

DP01

# Monetary Economics and the Malaysian Financial System

9 APRIL 2007

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) State **three** macroeconomic objectives of Bank Negara Malaysia (BNM). [3]
- (b) State **two** categories of monetary policy instruments that can be used by BNM to achieve its macroeconomic objectives. [2]
- (c) Describe how monetary policy can be used to make Malaysia competitive internationally. [5]
- (d) Differentiate between BNM's role as an economic adviser and a financial adviser to the Government. [5]
- (e) (i) What is the rationale for the introduction of overnight policy rate (OPR) by BNM? [2]  
(ii) What is the role of OPR? [3]
- (f) Define financial stability and explain its importance. [5]
- (g) Define gross domestic product and explain how it is calculated. [5]
- (h) Explain the negative impact of high inflation on savers and fixed income earners. [5]
- (i) State **two** main reasons why Malaysia needs to develop a more resilient, competitive and dynamic financial system. [5]

(Total:40 marks)

## PART B

### ANSWER THREE (3) QUESTIONS ONLY

2. (a) Explain the impact of globalisation on the financial markets. [6]
- (b) Describe the financial activities conducted at the International Offshore Financial Centre in Labuan. [6]
- (c) Explain how the World Bank helps to reduce world poverty. [5]
- (d) What are **three** main functions of the International Monetary Fund? [3]

(Total:20 marks)

3. (a) Define monetary policy and state the situation when contractionary or expansionary stance is warranted. [5]
- (b) What is Monetary Policy Statement and why was it introduced by Bank Negara Malaysia? [5]
- (c) Define monetary stability and explain its importance. [5]
- (d) (i) Explain the rationale for the integration of merchant banks, stock broking companies and discount houses into investment banks. [3]  
(ii) What is the scope of activities offered by the investment banks? [2]

(Total:20 marks)

4. (a) Briefly explain the following Islamic banking principles:
- (i) Al-Mudharabah (profit sharing) [2½]
  - (ii) Al-Musyarakah (joint venture) [2½]
- (b) State **four** main functions of Bank Simpanan Nasional. [4]
- (c) What are development financial institutions? [5]
- (d) (i) What is a unit trust? [3]
- (ii) Why are unit trust schemes widely accepted among small investors? [3]
- (Total:20 marks)
5. Briefly describe the objectives of the following legislation administered by Bank Negara Malaysia:
- (a) Central Bank of Malaysia Act 1958 (Revised 1994) [4]
  - (b) Banking and Financial Institutions Act 1989 [4]
  - (c) Islamic Banking Act 1983 [4]
  - (d) Development Financial Institutions Act 2002 [4]
  - (e) Anti-Money Laundering Act 2001 [4]
- (Total:20 marks)
6. (a) Briefly explain the following financial instruments:
- (i) Merdeka savings bonds [2]
  - (ii) Repurchase agreements [2]
  - (iii) Government investment issues [2]
  - (iv) Bank Negara bills [2]
- (b) Briefly explain the following financial markets:
- (i) Money market [4]
  - (ii) Foreign exchange market [4]
  - (iii) Primary market [2]
  - (iv) Secondary market [2]
- (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' strength was in the areas of central banking and monetary policy.
- Brief answers were given by candidates for the question on the need to develop a more competitive financial system. They were unable to explain the differences between the roles of Bank Negara Malaysia. Candidates had poor knowledge on financial stability. Answers for the way gross domestic product was calculated were short and not concise.
- Candidates must be able to explain and answer satisfactorily the issues or topics examined.

1. (a) The principal objective of Bank Negara Malaysia (BNM) is to promote monetary stability and a sound financial system. BNM therefore plays a key role in the formulation of the overall monetary policy, the principal macroeconomic objectives of which are (any three):
  - maintain price stability;
  - promote strong sustainable output growth;
  - ensure a low level of unemployment; and
  - achieve a satisfactory balance of payments position.
- (b) Monetary policy through the management and adjustment of money supply, bank credit, interest rate and liquidity can be used by BNM to achieve its macroeconomic objectives. The instruments that can be deployed by BNM to implement its monetary policy can generally be categorised into two broad categories:
  - general instruments (like statutory reserve requirements, open market operation, purchase/sale of government securities); and
  - selective instruments (like lending guidelines for certain sectors).
- (c) Malaysia is one of the most open economies in the world. This means that the performance of the Malaysian economy is significantly influenced by developments outside its borders. The economic performance of Malaysia's trading partners would affect the demand for Malaysia's exports. By maintaining a low inflation rate relative to our trading partners, monetary policy contributes to making Malaysia competitive internationally. High inflation on the other hand would make exports more expensive to foreigners and this would reduce the competitiveness of the exports. Persistently high inflation would also reduce the growth potential of the economy.
- (d) As an economic and financial 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. BNM does not provide financing to the Government.

As the financial adviser to the Government, BNM gives regular advice to the Government on the management of its domestic and external debts and the terms and timing of Government loan programs. BNM also act as the agent for the Government in negotiations and concluding of loan agreements. BNM is also responsible for trading, registering, settlement and redemption of Government securities through its computerised systems.

- (e) (i) The OPR was designed to enhance the effectiveness of monetary policy by facilitating the transmission of changes in the policy rate to the other market rates and ultimately, to key macroeconomic objectives. This is achieved by adopting a policy rate that is closely related to other interest rates and through appropriate changes in the monetary operating procedures. It was also designed to achieve greater efficiency in the operation of the financial markets and hence, facilitate more effective and efficient pricing of financial products.
- (ii) The overnight policy rate (OPR) is the indicator of the monetary policy stance and has 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 BNM.

Any change in the monetary policy stance would be signalled by a change in the OPR. It serves as the primary reference rate in determining other market rates.

- (f) Financial stability refers to an environment where institutions in a financial system are strong and can continue to meet their contractual obligations without interruption or without any external assistance. Market participants can also confidently enter into transactions at prices that do not change substantially over short periods when there has not been any change in market fundamentals.

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.

- (g) Gross domestic product (GDP) is defined as the total market value of goods and services produced by a country after deducting the cost of goods and services used up in the process of production (intermediate goods), but before deducting allowances for consumption of fixed capital (depreciation).

GDP can be calculated in three ways:

- the production approach, which involves totaling the value added by each enterprise in the economy;
  - the income approach, which involves summing factor incomes (gross returns to labor and capital), depreciation and net indirect taxes; and
  - the expenditure approach, which involves the total of final domestic expenditures plus expenditures by foreign residents on Malaysian produced goods and services (exports) minus expenditures by Malaysian residents on foreign-produced goods and services (imports).
- (h) 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.

- (i) Malaysia needs to develop a more resilient, competitive and dynamic financial system on account of the following factors:

- Global forces and competition whereby advances in technology have redefined the rules of the game and transformed the operational environment within which financial institutions operate. The ability of the financial system to survive from greater competition depends largely on their capability and capacity to adapt swiftly and to embrace the changes.
- The rapid pace of economic development and transformation will create new consumer demands as well as opportunities for businesses. As such, financial institutions must provide a more effective and efficient financial services to cater to consumer and business needs.

## PART B

### Question 2

- Candidates displayed poor understanding on topics that are more global in nature such as the topics examined in this question.
- Global issues in particular with respect to the Malaysian financial system are becoming more important. In answering such questions, candidates are advised that, while studying from the textbook, they must also update themselves with the latest developments, which can be obtained from current publications or materials.

2. (a) Globalisation process along with improvements in ICT has resulted in a massive increase in global capital flows, rapid expansion of financial markets (currency market in particular) and increased cross border investment flows. Increased activity by the global funds management industry and speculative activity by international hedge funds is a classic example of the impact of globalisation on the financial markets. Not only have financial markets grown, but they have become more interrelated and could result in greater instability. At a fundamental level, the movement towards freed trade has caused economies to become more open, in the process both exporting and importing more. This has increased the international interrelationship between economic growth and inflation.
- (b) The offshore market is another feature of the financial landscape of Malaysia. The Labuan International Offshore Financial Centre (IOFC) was established in October 1990. It is important to note that the offshore market deals in non-ringgit transactions and with non-residents only. The IOFC is aimed at enhancing the attractiveness of Malaysia as the regional financial centre as well as promoting the economic development of Labuan and its vicinity. The offshore products include:
  - offshore banking operations;
  - offshore insurance and offshore insurance-related activities;
  - corporate funding;
  - investment and fund management;
  - offshore investment holding companies;
  - professional services and other related services.
- (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 divide 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 country governments 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 primarily:
- (i) to promote international monetary cooperation, exchange stability, and orderly exchange arrangements;
  - (ii) to foster economic growth and high levels of employment;
  - (iii) 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.

### Question 3

- Candidates' strength was on Monetary Policy Statement.
- Candidates showed poor understanding of the rationale of the integration and the scope of activities offered by investment bank.
- Candidates need to refer to the recent years' annual report of Bank Negara Malaysia or their press statement on the subject matter. Candidates would be able to track and understand the rationale for the integration of merchant banks, stock broking companies and discount houses into investment banks.

3. (a) Monetary policy is the process by which the monetary authority manages the money supply to achieve specific goals – such as constraining inflation, maintaining an exchange rate, achieving full employment or economic growth. Usually, the goal of monetary policy is to accommodate economic growth in an environment of stable prices. Monetary policy can involve changing certain interest rates, either directly or indirectly through open market operations, setting reserve requirements, acting as a last-resort lender (i.e. discount window lending), or trading in foreign exchange markets.

Monetary policy is generally referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to combat inflation (or cool an otherwise overheated economy).

- (b) Monetary Policy Statement (MPS) is a forward looking statement, outlining the monetary policy stance of BNM in the near term and the rationale for the policy trust. Any change in the OPR will be announced in MPS.

MPS is part of the overall strategy to provide greater understanding of the monetary policy objectives and measures in light of a more complex and dynamic environment. In particular, it would help anchor expectations on growth and inflation. Signaling the BNM's policy intent through direct communication is aimed at increasing the understanding and appreciation of money market participants, and thereby, facilitating a more rapid transmission of the policy rate in the pricing of credit and longer-term rates, and thus enhance the overall efficiency of the monetary transmission mechanism.

- (c) Monetary stability refers to the stability of the value of the ringgit. The best way to ensure that the value of the ringgit is preserved 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. 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.

- (d) (i) The integration exercise is aimed at:
- strengthening the capacity and capabilities of domestic banking groups to contribute towards economic transformation and developing a more resilient, competitive and dynamic financial system to face the challenges of liberalisation and globalisation;
  - enhancing their efficiency and effectiveness by minimising duplication of resources and overlapping of activities, leveraging on common infrastructure and reaping benefits of synergies and economies of scale.
  - strengthening their potential to capitalise on business opportunities, increase their competitive advantage and leverage on a larger capital base to support their expanded range of activities. Customers will also benefit from wider access to financial services at more cost-effective prices.
- (ii) Investment banks will retain all activities based on the types of licenses they held prior to the rationalisation. Investment banks will therefore continue to accept wholesale deposits, conduct lending activities to complement their fee based activities and provide a wide array of investment banking activities which include, amongst others, financial advisory, underwriting, portfolio management and equity brokerage services.

#### **Question 4**

Candidates are generally aware of the main Islamic banking principles, role of Bank Simpanan Nasional and the structure of a unit trust.

4. (a) (i) Al-Mudharabah is an arrangement or agreement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilise funds for its business activities. Any profits made will be shared between the capital provider and the entrepreneur according to an agreed ratio while losses are borne solely by the capital provider.
- (ii) Al-Musyarakah is normally applied for business partnerships or joint ventures. The profits made are shared on an agreed ratio while losses incurred, will be divided based on the equity participation ratio.
- (b) The four main functions of the Bank Simpanan Nasional are to:
- promote and mobilise savings, particularly from the small savers and to inculcate the habit of thrift and savings;
  - provide the means for savings by the general public;
  - utilise the funds of the Bank for investment including financing of economic development of the nation; and
  - promote the interest of its depositors and other customers.
- (c) Development financial institutions (DFIs) was established by the Government to promote development programs in the agricultural, industrial and international trade and export sectors, the DFIs continued to play a complementary role to the banking institutions in the intermediation process. They maintained their role as niche providers of specialist capital financing for projects which required 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.
- (d) (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.

- (ii) Unit trusts are widely accepted 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 allow investors to have easy access to a wide range of investment exposures not normally available to them.

**Question 5**

- Candidates had superficial understanding of the various Acts examined.
- Candidates need to be precise and explain the answers in detail. They have to explain why the individual act was formulated. The Bank Negara Malaysia website provides a comprehensive review of all the acts under their administration.

5. (a) The Central Bank of Malaysia Act 1958 (Revised 1994) provides for the administration, objectives of the Central Bank. It also enumerates the powers and the duties of the Central Bank in relation to issuance of currency, maintenance of external reserve, authorised business of the bank, specific powers to deal with ailing institutions, its relationship with the Government and financial institutions. The Act also contains general provisions on the Bank's accounts, powers to compound, etc.
- (b) The Banking and Financial Institutions Act 1989 (BAFIA) came into force on October 1, 1989 provides for the licensing and regulation of institutions carrying on banking, finance company, merchant banking, discount house and money-broking businesses. It also provides for the regulation of institutions carrying on scheduled business comprising non-bank sources of credit and finance, such as credit and charge card companies, building societies, factoring, leasing companies and development finance institutions. Non-scheduled institutions which are engaged in the provision of finance may be subject to Part X and XI of the BAFIA as the Minister of Finance may decide.
- (c) Islamic Banking Act 1983, a legislation to provide for the licensing and regulation of Islamic banking business. The Act inter alia has provisions on the financial requirements and duties of an Islamic bank, ownership, control and management of Islamic banks, restrictions on its business, powers of supervision and control over Islamic bank and other general provisions such as penalties etc.
- (d) The Development Financial Institutions Act 2002, which came into force on 15 February 2002 focuses on promoting the development of effective and efficient development financial institutions (DFIs) to ensure that the roles, objectives and activities of the DFIs are consistent with the Government policies and that the mandated roles are effectively and efficiently implemented. DFIA also emphasises on efficient management and effective corporate governance provides a comprehensive supervision mechanism and mechanism to strengthen the financial position of DFIs through the specification of prudential requirements.
- (e) The Anti-Money Laundering Act 2001, which came into force on 15 January 2002 criminalises money laundering of proceeds from the predicate offences and provides for suspicious transaction reporting, record-keeping and the functions of a financial intelligence unit that could co-operate with domestic as well as foreign enforcement agencies. In this respect, the Minister of Finance has appointed BNM as the competent authority to carry out the functions of the financial intelligence unit. The law also provides for investigation into money laundering activities, law enforcement agencies to freeze, seize and forfeit proceeds from predicate offences as well as prosecution of money launderers.

### Question 6

- Candidates had good understanding of the main financial markets and securities.
- Candidates had poor knowledge on financial instruments.

6. (a) (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 5.00%, which is higher than the fixed deposit rates.
- (ii) A 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
- (iv) Government investment issues (GII) are non-interest bearing certificates issued by the Government to enable participants of the Islamic banking system to hold first class liquid assets instruments to meet the statutory liquidity requirements as well as for investment. The issuance of GII is based on the Shariah contract of Qardh Hasan (benevolent loan). Under this contract, the purchase of GII by any institution or individuals will be considered as a benevolent loan to the Government to undertake developmental projects for the benefit of the nation.
- (iv) Bank Negara bills (BNBs) are short-term paper 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.
- (b) (i) Money market brings together individuals and institutions with temporary surpluses of funds and those with temporary shortages of funds. By convention, a security or loan with a maturity of one year or less is referred to as a short-term security. Money market hence deals in short-term deposits (such as overnight money, weekend, 7 days, 1 month, 3 months etc.) and is not a physical market, as money market activity is handled by telephone, telex, or fax and on computer screens. Money market also trades Treasury Bills (TB), bankers acceptance (BA), negotiable instruments of deposit (NID), Government Investment Certificates (GIC), Cagamas notes and floating rate NID (or FRNID). Apart from Government and financial institutions, short-term debt is also issued by corporations such as revolving underwritten facility (RUF) and notes issuance facility (NIF).
- (ii) The foreign exchange market is essentially a wholesale interbank market for the sale and purchase of foreign currencies including purchases by importers to pay for their imports and sale of ringgit by exporters arising from receipt of export proceeds. Except for travelers, who can transact in foreign currency notes and coins through money changers, all foreign exchange dealings have to be conducted through institutions authorised under the Exchange Control Act 1953. These comprised the commercial banks and Islamic banks, and to a limited extent of merchant banks. The commercial banks however are the main players, participating as intermediaries for their corporate customers, exporters, importers as well as participating in their own account.
- (iii) Primary market refers to new issues of Government and corporate securities offered directly to the investors.
- (iv) Secondary market is where transactions in Malaysian Government securities are conducted mainly through the money market. Secondary market trading of corporate securities is carried out in the Bursa Malaysia.