

DP01

Monetary Economics and the Malaysian Financial System

10 OCTOBER 2005

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) The international reserves of Bank Negara Malaysia (BNM) rose from RM170.4billion at the end of 2003 to RM253.5billion at the end of 2004.
- In your opinion, what could have contributed to the sharp rise in the international reserves during 2004? [5]
- (b) The stable macroeconomic conditions in 2004 allowed BNM to introduce a new interest rate framework called the overnight policy rate (OPR).
- Explain the rationale for the introduction of the OPR. [5]
- (c) Briefly explain the following:
- (i) Merdeka Savings Bond [3]
 - (ii) Repurchase agreements [3]
 - (iii) Statutory reserve requirement [3]
 - (iv) Bank Negara Bills [3]
- (d) State **five** major groups of non-bank financial institutions. [2½]
- (e) State **five** financial assets that can be deemed as liquid assets. [2½]
- (f) (i) (aa) Define capital market. [2]
- (bb) State **two** major functions of the capital market. [4]
- (ii) Differentiate between the primary market and the secondary market. [3]
- (g) Briefly explain the interbank market and state **four** instruments traded in the interbank market. [4]
- (Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) Explain the following terminologies as defined in the Banking and Financial Institutions Act 1989:
- (i) Banking business [5]
 - (ii) Merchant banking business [5]
- (b) Why are discount houses also called as “keepers of liquidity”? [5]
- (c) State the principal macroeconomic objective of Bank Negara Malaysia and its relationship with monetary policy. [5]
- (Total:20 marks)

3. (a) Briefly explain the following Islamic banking principles:
- (i) Al-Wadiah (safe-keeping with guarantee) [2]
 - (ii) Al-Mudharabah (profit sharing) [2]
 - (iii) Al-Musyarakah (joint venture) [2]
 - (iv) Al-Murabahah (cost-plus financing) [2]
 - (v) Al-Bai Bithaman Ajil (deferred sale) [2]
- (b) List **four** main objectives of Bank Negara Malaysia as stated in the Central Bank of Malaysia Act 1958. [4]
- (c) (i) What is monetary stability? [4]
- (ii) Why is monetary stability important? [2]
- (Total:20 marks)

4. (a) Explain the economic implications under the following conditions:
- (i) When there is high inflation. [5]
 - (ii) When there is deflation. [5]
 - (iii) When there is price stability. [5]
- (b) How does Bank Negara Malaysia's monetary policy affect the economy and the inflation rate? [5]
(Total:20 marks)
5. (a) State one reason why Bank Negara Malaysia (BNM) needs to manage the foreign exchange reserves. [2]
- (b) What is the main objective of Malaysia's exchange control policies? [2]
- (c) Why is financial stability important? [4]
- (d) State **four** laws enacted by the Government to enhance BNM's regulatory authority. [4]
- (e) Describe BNM's role as an economic adviser to the Government. [4]
- (f) List **four** functions of development financial institutions in the economic development of Malaysia. [4]
(Total:20 marks)
6. (a) Provide **two** main reasons why Malaysia needs to develop a more resilient, competitive and dynamic financial system. [6]
- (b) (i) What is a unit trust? [4]
- (ii) Why are unit trust schemes popular among small investors? [2]
- (c) Explain how the World Bank helps to reduce world poverty. [4]
- (d) What are **four** main functions of the International Monetary Fund? [4]
(Total:20 marks)

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 showed poor understanding of the concept of international reserves, the ways reserves are derived and its link with the balance of payment (BOP).
- They had poor knowledge on overnight policy rate (OPR) and that it is now the key rate used by Bank Negara Malaysia (BNM) to signal a change in monetary policy stance. They were also not able to state that a change in OPR would result in changes to other rates.
- Answers given by candidates on Merdeka Savings Bond, repurchase agreements and Bank Negara Bills lacked elaboration.
- Candidates were not aware of the difference between banking and non-banking institutions as candidates included commercial banks, finance companies and merchant banks as non-bank financial institutions.
- They showed poor understanding of the concept of liquidity.
- They were also not conscious that financial assets have different degree of liquidity from the very liquid to illiquid. The most liquid financial asset is cash.
- Candidates were not able to explain the interbank market.
- Understanding the BOP concept, the component of the BOP and its link with the national account or gross domestic product is important. There are two major accounts in BOP, namely the current account and the capital account. The current account is further divided into three sub-accounts, namely the merchandise trade (export and import), services and income. The capital account, meanwhile, consists of inflow and outflow of borrowings, foreign direct investment and portfolio account. Any changes in these components will result in the movement of the overall account, which is also reflected in the changes of the international reserves of BNM. In general, if the external sector is doing well, there could be more export than import. There is also a possibility that the country would receive more FDI and portfolio funds if the economy and its fundamentals are strong. This inevitably would result in a rise in external reserves as seen in 2004.
- Candidates are advised to update themselves with the changes in government policies, particularly those related to the banking industry, finance and monetary issues announced by BNM or the Government. Policy announcements would normally be reported by the media but if candidates need to track past initiatives, it could be found in the BNM website under the press or public announcement section.
- Candidates have to understand that capital market is more than share market. It also includes debt market, either private debt or public debt.

1. (a) The rise in external reserves primarily reflected the larger surplus in the overall balance of payments in 2004 on account of:
 - repatriation of export proceeds as reflected by surplus in the current account.
 - net inflow of foreign direct investment.
 - net inflow portfolio capital.
- (b) The objective for the introduction of a new interest rate framework is to strengthen monetary policy transmission mechanism and to promote a more efficient pricing by the financial system. Particularly, the framework was designed to enhance the effectiveness of monetary

policy by facilitating the transmission of changes in the policy rate – the overnight policy rate (OPR) – to the other market interest rates, such as deposit and lending rates, and ultimately, to key macroeconomic objectives. The OPR serves a dual role – as a signaling device to indicate the monetary policy stance and as a target rate for BNM’s day-to-day liquidity operations.

- (c) (i) Merdeka Savings Bond (MSB) is a special instrument launched by BNM to alleviate the effects of lower interest rate on certain segments of the society who depend on interest income from deposits, such as senior citizens and charitable groups. The MSB provides holders with a return of 5%, which is higher than the fixed deposit rates. MSB is issued at regular intervals in 2004 and 2005.
- (ii) Repurchase agreements (repo) is an agreement under which a seller of securities, such as Malaysian Government securities, undertakes to repurchase the paper from a buyer at a pre-determined 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.
- (iii) Statutory reserve requirement (SRR) is one of the most effective instruments of liquidity, monetary and credit control. SRR is measured as a percent of eligible liabilities, and earn no interest for the banking institutions. An increase in these reserves would effectively “lock in” with BNM a larger proportion of the resources of the banking institutions and, thus, limit their lending capacity. A decrease would raise the volume of resources available to the banking institutions for granting new credit.
- (iv) Bank Negara bills (BNBs) are short-term papers similar to the Treasury bills, which will be issued on an auction basis. It represents an additional money market instrument at the disposal of the BNM to influence the liquidity situation. It also provides the financial institutions with an alternative instrument other than the Tabs and Government securities to meet the legal requirements on their investment portfolio.
- (d) Non-bank financial institutions can be divided into five major groups consisting of:
- development finance institutions.
 - savings institutions.
 - provident and pension funds.
 - insurance companies.
 - a group of other financial intermediaries, comprising building societies, unit trusts and several special investment agencies; leasing companies, etc.
- (e) Any **five** of the financial assets that are deemed as liquid assets:
- Cash.
 - Clearing account balances with BNM.
 - Money at call with the discount houses.
 - Treasury bills.
 - Bank Negara bills.
 - Malaysian Government securities.
 - Government Investment Certificates.
 - Cagamas bonds.
- (f) (i) (aa) The capital market refers to the market in longer-term financial assets, comprising all public and private debt instruments with maturities exceeding one year, corporate stocks and shares (for which there is no fixed maturity period) and commodity futures.
- (bb) The main purposes of a capital market in the country are firstly to assist the process of economic development by mobilising medium and long-term funds for a wide cross-section of the population to finance the public

development programs and to fund private investment as well as assist the banking system in securitising their assets.

Secondly, the market promoted private enterprise by providing intermediary services to raised funds for corporate investment and expansion, and in changing the ownership structure of companies.

- (ii) Primary market refers to new issues of Government and corporate securities offered directly to the investors. Secondary market is where transactions in Malaysian Government securities are conducted mainly through the money market, while secondary market trading of corporate securities is carried out in the Bursa Malaysia.
- (g) Interbank market
An interbank market is a place where the lending and borrowing of short-term funds take place, and the market operating through discount houses, which accept call money and engage in the purchase and sale of money market papers.

Instruments traded in the interbank market.

Interbank market instruments include overnight and 7-day money, short-term deposits or loans of one to 12-month maturities, Malaysian Government securities (MGS), Treasury bills (TBs), negotiable instruments of deposits (NIDs), bankers' acceptances (BAs) and Cagamas notes.

PART B

Question 2

- Candidates did not know the functions or reasons for the existence of discount houses. Discount houses are the major players in the money market with specialised role.
- They could not link the macroeconomic objectives with the monetary policy.

- 2. (a) (i) Banking business is defined as “the business of receiving deposits on current account, deposit account, savings account or other similar account; paying or collecting cheques drawn by or paid in by customers; and provision of finance; or such other business as the Bank Negara Malaysia (BNM), with the approval of the Minister of Finance, may prescribe”.
- (ii) Merchant banking business is defined as “the business of receiving deposits on deposit account; and provision of finance; and the business of providing consultancy and advisory services relating to corporate and investment matters; or making or managing investments on behalf of any person; or such other business as the BNM, with the approval of the Minister of Finance, may prescribe.”
- (b) Discount houses are deemed as keepers of liquidity because they were established to specialise in short-term money market operations, by mobilising surplus short-term funds from financial institutions, business enterprises and statutory bodies in the money market for investment in Malaysia Treasury bills, Malaysian Government securities (MGS), bankers acceptances (BA's), negotiable instrument of deposits, Cagamas bonds and floating rate NIDs.
- (c) The principal objective of the BNM is to promote monetary stability and a sound financial system. The BNM therefore plays a key role in the formulation of overall macroeconomic policy, the final objectives of which are price stability, strong sustainable output growth, a low level of unemployment, and a satisfactory balance of payments position. The conduct of monetary policy in Malaysia, a task assigned to the BNM is primarily to regulate the supply of money in circulation and the credit supplied to the economy. The instruments that can be deployed by BNM to implement its monetary policy and to achieve its macroeconomic objectives can generally be grouped into two broad categories: general instruments and selective instruments of monetary control.

Question 3

- Candidates were unable to differentiate between monetary stability and financial stability.
- Monetary stability is related to the stability of the local currency, its effect on prices, inflation and etc. Financial stability is more towards the stability of the financial system and institutions.

3. (a) (i) Al-Wadiah (safe-keeping with guarantee)
Refers to goods or deposits, which have been deposited with another person, who is not the owner, for safe-keeping. As wadiah is a trust, the depository becomes the guarantor and, therefore guarantees repayment of the whole amount of the deposits, or any part thereof, outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits but the depository may provide returns to the depositors as a token of appreciation.
- (ii) Al-Mudharabah (profit sharing)
Refers to an agreement made between a capital provider and another party (entrepreneur), to enable the entrepreneur to carry out business projects, based on a profit sharing basis, of a pre-agreed ratio. In the case of losses, the losses are borne by the provider of the funds.
- (iii) Al-Musyarakah (joint venture)
Refers to a partnership or joint venture for a specific business, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation.
- (iv) Al-Murabahah (cost-plus financing)
Refers to the sale of goods at a price, which includes a profit margin as agreed to by both parties. Such sales contract is valid on the condition that the price, other costs and the profit margin of the seller are stated at the time of the agreement of sale.
- (v) Al-Bai Bithaman Ajil (deferred sale)
Refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties.
- (b) Four main objectives of Bank Negara Malaysia (BNM) as prescribed in the Central Bank of Malaysia Act 1958:
- To promote monetary stability and a sound financial structure.
 - To act as a banker and financial adviser to the Government.
 - To issue currency and keep reserves safeguarding the value of the currency.
 - To influence the credit situation to the advantage of the country.
- (c) (i) Monetary stability refers to the stability of the value of the Malaysian currency, the ringgit. The best way to preserve the value of ringgit is by ensuring price stability, that is, to ensure that inflation in the country remains low and stable. By maintaining monetary stability through appropriate changes in monetary policy, BNM ensures that inflation is kept low and that the purchasing power of the ringgit is not diminished.
- (ii) Monetary stability is important because when there is monetary instability, prices are either rising (inflation) or falling (deflation) and this can result in distortions and undermine the long-term economic growth prospects of the country.

Question 4

- Candidates were unable to state the economic implication of deflation and price stability.
- They did not highlight on the use of interest rate in relation to monetary policy.

4. (a) The economic implications under the following conditions:

- (i) When there is high inflation
If inflation is too high, people will be concerned about the purchasing power of their money balances. This would result in a greater demand for real assets like houses and properties, which are thought to be more “inflation-proof”. There would be less interest to invest in productive capacity of the economy. Similarly, savers would be less inclined to hold savings in the financial system if they expect that the value of their savings would be diminished. Fixed income earners will find that they are able to buy less goods and services and will experience a reduction in their standard of living. High inflation would also make exports more expensive to foreigners and this would reduce the competitiveness of the exports. Persistently high inflation would therefore reduce the growth potential of the economy.
- (ii) When there is deflation
Similarly, when the rate of inflation is negative, prices are falling and businesses find their profits shrinking. They may reduce their costs by cutting expenditure and laying off staff. Workers in turn would have less money to spend and thus reduce spending, resulting in a further reduction in the demand for goods and services. This creates a vicious circle of falling prices and contracting demand resulting in a contraction in the level of overall economic activity.
- (iii) When there is price stability
When there is price stability, the future value of savings and the future returns on investments are preserved. This gives savers the incentive to save while investors have greater confidence to undertake productive activities. Increased investment leads to an increase in the productive capacity of the economy and increased economic activity leads to new job creation. Therefore, by maintaining monetary or price stability, it creates a conducive environment that allows the economy to expand in a sustainable manner at close to its potential.
- (b) Bank Negara Malaysia (BNM) has a number of monetary instruments at its disposal to inject and withdraw funds to influence the level of interest rates in the financial system. Changes in interest rates will ultimately affect consumer and investor decision to save, invest or consume (aggregate demand), as well as the price level. Examples of these instruments would include the purchase and sale of BNM and Malaysian Government papers, changes in the statutory reserve requirements and direct lending and borrowing in the interbank market.

Question 5

- Candidates had poor knowledge on the concept and link between foreign exchange reserves and exchange rate.
- They mentioned about the dismantled exchange control and pegging system, instead of stating the main objective of exchange control policies.
- Candidates could not differentiate between financial stability and monetary stability.

5. (a) Bank Negara Malaysia (BNM) manages the foreign exchange reserves of the country to ensure that Malaysia is able to meet its international obligations, thereby cushioning any temporary shifts in inflows and outflows in Malaysia’s balance of payments and thus promoting a stable and fundamentally sound ringgit exchange rate. A strong foreign exchange reserve position would also enhance investor confidence towards the country.
- (b) The exchange control policies in Malaysia are directed at ensuring the stability of the ringgit as well as encouraging the use of the country’s financial resources for productive purposes. There is generally free movement of funds into and out of the country subject to certain prudential regulations administered by BNM under the Exchange Control Act 1953.
- (c) Financial stability is important because it creates a conducive environment for businesses to undertake their activities and for savers and investors to enter into short-term or long-term

contracts. As the financial sector has a central role in promoting economic growth, it is important that the financial system is strong, resilient and efficient in mobilising savings and undertaking lending activities. It is vital that this intermediation process continues uninterrupted even in periods of economic difficulties.

- (d) Any four laws that enhance BNM's regulatory authority over the financial system:
- Banking and Financial Institutions Act in 1989.
 - Insurance Act in 1996.
 - Islamic Banking Act 1983.
 - The Exchange Control Act 1953.
 - The Central Bank of Malaysia Act 1958.
- (e) In its role as the economic adviser to the Government, BNM analyses and assesses the developments in the international and domestic economy and highlights the areas that need to be addressed. BNM undertakes economic intelligence and surveillance and carries out forecasts on the economic condition of the country. Based on these assessments, BNM presents policy recommendations at regular briefings to the Minister of Finance as well as at various economic policy making forums at the national level.
- (f) Any four functions of development finance institutions:
- Extension of financial assistance in the form of medium and long-term loans.
 - Participation in equity capital.
 - Underwriting and, wherever relevant, acting as issuing house for public shares issues.
 - Provision of guarantees for loans.
 - Identification of new projects, participation in promotion and, wherever appropriate, provide ancillary financial, technical and managerial advice.

Question 6

- Candidates were unable to highlight the challenges facing our country and the financial system.
- They also had poor knowledge on the World Bank and International Monetary Fund.

6. (a) Two main reasons for Malaysia to develop a more resilient, competitive and dynamic financial system are:
- to ensure international competitiveness arising from global forces and competition
Global forces at work and advances in technology have redefined the rules of the game and transformed the operational environment within which financial institutions operate. Indeed, the ability to reap the benefits arising from greater competition depends largely on the capability and capacity of financial institutions to adapt swiftly and to embrace the changes while at the same time remain internationally competitive.
 - to support economic development by meeting the financing needs of the economy
The rapid pace of economic development and transformation that creates new demands as well as opportunities for businesses have also called for a more effective and efficient provision of financial services. It is envisaged that Malaysia's economy will continue to expand significantly and becoming more internationally integrated and dynamic (with more high-tech services, with greater reliance on small and medium-sized industries and with increasingly rapid rate of innovation) and with more differentiated and demanding consumers.
- (b) (i) A unit trust is a form of collective investment that allows investors with similar investment objectives to pool their funds to be invested in a portfolio of securities or other assets. A professional fund manager then invests the pooled funds in a portfolio which may include cash, bonds and deposits, shares, property or commodities. Unit holders do not purchase the securities in the portfolio directly.

Ownership of the fund is divided into units of entitlement. As the fund increases or decreases in value, the value of each unit increases or decreases accordingly. Each investor of the fund receives a certificate of entitlement, known as a unit trust certificate. The number of units held depends on the unit purchase price at the time of investment and the amount of money invested. The return on investment of unit holders is usually in the form of income distribution and capital appreciation, derived from the pool of assets supporting the unit trust fund. Each unit earns an equal return, determined by the level of distribution and/or capital appreciation in any one period.

- (ii) Unit trusts are popular among small investors, who neither have the time nor the inclination to hold portfolios of direct investments or shares, because they can invest in small amount in a secure, reputable investment vehicle which suits their purposes. Unit trusts also allows investors to have easy access to a wide range of investment exposures not normally available to them.

- (c) The World Bank's main objective is to fight poverty and improve the living standards of people in the developing world. It is a development bank which provides loans, policy advice, technical assistance and knowledge sharing services to low and middle income countries to reduce poverty. The Bank promotes growth to create jobs and to empower poor people to take advantage of these opportunities. The World Bank also works to bridge this division and turn rich country resources into poor country growth. One of the world's largest sources of development assistance, the World Bank supports the efforts of developing countries to build schools and health centers, provide water and electricity, fight disease, and protect the environment.

- (d) The International Monetary Fund (IMF) is an international organisation of 184 member countries. It was established to promote international monetary co-operation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment. Since the IMF was established, its purposes have remained unchanged but its operations – which involve surveillance, financial assistance, and technical assistance – have developed to meet the changing needs of its member countries in an evolving world economy.