the liquidity situation in the banking system.

- (c) Intermediate targets are objectives for financial variables and include money supply and short-term interest rates and are required to assist the Central Bank to achieve its monetary policy goals. The effectiveness of the intermediate targets depends on several prerequisites of these targets, namely, the variable:
- must be measurable over time
 - controllable
 - predictable

Question 6

Although many candidates could answer this question well, they still lacked in providing consistent overall answers.

6. (a) The Asian financial crisis that erupted in Asia in mid-1997 led to sharp declines in the currencies, stock markets, and other asset prices of a number of Asian countries. It threatened these countries' financial systems and disrupted their real economies, with large contractions in activity that created a human crisis alongside the financial one.

The IMF is charged with safeguarding the stability of the international monetary system. As such, the IMF has a central role in resolving the Asian financial among others in these aspects:

- Helping Korea, Indonesia and Thailand to arrange programmes of economic stabilisation and reforms that would restore confidence and be supported by the IMF
- Intensifying its consultations with other members both within and outside the region that were affected by the crisis
- Approved in 1997 some SDR 26 billion or US\$35 billion of IMF financial support for reforms in Indonesia, Korea and Thailand

(b) **Fixed Exchange Rate System**

The exchange rates are set at levels determined and maintained by the government. The government would attempt to maintain the exchange rate of their country at a fixed rate or

within a narrow margin of a predetermined value, compared with other currencies. The Central Bank would intervene in the foreign exchange market to buy or sell foreign currencies in order to maintain the exchange rate at a predetermined rate. Under the fixed exchange rate system, the Central Bank would need to have sufficient amount of foreign reserves.

Floating Exchange Rate System

Under this regime, the Central Bank will allow the exchange rate to adjust to equate the supply and demand for foreign currencies. The Central Bank would simply stand aside and allow the exchange rate to adjust itself.

- (c) Countries will devalue their domestic currency as a policy instrument to improve a deteriorating balance of payments position. By devaluing, the domestic currency will be cheaper compared with foreign currencies. A foreigner will pay less for the devalued currency while the residents of the affected country will pay more for foreign currencies. The impact is the increase in prices tradable and thus, raises the prices and profitability of tradable relative to non-tradable. The adverse impact is reflected by increase in inflationary pressures in the economy. However, there could be an unfavourable impact on the trade balance termed as the “J-curve” phenomenon when the positive impact on trade balances occurred after a period of time.
- (d) (i) Short-term capital flows are basically volatile in nature. As such, short-term capital is not dependent upon to build up reserves of the country. Short-term capital flows or “hot money” reflects mainly external factors such as differentials; exchange rate speculations and the performance of the stock market. Short-term capital also responds to higher returns and expectations of an appreciation of the exchange rate. A reversal in interest rate trend in favour of international interest rates and an appreciation of the domestic currency can cause a reversal in movements of short-term capital.
- (ii) A balance of payments surplus position is recorded when:
- Both the current account and the capital account is in surplus; or
 - The deficit in the current account is more than financed by inflows in the capital account.
- (iii) Merchandise imports = -RM 20 million
Net unilateral transfers = +RM 20 million
Therefore, there is no change in the current account balance.