DP01

Monetary Economics and the Malaysian Financial System

3 SEPTEMBER 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) Explain why does a country need a resilient, competitive and dynamic financial system. [5]

(b) Describe the functions of the following financial institutions:

(i) Bank Negara Malaysia (BNM) [3]

(ii) Malaysian Industrial Development Finance Berhad [3]

(c) What are **four** important roles played by the Labuan Offshore Financial Services Authority? [4]

(d) Explain the functions of the following institutions:

(i) World Bank [4]

(ii) International Monetary Fund [4]

(e) For each of the following Acts, explain the main provisions:

(i) Central Bank of Malaysia Act 1958 (Revised 1994) [3]

(ii) Banking and Financial Institutions Act 1989 [3]

(f) Describe the present interest rate framework of BNM. [5]

(g) 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]

(Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) Briefly explain the money market and the interbank market. Your answer should include the participants and instruments traded in each of these markets. [5]

(b) Briefly describe the foreign exchange market, its activities and players. [5]

(c) (i) What are the major services offered by commercial banks? [3]

(ii) Provide **two** reasons why commercial banks are considered an important financial institution in the financial industry. [2]

(d) Define venture capital and explain its importance. [5]

(Total:20 marks)

3. (a) Explain the principal macroeconomic objective of the monetary policy and the instruments that can be deployed by Bank Negara Malaysia to implement its monetary policy. [5]

(b) (i) What is a unit trust? [4]

(ii) Why are unit trust schemes popular among small investors? [2]

(c) Describe **three** main objectives of the National Syariah Advisory Council. [3]

(d) Define inflation and explain why it can be a concern. [6]

(Total:20 marks)

4. (a) (i) Define financial stability and explain its importance. [5]

(ii) How can financial stability be achieved? [5]

(b) Explain the balance of payments concept by highlighting its major components. [5]

(c) Explain why a country needs to maintain a strong external reserve position. [5]

(Total:20 marks)

5. (a) (i) What is Monetary Policy Statement (MPS)? [3]

(ii) Why was MPS introduced by Bank Negara Malaysia? [3]

(b) "An economy is very complex and consists of a number of activities, each owning, producing or purchasing the resources, goods and services flowing through the system."

List **five** sectors related to the activities mentioned above. [5]

(c) List **three** main components of the Islamic financial system and explain the role played by each of these components. [9]

(Total:20 marks)

6. (a) Using a schematic diagram, explain the following:

(i) How does Bank Negara Malaysia's (BNM's) monetary policy affect inflation and the economy? [5]

(ii) How does BNM stimulate the economy? [5]

(iii) How does BNM constrain the economy? [5]

(b) State **five** factors that affect the exchange rate of Malaysia. [5]

(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

- Generally, candidates were aware of globalisation forces, competition, trade liberalisation and ICT issues that require financial institutions to adapt and embrace changes.

- In relation to developing a resilient, competitive and dynamic financial system, some candidates were unable to highlight the demand by individuals and businesses for a more effective and efficient provision of financial services.

- Candidates gave inadequate and unsatisfactory answers in relation to the Labuan Offshore Financial Services Authority (LOFSA). To be able to answer this question satisfactorily, candidates must also understand LOFSA's roles and activities.

- Candidates were unable to state the functions of the World Bank and International Monetary Fund (IMF). Candidates must always remember that the World Bank's main objective is to fight poverty and improve the living standards of people in the developing world. The IMF, on the other hand, promotes international monetary cooperation, exchange stability for economic growth and employment.

- In relation to the Central Bank of Malaysia Act 1958, quite a number of candidates incorrectly cited the macroeconomic objectives of Bank Negara Malaysia (BNM). Candidates must cite the main or broad provisions of the Acts.

- Candidates wrote on the old interest rate framework based on the 3-month KLIBOR, instead of describing the present interest rate framework. Candidates are advised to check the BNM website or annual reports for announcements on the new interest rate framework – the mechanism and rationale for its introduction.

1. (a) **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.

Economic development and consumer demand – The rapid pace of economic development and transformation that creates new demands as well as opportunities for businesses has also called for more effective and efficient provision of financial services. It is envisaged that Malaysia's economy will continue to expand significantly, becoming more internationally integrated and dynamic (with more high-tech services, greater reliance on small and medium-sized industries and with an increasingly rapid rate of innovation) and with more differentiated and demanding consumers.

(b) (i) **Bank Negara Malaysia**

- issues currency and keep reserves safeguarding the value of the currency;
- acts as a banker and financial adviser to the Government;
- promotes monetary stability and a sound financial structure; and influences the credit situation to the advantage of the country.

(ii) **Malaysian Industrial Development Finance Berhad (MIDF)**

MIDF was established to promote the development of the manufacturing industry in Malaysia through the provision of medium and long-term loans for financing new fixed assets for new industrial ventures as well as existing enterprises undertaking modernisation and/or expansion.

(c) **Roles of the Labuan Offshore Financial Services Authority (LOFSA)**

- To supervise the activities and operation of the offshore financial services industry in Labuan.
- To process applications to conduct business in the Labuan IOFC, specifically in offshore banking, offshore insurance and insurance related business, offshore trust and fund management and in incorporating and registration of offshore companies.
- To set up Labuan trust companies.
- To administer and enforce offshore financial services legislation and work together with the offshore players in Labuan to promote offshore financial services.

(d) (i) **The World Bank**

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 World Bank promotes growth to create jobs and to empower poor people to take advantage of these opportunities. It also works to bridge the rich- poor divide and channel the rich countries' resources to poor countries. It is one of the world's largest sources of development assistance. The World Bank supports the efforts of developing countries to build schools and health centres, provide water and electricity, fight disease and protect the environment.

(ii) **The International Monetary Fund (IMF)** is an international organisation of 184 member countries. It was established to promote international monetary cooperation, 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. The IMF's purposes have remained unchanged since its establishment, but its operations - which involve surveillance and financial and technical assistance - have developed to meet its member countries' changing needs in an evolving world economy.

(e) (i) **The Central Bank of Malaysia Act 1958 (Revised 1994)** provides for the Central Bank's administration and objectives. It also enumerates the Central Bank's powers and duties in relation to issuance of currency, maintenance of external reserves, authorised bank business, specific powers to deal with ailing institutions and its relationship with the Government and financial institutions. The Act also contains general provisions on the bank's accounts, powers to compound, etc.

(ii) **The Banking and Financial Institutions Act 1989,** which came into force on 1 October 1989, provides for the licensing and regulation of institutions carrying on banking, finance company, merchant banking, and 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.

(f) **The present interest rate framework** was introduced to enhance the effectiveness of the monetary policy transmission mechanism, and, secondly, to promote more efficient pricing by banking institutions. The present framework is also designed to enhance the effectiveness of monetary policy by facilitating the transmission of changes in the policy rate to other market rates and, ultimately, to key macroeconomic objectives. This is achieved by adopting the overnight policy rate (OPR), a policy rate closely related to other interest rates and through appropriate monetary operating procedure changes. The OPR is now the main monetary policy stance indicator.

(g) (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 deposit, 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.

PART B

Question 2

- Candidates were good in the area of commercial banking.
- Candidates were unable to describe the money market and the interbank market.
- Candidates could not highlight the money market instruments.
- Candidates gave shallow answers that lacked substance for the foreign exchange market and venture capital. Candidates must understand the specific roles of each component of the financial markets and new financing instruments such as those offered by venture capital.

2. (a) The money market is a market where the lending and borrowing of short-term funds take place. It operates through discount houses, which accept call money and engage in the purchase and sale of money market papers. The money market instruments include overnight and 7-day money, short-term deposits or loans of one to 12-month maturities, Malaysian Government Securities, Treasury Bills, Negotiable Instruments of Deposit (NIDs), bankers acceptances (BAs) and Cagamas bonds. The NIDs and BAs are the two most heavily transacted instruments.

The largest component of the money market is the interbank market representing transactions among commercial banks, merchant banks and selected finance companies. Transactions are mainly in the form of interbank deposits and loans due to the limited range of money market papers. A large part of the secondary market transactions are in money market papers and in the form of repurchase agreements, because these transactions can be for very short as well as odd periods, thereby providing flexibility to change the maturity structure of assets and liabilities.

(b) In Malaysia, all dealings in foreign exchange are required to be conducted through licensed money changers or authorised dealers under the Exchange Control Act 1953. The authorised dealers are commercial banks including Bureau De Change outlets and Islamic banks. As in the money market, transactions in foreign exchange among authorised dealers (largely commercial banks) form the core of the foreign exchange market. Exchange transactions are undertaken on both spot and forward basis.

The commercial banks' main customers are the traders in the export and import business including corporations remitting profits or dividends abroad, businessmen making overseas payments for services rendered by enterprises, payments by travelers, and remittances to support overseas education.

(c) (i) Commercial banks are the largest group of financial institutions in Malaysia. The range of transaction accounts commercial banks typically offer are savings accounts, current accounts, fixed deposits and negotiable instrument of deposits. They also provide facilities for making payments or monetary transfers in domestic or foreign currencies, both locally and internationally. In addition to collecting deposits and making payments from or to the public, commercial banks provide loans in the form of overdrafts, revolving credit, term loans and advances, bridging finance, trade bills, bankers acceptances for working capital, trade finance and capital expenditure.

(ii) Although there are other types of financial institutions and intermediaries, commercial banks are usually considered the most important for two reasons. Firstly, while commercial banks are deposit takers and loan providers, just like other financial institutions, they are thus far the only institutions authorised to offer current accounts or demand deposits which provide chequeing facilities. Secondly, unlike other financial intermediaries, commercial banks are allowed to undertake foreign exchange business. In other words, besides functioning as an intermediary between the surplus and deficit units, commercial banks also offer a major role in facilitating the payments system within the country as well as with the rest of the world.

(c) Venture capital is a specific type of finance provided by certain firms who invest alongside with management in young but rapidly growing companies that are not listed on the stock market. These new and young companies have the potential to become major players in the economy. Venture capital investments generally involve (i) a long time-frame; (ii) an element of risk; (iii) partnership with management; and (iv) returns that are normally in the form of capital gains rather than dividends. Venture capitalists (those who supply the capital funds) are needed to support high-risk investments in small, technology-based firms, which are often passed over or ignored by large companies and traditional financial institutions.

Venture capital is crucial to the innovation process. For a variety of reasons, it is very difficult for large companies to undertake high-risk innovative projects. Such projects have the greatest chance of success if small technology-based firms undertake them. In this regard, venture capitalists are willing and able to invest in such high-risk innovative projects through their financial instruments. Hence, venture capital has an important role to play as a specific type of finance that has been developed to fund high-risk projects.

Question 3

- Candidates were able to explain the macroeconomic objective of Bank Negara Malaysia's monetary policy and also the question on unit trust.
- Candidates could not state the main objectives of the National Syariah Council.
- Candidates were unable to answer the question on inflation.

3. (a) Bank Negara Malaysia's (BNM) principal objective is to promote monetary stability and a sound financial system. BNM therefore plays a key role in formulating 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 BNM, is primarily to regulate the supply of money in circulation and the credit supplied to the economy.

The instruments that BNM can deploy to implement monetary policy can be grouped into two broad categories: general instruments (like statutory reserve requirements, open market operations, purchase/sale of government securities) and selective instruments (like lending guidelines for certain sectors) of monetary control.

(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 investors, who neither have the time nor the inclination to hold portfolios of direct investments or shares, because they can invest in small amounts 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.

(c) The National Syariah Advisory Council on Islamic Banking and Takaful (NSAC) was established on 1 May 1997. The main objectives of the NSAC are as follows:

- To act as the sole authoritative body to advise BNM on Islamic banking and takaful operations;
- To coordinate Syariah issues with respect to Islamic banking and finance (including takaful); and
- To analyse and evaluate Syariah aspects of new products/schemes submitted by the banking institutions and takaful companies.

(d) Inflation is a rise in the general level of prices. Inflation causes money to lose its purchasing power because more money is needed to purchase the same volume of goods and services.

Inflation distorts all price signals and affects the efficient functioning of an economic system. The higher the inflation rate, the greater the distortion. Persistent increases in prices have a number of adverse economic and social consequences. Fixed-income earners may see their standard of living decline; the disparity between the rich and poor may increase; the distribution of national income between wages and profits will change; our industries become less competitive; the exchange rate may fall.

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

<u>Question 4</u>

- Candidates were generally good in answering the question on the components of the balance of payments.
- Candidates wrote on monetary and macroeconomic stability, instead of financial stability.
- Candidates could not differentiate between external reserves and statutory reserves of the banks under Bank Negara Malaysia.
- A country needs to maintain a strong external reserves position for a variety of reasons. The most important factor is to sustain market confidence and currency stability.

4. (a) (i) 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 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 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 be 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.

(ii) Financial stability can be achieved by developing a sound banking system made up of strong and resilient financial players and well-functioning financial markets that responds to the changing needs of the economy and society.

Financial stability can be also achieved by formulating a strong legal, regulatory and supervisory framework, as well as through the development and strengthening of new institutions and system infrastructure. Regulatory rules need to be continuously enhanced with the adoption of international standards to instill appropriate risk management systems to enable financial institutions to undertake their intermediation function effectively.

The enactment of new laws such as the Banking and Financial Institutions Act in 1989 and the Insurance Act in 1996 helped enhance financial stability.

In addition, the availability of "lender of last resort facility" with Bank Negara Malaysia (BNM) (whereby banking institutions in need of funds could come to BNM to sell their securities to deal with short-term liquidity problems) could also enhance financial stability and maintain public confidence in the financial system thereby avoiding widespread failure.

(b) The balance of payments is the record of a country's residents' transactions with the rest of the world. It is also a reflection of the economy's health. The benefits of economic development are reflected in the balance of payments through the magnitude of inward and outward flows of relevant items. There are two main accounts in the balance of payments, namely the current account and the capital account.

The current account comprises the merchandise account and the services account. The merchandise balance simply records trade in goods. By adding the merchandise account to the trade in services and net transfers, we arrive at the current account balance. The capital account, on the other hand, records capital inflow and outflow. The capital account distinguishes between short-term and long-term flows as well as official and private flows. The sum of the current and capital accounts will give the overall balance of payments which also represents the change in the Central Bank's external reserves.

(c) Maintaining a strong external reserve position is important for both the short term objective of economic recovery as well as the long-term aim to maintain a sustainable external position. A large reserves cushion is indeed a key element in protecting the country against unforeseen destabilising developments. This is important to sustain market confidence and stability, enhance credit worthiness and, at the same time, provide the Government with greater stability in the conduct of domestic policies.

Question 5

- Candidates were unable to answer the question relating to the Islamic financial system.

5. (a) (i) The Monetary Policy Statement (MPS) is a forward looking statement, outlining the monetary policy stance in the near term and the rationale for the policy thrust. The objective of issuing this statement 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. Direct communication signaling a bank's policy intent is aimed at increasing the money market participants' understanding and appreciation of said intent. It, thereby, facilitates a more rapid transmission of the policy rate in pricing credit and longer term rates, and thus enhances the monetary transmission mechanism's overall efficiency.

(ii) The issuance of the MPS is part of the ongoing process to enhance market understanding of a bank's financial and economic assessments, operations and policy objectives. Since 1998, in a drive to ensure symmetric information to the public, the bank has disseminated a wider range of information, which included among others, on-line information on its daily liquidity forecasts and money market operations. Over the years, there has also been significant enhancement of the coverage of information available through the bank's website, and reduction in the time lag of data releases to the public.

(b) **Household sector:** the consumer of goods and services (and savers therefore usually lenders)

Business sector: the producers of goods and services (usually borrowers)

Government sector: includes Federal, state, local government and institutions (usually borrowers)

Overseas sector: where imports come from and exports are sent (usually lenders to Malaysia)

Finance sector: include financial intermediaries that specialise in transferring funds between lenders and borrowers

(c) The Islamic financial system encompasses the following, which provide alternative sources of financing.

- **Islamic banking system** - forms the backbone of the Islamic financial system and plays an important role in globalising deposits and providing financing to facilitate growth. In Malaysia, Islamic banking activities are conducted either by Islamic banks that carry out Islamic banking exclusively, or through Islamic banking windows or subsidiaries set up by conventional banks.

- **Islamic interbank money market** - another important component in the Islamic financial system. Under the mudharabah (profit-sharing) interbank investment mechanism, Islamic banking institutions are able to raise funds to meet their short-term funding requirements based on profit sharing arrangements.

- **Islamic capital market** – where funds are raised to finance long-term infrastructure and development projects through the issuance of Islamic private debt securities. The Islamic capital market reduces over-dependence on the Islamic banking system for long-term financing and allows Islamic banking institutions to diversify part of the risks emanating from asset and liability mismatches. The existence of the Islamic capital market plays an important role in reducing potential source of financial vulnerabilities and contributes to enhancing the Islamic financial system's robustness and resilience.

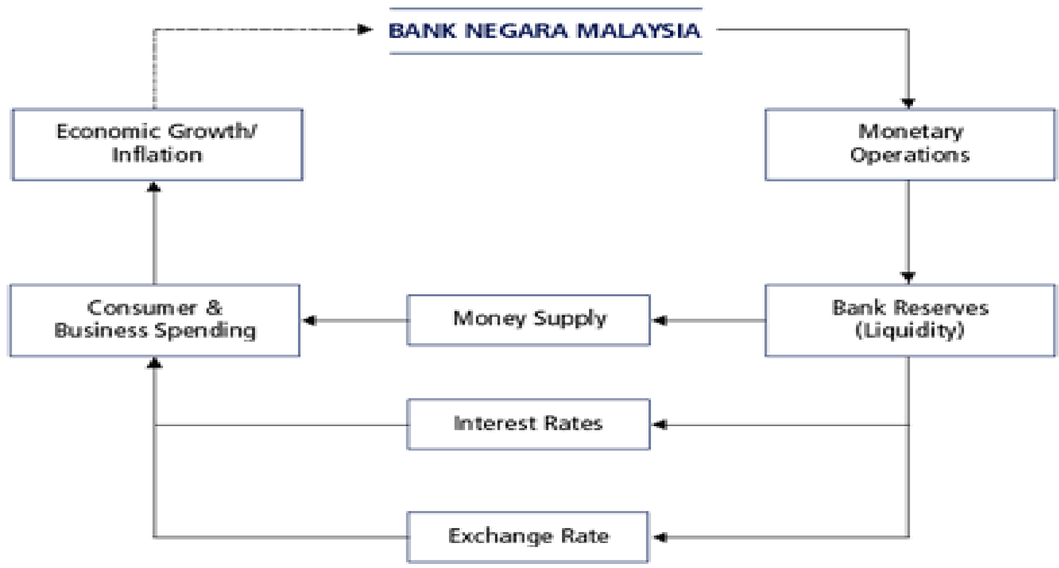
- **Takaful industry** - adds significant synergies to the overall Islamic financial system. Takaful operators, particularly general takaful business operators, contribute to mitigate part of the banking system's risks emanating from financing transactions and hence strengthen the Islamic financial system's resilience.

- **Specialised non-bank institutions** - as the development financial institutions and Pilgrims Fund Board offer Islamic financial products and services and complement the Islamic banking system in expanding its reach to specific strategic economic sectors thereby enhancing the Islamic financial system's capacity in its overall contribution to economic growth and development.

Question 6

- Candidates could not state the factors that affect the exchange rate.

6. (a) (i)



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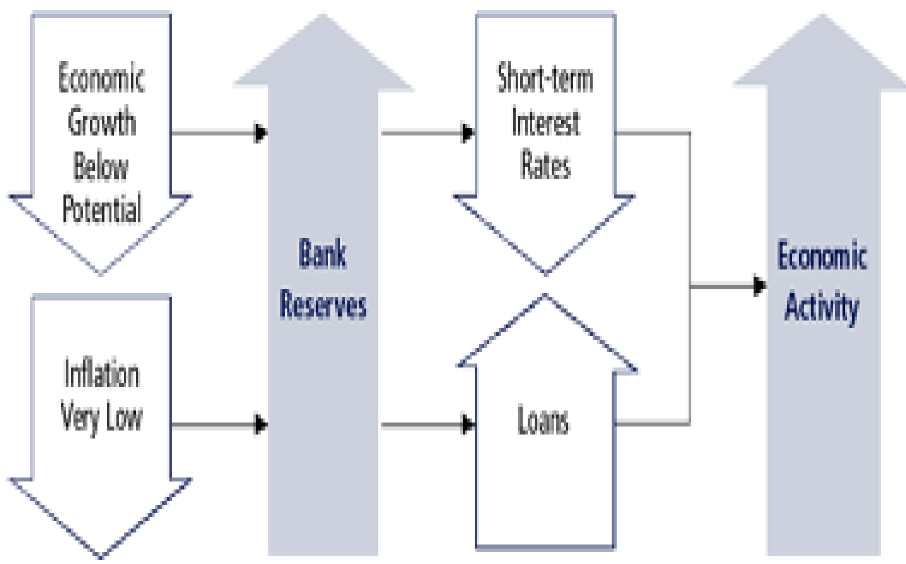

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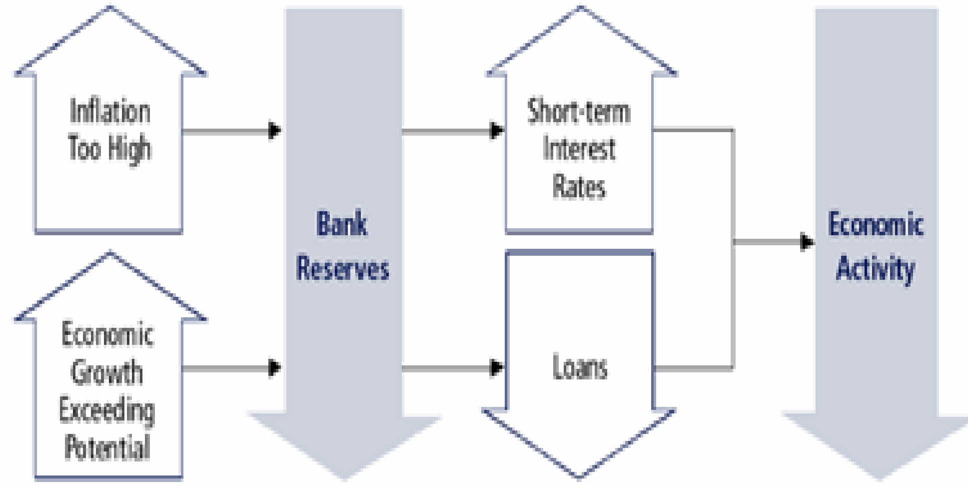

(b) As with interest rates, exchange rates also depend on supply and demand interactions. Even a fixed exchange rate (FX) regime must be set in the supply and demand context. Some of the factors which affect FX supply or demand are:

*(Give any **5** of the following factors)*

- **World growth** - The demand for Malaysian exports (and hence for Ringgit) depends on the state of the world economy (particularly that of our major trading partners).

- **Malaysian domestic demand** - The demand for imports depends on the strength of domestic spending.

- **Inflation** - Changes in domestic costs or prices compared with cost and price movements in the rest of the world influence Malaysia's ability to compete in world markets. For this reason, an inflation rate consistently higher than that of our competitors will, in time, lead to a compensating lower currency value.

- **Interest rate differentials** - Australia and the UK, for example, had high interest rates in the 1980s, which attracted funds into these countries and assisted with boosting their exchange rates relative to other exchange rates.

- **Exchange rate expectations** - Market sentiment refers to the market's perception of the expected future direction of exchange rates based on the above factors. This can have an overwhelming influence in the short term.

- **Political factors** - Changes in Government policy and types of actions in the financial markets can affect its exchange rate.

In short, numerous factors, both within and outside the Malaysian economy, affect exchange rates. A number of these factors are beyond the Government's control.