

DP01

Monetary Economics and the Malaysian Financial System

6 MAY 2002

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) Describe briefly how funds are mobilised in the financial system in Malaysia. [3]
 - (ii) Explain briefly the process of financial intermediation and its advantages to the financial system. [3]
 - (iii) Describe briefly the challenges faced by the financial market. [3]
 - (b) (i) Explain briefly the structure of the capital and money markets in Malaysia. [3]
 - (ii) Describe briefly the measures that are needed to develop the capital and the money markets. [3]
 - (iii) Explain briefly the roles of venture capital in financing new high-growth activities in Malaysia. [3]
 - (c) Explain briefly all of the following:
 - (i) Base lending rate [2]
 - (ii) Components of reserve money [2]
 - (iii) Intermediate targets of monetary policy [2]
 - (iv) Velocity of money [2]
 - (d) (i) Describe briefly the stance of monetary policy in Malaysia during 1998-2001. [3]
 - (ii) What are the prerequisites for a successful implementation of monetary policy in a country? [3]
 - (iii) Describe briefly the prerequisites for the successful development of an international offshore financial centre. [3]
 - (e) Using a schematic diagram, explain the monetary transmission mechanism in the Malaysian economy. [5]
- (Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) Describe briefly the statutory reserve and liquidity requirements of commercial banks in Malaysia. [3]
- (b) (i) Describe briefly the sources and uses of funds of finance companies. [3]
- (ii) Differentiate between the credit extended by commercial banks and finance companies. [3]
- (iii) The Statutory Reserve Ratio (SRR) of finance companies is 14% of their eligible liabilities and RM20billion of their reserves are kept with the central bank.

Calculate the reserves released to finance companies when the SRR is reduced to 12%. [3]
- (c) Describe briefly the banking services of the merchant banks that may overlap and compete with those services rendered by the commercial banks. [3]

- (d) Describe briefly the recent measures that have been implemented to develop the venture capital industry in Malaysia. [3]
- (e) Explain briefly the importance of asset-liability management for financial institutions. [2]
(Total:20 marks)
3. (a) Explain the functions of a central bank. [5]
- (b) Describe briefly how a central bank influences liquidity, interest rate, money supply, and credit growth in the economy. [5]
- (c) (i) Explain the characteristics of **two** key monetary instruments that are available to policy makers. [3]
- (ii) Explain the prerequisites for an effective moral suasion policy as a monetary tool in an economy. [3]
- (d) Discuss briefly the advantages and disadvantages of selective lending control in an economy. [4]
(Total:20 marks)
4. (a) Explain briefly the terms “narrow” money and “broad” money in the financial system in Malaysia. [4]
- (b) Describe the key determinants of the level of money supply in the Malaysian economy. [5]
- (c) What are the main components of monetary base (high-powered money) from the asset and liability sources of the central bank balance sheet? [5]
- (d) Answer any **three** of the following questions:
- (i) What are the factors that change the level of money stock in an economy? [2]
- (ii) What happens when the supply of money exceeds demand, i.e. lower than the amount desired by public? [2]
- (iii) What are the values of the currency-deposit ratio and the reserve-deposit ratio respectively when the money multiplier reaches the maximum? [2]
- (iv) Compute the value of the money multiplier, given the currency-deposit ratio is 0.5 and the statutory reserve ratio is 0.4. [2]
(Total:20 marks)
5. (a) The goals of the central bank through monetary policy are to achieve internal balance and external balance in the economy. Discuss briefly the broad macroeconomic goals of the central bank. [5]
- (b) Describe briefly the importance of monetary stability and a sound financial structure for an economy. [4]
- (c) What is the dilemma of a central bank in policy setting between money supply and interest rates as intermediate targets? [5]
- (d) (i) How are external reserves accumulated in the economy? [2]
- (ii) What are the others factors (apart from external reserves) that influence the flow of credit and money in an economy? [2]
- (e) What are the types of services rendered by the central bank to the Government? [2]
(Total:20 marks)

6. (a) Both the International Monetary Fund and the World Bank have been established to provide specific functions for economic development. Discuss briefly. [4]
- (b) Describe briefly the roles of unit trusts in promoting saving habits in Malaysia. [3]
- (c) Explain briefly the factors that can affect fluctuations in the exchange rate in an economy. [3]
- (d) Describe briefly the concepts of "fixed exchange rate regime" and "floating exchange rate regime". [4]
- (e) When does a revaluation and devaluation of the domestic currency take place in the economy? [2]
- (f) How does a country finance the deficit in the current account of the balance of payments? [2]
- (g) What are the factors that determine the movements of short-term capital in a country? [2]
- (Total:20 marks)

OUTLINE ANSWERS

PART A

Question 1

Candidates could not answer well the questions relating to monetary policy in Malaysia. Many also could not draw a complete diagram of the monetary transmission mechanism in the Malaysia economy.

1. (a) (i) The funds in the financial system are mobilised through the sources and its uses. The three key sources of funds in the financial system are private savings, long-term capital from abroad and public savings. In Malaysia, the process of resource mobilisation through the financial system has been facilitated by the sound development of the financial structure. Indeed, over the years, the broad financial system has been sufficiently developed to effectively intermediate and mobilise the savings of the nation for productive use.

The funds are used to finance public investment; private investment or placed abroad, including for portfolio investment purposes. The banking system had mobilised more than 50% of private savings in 1981. This share had increased to about 70% in line with the important role of the private sector in economic development. On the other hand, the share of public investment is around 30%.

- (ii) The term “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 channel funds from depositors to the borrowers. The bank will assume the credit risk of the borrowers in return for an interest. Financial intermediaries basically operate in the savings market where they operate as borrowers, while meeting the demand for financial assets by surplus units. To meet this demand, financial institutions have introduced various savings and investment instruments to attract funds from the surplus units. The other market is the 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. Financial intermediaries also operate in various markets where they transact their own instruments not only directly with the economic units in an economy, but also among themselves. These markets are, namely, the money and foreign exchange market, the capital market and the financial futures and options market.

Among the advantages of financial intermediation include savers can purchase relatively safe assets and more liquid; borrowers realise lower cost of funds; savers have a more diversified portfolio assets; mobilisation of savings for productive investments by borrowers.

- (iii) There are several challenges faced by the financial system:
- The rapid intensification of globalisation in recent years has significantly affected the structure and operations of financial institutions. Competition will undoubtedly intensify, in an environment where the liberalisation of domestic financial markets are taking place in forums such as WTO and ASEAN.
 - Financial institutions need to focus on improving their efficiency and competitiveness. Thus, there is a need for innovation, flexibility, skill enhancements and product development.
 - In the 21st century, 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. These characteristics reflect the nature of activities which rely on intangibles assets such as knowledge, skills, human capital, while the innovative and "path-breaking" nature of their products lack track record and require long lead time from investment to fruition.

- The capital market will play an important role in financing the growth of new growth areas and businesses. The recent launching of the Financial Master Plan and the Capital Market Master Plan (CMP), and the various recommendations made would a strong contribute to building the vibrant and efficient capital and money markets.

- (b) (i) The **capital market** is a market in longer-term financial assets, comprising all public and private debt instruments with a maturity of one year or more are exchanged. The capital market comprises a primary and a secondary market. The primary market is one which new issues of the Government and corporate securities are offered to public and institutions. In the secondary market, existing Government and corporate securities are transacted.

The components of the capital market are as follows:

- The equity market: trading in corporate stocks and shares for which there is no maturity. The holdings are mainly cantered on both individuals and institutions;
- Government securities market are held mainly by institutions, including the provident and pension funds and trust funds; and
- Corporate bond market are dominated by institutions and determined by a number of factors, including marketability, stability of returns, prospects for capital gains.

The instruments traded in the capital market are as follows:

- 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); and
- Short-term securities (commercial papers and Cagamas notes).

On the other hand, the **money market** comprises the inter-bank market where lending and borrowing of short-term funds will take place. The money market is an integral part of the financial system and the money market instruments are generally more liquid compared with the capital market individuals who are in need of funds immediately for short period.

The instruments traded in the Money Market are as follows:

- Treasury bills, Malaysian Government Securities, Bankers Acceptances, Negotiable Instruments of Deposits and Bank Negara Bills

- (ii) Over the years, several measures were implemented to develop the capital market.

- Development of the private debt securities with the introduction of new innovative instruments. A milestone in its development was the establishment of the National Mortgage Corporation (Cagamas) in 1986 to issue mortgaged-backed bonds and notes. Next, was the incorporation of the first credit rating agency in Malaysia, namely, the Rating Agency Malaysia Berhad (RAM) in 1990. The second rating agency, Malaysian Rating Corporation was established in 1996.

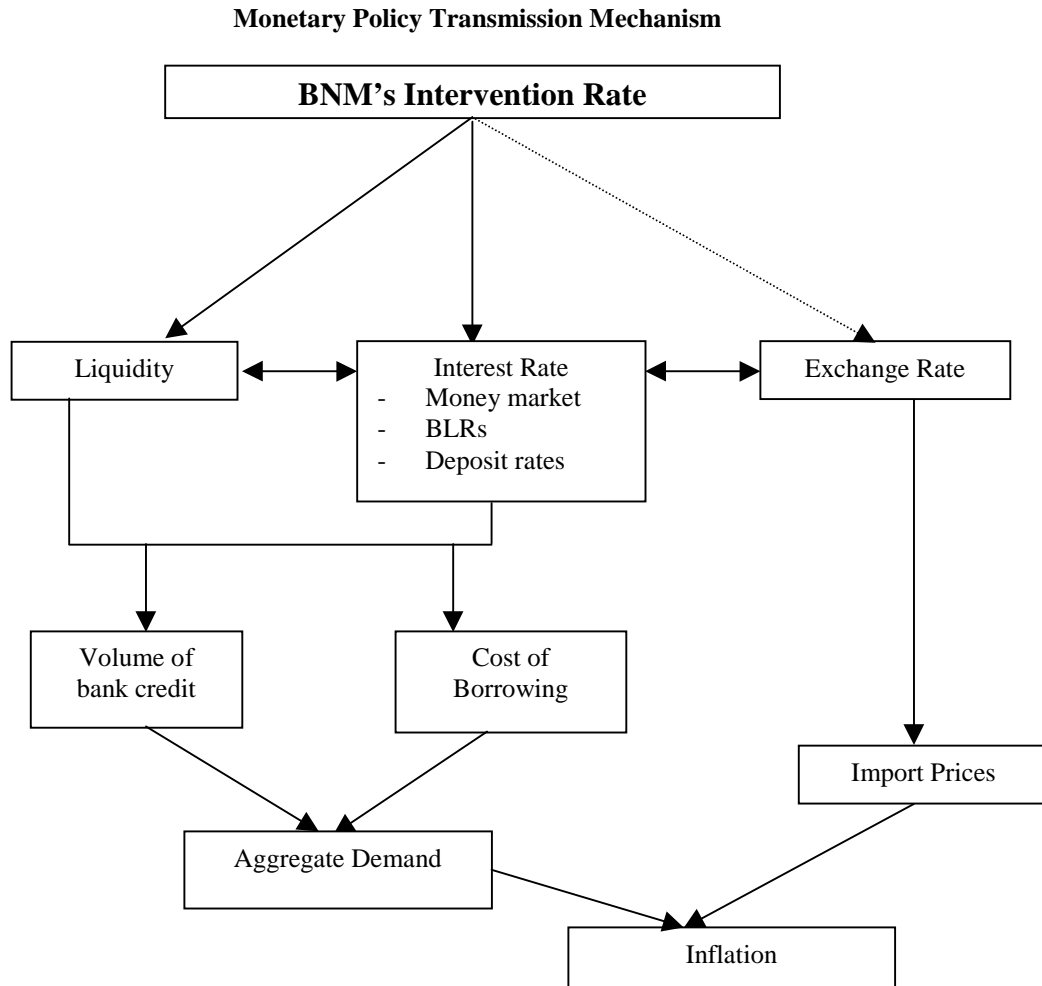
The money market has been undergoing numerous reforms since the late 1980s. The aim is to deepen and broaden the money market. Some of the measures are as follows:

- The introduction of SPEEDS or “Sistem Pemindahan Elektronik untuk Dana dan Sekuriti” to enable a faster settlement and clearing arrangement for securities and money market funds; and

- Minimum capital requirement for finance companies to participate in the interbank market was accordingly raised from RM100 million in 1997 to RM350 million in 1998. It was raised again to RM600 million effective 1 January 1999.
- (iii) Venture capital is an alternative form of financing for financing the new growth economic activities including emerging technologies. The majority of them will be start-ups that require the support of the financial systems, and in particular venture capital. Financing of new growth activities requires a more co-ordinated approach to the development of the venture capital (VC) industry. VC will fill the void between sources of funds for innovation and the investors' friends and traditional lower-cost sources of financing. There is a need to promote a deeper pool of private venture capital funds and related management expertise to facilitate the effective matching of the risk appetites of private equity investors with the risk profiles of emerging businesses. There is also a need to enhance the efficiency and competitiveness of market-based exit mechanisms for venture capitalists in terms of cost, pricing efficiency and value realisation for issuers and venture capitalists.
- (c) (i) The **base lending rate** refers to the average of the base lending rates that commercial banks and finance companies quote to their customers. Essentially, the formula computation for the ceiling BLR is now based on the prevailing BNM 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 = $\frac{[\text{BNM intervention rate}]}{1 - \text{SRR}\%} + 2.25\%$
- (ii) **Reserve money:** The components are currency in circulation + required reserves + excess reserves + deposits of the private sector.
- (iii) The two "**intermediate targets**" for monetary policy include money supply and short-term interest rates. These targets are needed to assist the Central Bank to achieve its goals. The choice of the intermediate targets, includes measurability, controllability and predictability. The basis of the selection is crucial to ensure the effectiveness of the "intermediate targets".
- The measurability of the variables e.g. money supply and interest rates
 - Controllability of the variables by the Central Bank
 - Predictability of the variables
- (iv) **Velocity of money** is a ratio of nominal GDP to various monetary aggregates. They have indicated frequent and marked departures from historical patterns. Thus, monetary aggregates are unreliable indicators of economic activity and as guides for stabilising prices. In fact, the velocities of M1 and M3 and their average values over the past five to ten years have diverged from their long-run trends.

- (d) (i) The **stance of monetary policy** was to maintain domestic and external stability. The recent stance of monetary policy was directed at supporting economic recovery. The focus was to create a conducive environment that will support economic recovery while preserving price stability. The policy stance would ensure that there were adequate funds at reasonable cost to support private sector activity. Interest rates were kept competitive to promote investments in the real sector and also to provide a positive real rate of return on savings. It would be maintained as long as there are no build up in inflation. In short, the sharp easing of monetary policy following the introduction of the exchange control measures has thus, provided an environment of low interest rates and ample liquidity to support the economic recovery.
- (ii) For monetary policy to be successful, the following factors are crucial:
- Central Bank as the sole cash issuing authority;
 - Central Bank as the lender of last resort;
 - Central Bank's ability to influence the overall supply of liquid assets as the Reserve base for private sector's lending;
 - Lending institutions complying positively with the Central Bank directive guidelines;
 - The threat of disintermediation is too weak to overcome the official portfolio constraint; and
 - The ability of the government to strike a balance between its financing of public sector borrowings/deposits and the creation of additional credits in the private sector.
- (iv) The prerequisites for the success of an international offshore financial centre are as follows:
- Political stability;
 - Stable currency with minimum or no exchange control;
 - Banking secrecy and confidentiality with minimum rules and regulations;
 - Good infrastructure support facilities, e.g. excellent communications and transportation system with other financial systems; and
 - Professionally qualified and experienced staff.
- (e) Monetary policy operates through short-term interest rates to achieve its ultimate objective of price stability. The level and direction of interest rates is influenced through liquidity management and its signalling impact. A change in policy rate will trigger a chain of events that affect the whole range of market rates. The transmission of monetary policy is through the money market to the financial system by the price and quantity effects. The two key channels for the transmission of monetary policy are open market operations and the interbank rate. Stability in the money market is an important precondition for the effective transmission of monetary policy. The interbank rates are an important signalling device to the market of monetary policy intentions. The resultant change in relative prices and yields of financial and real assets cause portfolio adjustments. Consequently, this will affect the level of income and spending in the economy. In the 1960s, the relatively underdeveloped financial market necessitated the development of the financial infrastructure to establish the necessary basic framework for the effective implementation of monetary policy. Financial institutions were strengthened and developed. New intermediaries and markets were set up. Other major policies included the deregulation of interest rates, and the introduction of new instruments like BAs and NIDs.

The schematic chart shows the transmission mechanisms for a change in the intervention rates by the Central Bank.



PART B

Question 2

Candidates also showed weak understanding of the concepts examined and were not able to answer the calculation question based on the SRR. They also could not describe the measures implemented to develop the venture capital in Malaysia.

2. (a) The statutory requirement (SRR) and liquid asset ratio (LAR) are two key instruments for monetary management. Commercial banks have to fulfil the statutory reserve requirement (SRR) as well as and liquid asset requirements. Commercial banks are required to adhere to certain ratios expressed in relation to pre-defined liabilities base. The base comprises essentially the deposit liabilities, net amount due to other financial institutions, net purchase agreements or repos and net amount of NIDS. The SRR aims to control the volume of liquidity in the banking system and the capacity of the banks to generate loans and advances. The SRR earns no interest. An increase in the SRR will “lock in” with the Central Bank a large proportion of resources of the commercial ban. Thus, this will limit its capability to lend and vice-versa. A reduction in the SRR will enhance the flow of liquidity in the economy. The present SRR is 4 %.
- (b) (i) The sources of funds for finance companies are:

- Fixed deposits, which are the principal form of deposits, mobilised by finance companies accounting for about 80% of total deposits placed with finance companies.
- Saving deposits represented a smaller share of about 3%.
- Since October 1987, finance companies are allowed to participate in the interbank money market. Interbank money market is the next major source of funds for finance companies.

The uses of funds for finance companies are mainly for loans:

- Hire purchase and leasing of motor vehicles.
- Agriculture equipment.
- Industrial and construction equipment.
- Other consumer durables.
- Financing purchase of houses by individuals.

(ii) The differences between the type of credit that is extended by finance companies and commercial banks are:

- Finance companies mainly cater for small borrowers in line with the retail nature of finance company business. Consumption credit and hire purchase are the two key types of loans. Financing for the manufacturing sector has been growing in importance.
- Loans and advances to the various sectors of the economy are the major sources of uses of funds of commercial banks.

(iii) The statutory reserve ratio is 14% of eligible liability and RM20 billion of finance companies were statutorily kept at the Central Bank. When the SRR is cut to 12%, RM 2.9 billion would be released to finance companies.

(c) The banking services offered by merchant banks may overlap and compete with those offered by commercial banks. Merchant banks are financial intermediaries like commercial banks and their functions are mainly focused on wholesale banking areas. Their expertise is providing tailored financial services including financial advisory and consultancy services. Thus, merchant banks are not allowed to open current and saving accounts. However, merchant banks are allowed to offer fixed deposits accounts just to corporations, associations, clubs, foundations, trust companies and pension funds. Merchant banks can also raise NIDS.

(d) **Measures taken to develop the VC Industry**

- Venture capital companies investing in venture companies are given full tax exemption on all sources of income for 10 years.
- A company or individual having a business source, having invested in a venture company at start-up, seed capital and early stage financing is entitled to a reduction from the adjusted income equivalent to the value of the investment made in the venture company.

Recommendations in the Capital Market Master Plan

- The listing of technology incubators will be allowed in 2001.
- The promotion and development of the venture capital industry should be centrally controlled.
- Venture capital companies will be granted exempt dealer status under the Securities Industry Act.
- The participation of local institutional investors in venture capital funds should be promoted.
- The establishment of venture capital trusts that can invest up to 100% in unquoted companies will be allowed.
- The Securities Commission will undertake a review of the tax framework for the

venture capital industry in collaboration with the tax authorities, industry participants and the central co-ordinating agency for the industry.

- Joint investment programmes between the government and private sector venture capitalists should be increased to boost private sector participation in disbursing government funds for seed and start-up capital.
- Greater foreign participation in the venture capital industry should be allowed.
- Establish a "one-stop" centre for venture capital.
- Establish a RM500 million venture capital fund.
- Introduce further tax incentives for the venture capital industry.
- Liberalise the MESDAQ listing requirements.
- Comprehensive measures to enhance MESDAQ's role as a fund raising center for high-growth companies will be implemented.
- Establish Islamic venture capital funds.
- Increase the sources of financing to the venture capital industry.
- Enhance the promotion of venture capital investment opportunities in Malaysia.
- Provide training to venture capital professionals.
- Increase the awareness of Malaysians regarding the roles and significance of business angles.
- Establish more business angel clubs and networks
- Establish more matching services..
- Establish technology appraisal centres in promoted high technology sectors

- (e) **The role of asset management** is to address the exposure of the banks to liquidity risks by lending money to other banks through the interbank market. Another alternative is to lend repurchase agreements for government securities, lending securities to businesses and other banks overnight. On the other hand, the role of **liability management** is to manage liquidity, as the banks' liabilities are usually of shorter-term than their assets. Banks have to keep sufficient cash or assets on hand that is easily converted to cash to meet depositor's withdrawals. This will be conducted without sacrificing too much operating income by holding cash rather than loans or securities.

Question 3

Candidates showed good understanding of the concepts examined, e.g. the roles of central bank and monetary instruments.

3. (a) **Bank for Currency Issue**
The Central Bank is the sole currency issuing authority in the country

Keeper of International Reserves

Holdings of the country's official external reserves are centralised at the Central Bank. The Central Bank's international reserves comprise gold, foreign exchange, reserve position with the IMF and holdings of special drawing rights. To safeguard the external value of the ringgit, the Central Banking Act, 1958 provides for the maintenance of a minimum external reserves backing of 80.59% against the currency issue.

Government Banker and Financial Advisor

The Central Bank acts as a banker, fiscal agent and financial advisor to the Government. Close cooperation between the government and the Bank is also evident from the centralisation of government deposits with the Bank. With this arrangement, government receipts, arising mainly from the new issue of government securities, tax and dividend payments are placed with the Bank and managed by the Bank depending on the liquidity situation of the system.

The Central Bank manages the government accounts and performs the same functions as the commercial banks perform for their customers. The Central Bank is also empowered to provide temporary advances to the government to cover any deficit in the budget revenue. Finally, the Central Bank manages the public debt and is responsible for the floatation of government loans, both in Malaysia and abroad.

- (b) The Central Bank conducts money market operations (MMO) to influence the liquidity situation in the financial system. MMO is conducted by open market operations (OMO) through the sale and purchase of government papers and borrowing or lending by the Central Bank in the interbank market.

In an OMO, it involves the sales and purchases of government papers by the Central Bank in open organised markets. The purpose is to affect directly the reserves of banks and thus, the flow of credit and money. OMO are conducted either outright or through repurchase agreements.

Another manner to conduct MMO is through direct borrowing and lending in the interbank market. Direct borrowing or lending was normally undertaken in short-term maturity periods of one to three months.

MMO is also conducted by discount operations, which is defined as deliberate measures by the Central Bank to influence interest rate and liquidity situations via variation in the terms, and conditions under which the commercial Bank and money market may have temporary access to the Central Bank credit facilities. Discount operations are conducted by the rediscounting of eligible short-term assets and secured advances.

- (c) (i) Two key instruments of monetary policy are the Statutory Reserve Requirements (SRR) and the liquidity ratio (LR) and both are classified as general instruments of monetary policy.

Statutory Reserve Requirements (SRR)

SRR is one of the oldest and most important monetary instruments deployed by the Central Bank to control liquidity situation in the banking system. SRR is defined in terms of a bank's eligible liabilities. SRR is a strong instrument available to the Central bank as it affects the level of deposits and loans that a bank can legally support given the size of its reserves. The SRR is reduced in an expansionary monetary policy and vice-versa. The SRR is also part of the safety net put in place for the protection of depositors. The present SRR is 4%.

Liquidity Assets Requirements (LAR)

The LAR is another important monetary tool of the Central Bank. The ratio, which is akin to the SRR, is expressed as a percentage of the EL base of the banking institutions. It operates in a similar manner as the SRR, i.e. an increase in the LR will reduce the amount of deposits and loans a given supply of reserves can support is lowered and vice-versa when the ratio is reduced. The present LAR is 15 %.

- (ii) Prerequisite for Effective Moral Suasion

- There must be a voluntary response from the system to its policy initiatives
- It would be effective if financial institutions on their own accord take the necessary action to fulfil the role required of them
- The prestige and standing of the monetary authority in the eyes of the public
- The degree to which the financial institutions are convinced that the actions to be taken are not only in the national interest but also theirs.

- (d) **Pros:** It is among the most effective measures available to the Central Bank in regulating the volume and direction of credit. Its use will ensure that its economic and social goals are met and are consistent with national goals. Selective credit controls do not tend to raise interest rates. Selective credit controls would be effective in reduce conspicuous spending and accord priority to domestic financing from productive investment. Selective credit controls are necessary to contain the rate of credit and monetary expansion, and to dampen potential inflationary pressures due to excess liquidity in the banking system.

Cons: Selective controls may have an undesirable impact on the efficiency of the allocation of resources in the economy, particularly over the long run. They should be implemented only under compelling circumstances and for a limited time period.

Question 4

Candidates failed to provide good answers for components of monetary base, factors that change, and the level of money stock. However, they were able to provide good answers for definition of money aggregates.

4. (a) In the Malaysian financial system, “narrow” and “broad money” is distinguished as follows:
- Narrow money or M1 refers to the total supply of money available for the public to spend. The supply of money is basically for payment purposes. M1 comprises currency holdings and demand deposits held by the private sector.
 - Broad money refers to M3 (private sector liquidity) and comprises M1 and private sector holdings of fixed and savings deposits with the commercial banks and the Central Bank. Very broad money or M3 comprises M2 and all private sector deposits including Repos, placed with finance companies, merchant banks, discount houses and Bank Islam or M2 plus broad quasi money.

- (b) The following are the determinants of the level of money supply:

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.

Central Bank Action

The Central Bank influences money supply through monetary policy instruments, including reserve requirements, liquidity requirements, interest rates and open market operations.

- (c) Based on the Malaysian experience, the sources and uses of the monetary base (MB) can be derived from the consolidated balance sheet of the Central Bank (BNM). The sources of the base reflect primarily the assets of the Central Bank. The uses of the base indicate the commercial banks’ demand for reserve and public demand for currency. The detail of the MB components are summarised as follows:

Sources of MB: Net foreign assets (NFA), Net claims on Government, Central banks on the commercial banks and other factors.

Uses of MB: Currency notes and coin in the hands of the public, currency in the vaults of the commercial banks, deposits maintains by the commercial banks at the Central Bank (Bank reserve).

- (d) (i) Changes in money stock reflects:
- Increasing/reducing spending on goods and services
 - Converting money into other form of existing assets
 - Increasing/extinguishing existing liabilities
- (ii) When the supply of money exceeds that demanded, it implies that the aggregate surplus of cash balances held by households and business firms is not completely offset by the aggregate deficit of cash balances of other households and firms. They

are expected to increase spending on goods and services; convert into other assets and extinguish existing liabilities.

- (iii) The value of the currency-deposit ratio is zero, and the value of the reserve-deposit ratio is zero.
- (iv) The value of the multiplier is $= (0.5+1)/(0.5+0.4) = 1.67$

Question 5

Candidates seemed to understand the concepts but were not able to provide satisfactory answers.

5. (a) Demand management policies consist of monetary and fiscal policies often these policies fail to achieve the desired goals. **Internal balance** refers to a situation of full employment, price stability, economic growth, and distribution. **External balance** refers to the balance of payments equilibrium. There is a need to supplement with expenditure switching policies, e.g. exchange rate policy or supply side management policy (e.g. income policy). The bottom line here is, mix policy is required to achieve the desired goals (internal and external balance), that is, the combinations of demand management and expenditure switching policy or supply side management policy.

The goals of the Central Bank are to achieve sustained economic growth path; high level of employment; maintain stability in the purchasing power of the ringgit; eradication of poverty, to raise the living standard of Malaysians and to achieve a reasonable balance of payments position.

Achieve price stability

Inflation erodes the value of money as a medium of exchange and a unit of account. Thus, policy makers have emphasised price stability as a policy goal. In a market economy where prices contain information about costs and demand, inflation would make prices less useful as signals for resources allocation. It would also make decisions more difficult for households and firms

Achieve high employment

An important monetary objective is to maintain a low rate of unemployment. The reasons being unemployment leads to excess productive capacity, financial stress and low-esteem for those who lost jobs. Indeed, excess production capacity evident during an economic slow down.

Achieve real economic growth

To promote the highest sustainable rate of real economic growth that is consistent with domestic prices and exchange rate stability. A steady economic growth and increase in the output of an economy leads to higher revenue for the government. Moreover, economic growth policies would induce savings and ensures that a large pool of investment fund is created in the economy. Stability of economic growth is crucial as it allows for precise planning and promotes long-term investment in the economy.

Achieve financial market and institutional stability

This ensures that funds are channelled from savers to borrowers. Moreover, this would also involve growth in bank credit and money supply is adequate to accommodate and fuel economic growth without causing inflationary pressures.

Maintain interest rate stability

Any volatility of the interest rate makes planning and investment decisions a difficult exercise for investors and households.

- (b) Monetary stability and a sound financial system is important for an economy due to these reasons:
- The need to ensure that the growth in bank credit and money supply are adequate to accommodate and fuel real growth in the economy without causing inflationary pressures.
 - Ensure that the supply of money and the volume of credit are sufficiently elastic to meet domestic demand in the economy and without creating undue pressure on resources.
 - Need to influence the availability and the cost of funds to the banks, bank credit and money. To direct the flow of credit to priority sectors of the economy.
 - A sound financial system is important for effectively intermediate and mobilise the savings of the nation for productive use, and with the capital market institutions playing an increasingly important role.
 - The financial system performs an important intermediation function in the economy, as well as plays a critical role in the payments system. A well-functioning and efficient financial system is vital in ensuring effective and efficient conduct of monetary policy.
 - The financial intermediation system helps channel resources efficiently toward activities with high rates of return, as well as allows implementation of projects that are larger in scale, and with longer gestation periods and riskier prospects. With the financial intermediation function, the financial system has strong linkages to savings and investment decisions in the economy and, thus, can influence the pace of economic growth.

- (c) The two “intermediate targets” for monetary policy include money supply and short-term interest rates. These targets are needed to assist the Central Bank to achieve its goals. However, the Central Bank faces a dilemma of a choice of either one of the two intermediate instruments.

The reason is that 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 lose 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.

- (d) (i) International reserves are accumulated as follows:
- Large net inflows of short-term as well as long-term capital
 - A balance of payments surplus position
- These new reserves are added to the outstanding Central Bank’s international reserves.
- (ii) There are forces that could affect the flow of money and credit :
- Government’s budgetary policies on expenditures, taxes and debt
 - Distribution of income and the allocation of this income between spending and savings
 - Business plans to invest and to employ labour
 - Movements of international trade and foreign investments
- (e) The types of services rendered to the government are:
- Management of national debt. The Central Bank advises the government on its loan programmes, including the terms and timing of loans and issue of new types of securities.
 - The Central bank is responsible to the government for promoting monetary stability and a sound financial structure in the country.
 - The Central Bank acts as a banker, fiscal agent and financial advisor to the government.

- The central Bank manages the government accounts. The Central Bank operates as the government banker. In keeping the banking accounts of the government, the Central Bank performs the same functions as the commercial banks functions for the customers.
- The Central Bank is empowered to provide temporary advances to the government to cover any deficit in the budget revenue. The underlying principle is to prevent the government from resorting to deficit financing.

Question 6

Candidates had good understanding of the roles of IMF, World Bank, unit trusts and exchange regimes but showed weak understanding for financing deficit in the current account and the movement of short-term capital.

6. (a) Both the World Bank and the International Monetary Fund (IMF) were established for specific reasons.

The World Bank: It is primarily a development institution. The World Bank central purpose is to promote economic and social progress in developing countries in order to raise productivity. The World Bank is an investment bank that intermediates between investors and recipients. The funding comes mainly from market borrowing through the issue of bonds to individuals and private institutions in more than 100 countries. The World Bank only lends to creditworthy governments of developing countries.

IMF: The IMF is a co-operative institution that seeks to maintain an orderly system of payments and receipts between nations. However, the IMF was set up in the midst of unresolved financial problems that were instrumental in initiating and protracting the Great Depression of the 1930s. While it is not primarily a lending institution, it is an overseer of the members monetary and exchange rate policies and a guardian of the code of conduct. The IMF is not a bank and does not intermediate between investors and recipients. The funding comes mainly from quota subscriptions or membership fees paid by the 182 members. The IMF is like a credit union whose members have access to a common pool of resources. All member countries have the right to financial assistance of the IMF.

- (b) Unit trusts play an important role to promote saving habits in Malaysia. A unit trust is an investment, which enables individuals, corporations and institutions that have common investment objectives to pool their money. The working of unit trusts normally involves a tripartite trust between the unit trust management company which manages the business of the trust fund; the trustee who acts as custodians of all the assets of the fund and the unit holders or investors who are the beneficiaries. The benefits of unit trusts are that investors with a small amount of savings may enjoy the benefits of diversification; professional selection; and management of investments. This will spread out the risk. The unit holder will obtain better yield and capital appreciation compared with the return from his or her own investments. Thus, this will contribute to increase savings in the economy.
- (c) Several factors that can affect the fluctuations in the exchange rate in the economy. When exchange rates are flexible, they would be determined by the forces of the supply and demand of the currency. Demand and supply would work together to set the equilibrium exchange rate.
- The sources of demand for a currency emanate from the value of exports. Exports result in the currency of the export's country being increased in demand. This would strengthen the country's currency.
 - The sources of supply is derived from a country's demand for imports of goods and services, capital outflow and outflow of transfer. Imports would result in the currency of the importer's country being increased in supply. This would weaken the currency.
- (d) **Fixed exchange rate regime:** 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. An example of the fixed exchange rate system was the Bretton Woods Agreement's adjustable peg system that was in operations during 1945-72. Another example was the European Monetary Systems European Currency.

Floating exchange rate regime: 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.

- (e) A revaluation and devaluation takes place in the economy under **different circumstances**. **Revaluing** the domestic currency involves raising the official value of currency relative to other currencies, thereby resetting the exchange rate. This is necessary when the domestic currency is undervalued relative to the other currencies. **Devaluing** takes place when the price of foreign currencies under the fixed rate regime is raised due to official intervention. Hence, 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. Countries will devalue their domestic currency as a policy instrument to improve a deteriorating balance of payments position. The impact is the increase in prices tradable and thus, raises the prices and profitability of tradable relative to non-tradable. The government devalues the domestic currency in order to improve aggregate demand in the economy. The adverse impact is reflected by increase in inflationary pressures in the economy.
- (f) The deficit in the current account of the balance of payments of a country can be financed by inflows of long-term and short-term capital. If the inflows more than offset the deficit current account position, there will be a surplus basic balance position. The additional capital in the basic account would contribute to build up the external reserves of the country.
- (g) Short-term capital flows or "hot money" reflects mainly external factors such as interest 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 money. Thus, in view of its characteristics, short-term capital is not dependent upon to build up reserves of the country.