Chapter 2 LITERATURE REVIEW

2.1 INTRODUCTION

The literature on the role of financial intermediation in economic development is well established. According to M.P. de Lange (1990), the literature on financial intermediation might roughly be divided into two types. In the first type, most attention is paid to the monetary nature of the intermediaries' assets and liabilities. The second type focuses on certain real functions of intermediaries. The former type is mainly concerned with macroeconomic issues such as variations in prices, interest rates and economic activity. The latter usually starts by describing some economic environment in which intermediaries play a useful role such as helping to overcome some market imperfections involving asymmetric information. It proceeds to examine the characteristics of the intermediation process.

The theoretical literature of financial intermediation in this research paper will be more to the second type. This chapter will be divided into five parts. Firstly, the definition of financial intermediation will be discussed, and followed by the role of financial intermediaries, the efficiency of financial intermediates in providing financial services, the flow of funds and the empirical studies of financial intermediation in Malaysia.

WHAT IS FINANCIAL INTERMEDIATION ?

Financial intermediation is the process of indirect finance using financial intermediaries (Mishkin, 1997). It is the activity of moving funds from surplus units to deficit units. Surplus units consist of persons or enterprises with funds to lend, where as deficit units refers to individuals or enterprises that require borrowing fund.

THE ROLE OF FINANCIAL INTERMEDIARIES

Financial intermediaries play an important role in an economy because they ensure that savings are channeled from households to firms and the public sector for investment in the productive sector. According to Mark Gertler and Andrew Rose (1994), an added task for financial intermediaries within an open economy is helping domestic lenders and borrowers compete effectively in international capital markets.

Basically, financial intermediaries perform two major economic functions. First, they create money and administer the payments mechanism. Second, they bring together savers and investors, lenders and borrowers (Fry, 1988). The differences between financial intermediaries or financial institutions from all other business enterprises is that their assets consist predominantly of financial claims, such as treasury bills, mortgages, and commercial notes, from borrowers.

On the other hand, they offer their own financial claims to lenders, such as deposit with passbook entries and deposit receipts that represent claims against the bank. [1]

The existence of financial intermediaries enables surplus units to save in financial assets and the deficit unit to invest in excess of their own savings. In the absence of financial instruments, each unit's saving is necessarily equal to its investment, whereas with the existence of financial intermediaries and various financial instruments, an economic unit's would be allowed to invest more or less than its savings. The importance of the existence of financial institution and instrument lies in the fact that savings that are not invested within the economic units can now be transferred to investing units through the conduit of financial papers (Goldsmith, 1969).

Besides that, financial institutions have the ability to collect savings that are needed in order to undertake large and indivisible investment projects. In order to let an economic unit to operate at its minimum cost level, it may require large amount of financing, which is far in excess of its savings (except possibly central government), but with the existence of financial institution, it increases the chances to undertake large investment projects. Through their specialized knowledge of the credit market, the savings would be allocated more efficiently among potential investments. By evaluating alternative investments and

'he detail explanation about the significance of financial intermediaries has been conveyed in Fry's study. ry, 1988, pp. 235 – 237) monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use (Goldsmith, 1969).

In financial market, financial intermediaries also play an important role as they can reduce the problem of adverse selection[2] and moral hazard[3], which are created by asymmetric information. These two problems can increase the bad credit risks and the lenders may decide not to make any loans even though there are good credit risks in the market place. In view of the financial intermediaries are better equipped than individuals to screen out good from bad credit risks, hence reduces losses due to adverse selection. In addition, financial intermediaries have the expertise in monitoring the parties they lend to, thus reducing losses due to moral hazard (Mishkin, 1997).

4 THE EFFICIENCY OF FINANCIAL INTERMEDIARIES IN PROVIDING FINANCIAL SERVICES

A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides these services. Competition ensures that transaction costs are held down as risk is allocated to those most willing to bear it, and that investment is undertaken by those with the most promising opportunities (World Bank, 1990).

Adverse selection in financial markets occurs when the potential borrowers, who are most likely not able pay back, are the ones who most actively seek out a loan and are thus most likely to be selected.
Moral hazard the problem created by asymmetric information after the transaction occurs. It is the risk ıazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point f view because they make it less likely that the loan will be paid back.

In order to face the heavy competition in financial industry, financial intermediaries must compete successfully with other borrowers to attract lenders, depositors or savers. With funds thus obtained, they must then compete with other lenders to buy direct claims. Financial intermediaries must offer indirect claims that are as attractive as or better than direct claims to lenders, while at the same time competing with lenders to buy direct claims. This is achieved through specialization and by reaping economies of scale in financial transactions, information gathering, and portfolio management (Fry 1988).

Tobin (1984) indicates that there are at least four separate concepts of efficiency by which the financial system can be measured: Information arbitrage, fundamental valuation, full insurance, and functional efficiency:

i. ***Information arbitrage efficiency*** measures the extent to which it is possible to gain on average from trading on the basis of generally available information. Complete information arbitrage efficiency implies that it is not possible to gain from such trading.

ii. ***Fundamental valuation efficiency*** measures the degree to which market values of financial assets reflect accurately the present value of the stream of future payments associated with holding that asset.

iii. ***Full insurance efficiency*** measures the degree to which the financial system offers ways of hedging against all possible future contingencies.

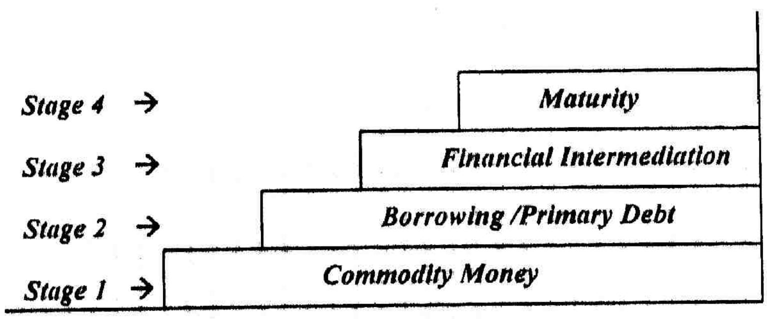
iv. ***Functional efficiency*** measures the degree to which the financial intermediaries administer the payments mechanism and intermediate between savers and investors. It involves risk pooling, resource allocation, general insurance, administering the payments mechanism, and mobilizing saving for investment.

Fry (1988) extended the study on functional efficiency. He pointed out that financial intermediaries administer a country's payments mechanism by providing currency notes of desired denominations when and where they are wanted and by transferring deposits upon instructions. In the case of deposit transfer from one part of the country to another, a financial system is considered efficient in administering its country's payments mechanism if and only if it is able to develop a cheap, quick, and safe method for interregional payments.

2.5 THE FLOW OF FUNDS

As shown in Figure 2.1, the development of a financial system in most countries may be said to involve four basic stages : a commodity money stage, a borrowing or primary debt stage, a financial intermediation stage and finally, a maturity stage (BNM, 1989).

Figure 2.1 : Stages of the Development of a Financial System



Source : BNM (1989), World Bank (1990).

In the early stage, as the economy developed from a barter trade system, the "commodity" money such as tokens, which often made of precious metal, was used in the monetary system. They were used to facilitate trade and served as standard units of account and measures of value. However, barter was inefficient, transaction costs were high, and the lack of a medium of exchange limited the extent of the market and the opportunities for specialization (World Bank,1990).

When there was a need from entrepreneurs and consumers to invest or consume in excess of their own resources or income, the practice of borrowing emerged and the next stage of development arrives. In this stage, funds that were accumulated by wealthy persons are channeled in the form of loan to other individuals or enterprises, which need to utilize these excess funds for a fee or investment.

However, the amount and maturity of the loans offered by the surplus units may not meet the exact requirements of the deficit units. In addition, the surplus units, which hold financial assets, always incur an element of default risk where the deficit unit may not be able to pay back their debt. This risk reduced the confidence of surplus units on the repayment ability of deficit unit. Furthermore, the surplus units also faced the "liquidity" problem as the holder of a direct loan may not be able to dispose of his claim on the deficit unit to another person, who may not be willing to purchase the financial assets without adequate knowledge of the credit standing of the borrower. Therefore, in this simple financial system, markets for such primary debt[4] arose particularly for the debt of reputable borrowers, such as Government. A partial solution to "default risk" problem was the issue of shares by limited liability companies, whose shareholders could benefit from profits but incurred losses limited only to the extent of their shareholding.

The problem of borrowing-lending process raised in second stage of financial system can be overcome by the development of financial intermediaries. This involved the third stage of evolution. A body of specialized financial institutions was established to issue relatively risk-free liabilities to meet the varied needs of the surplus units. This helped to reduce the default risk that faced by surplus unit in the previous stage. On the other hand, these financial institutions were able to mobilize the funds from savings by surplus units to the deficit units, in amounts and maturity, with terms and conditions that could match the requirements of the deficit units.

The final stage of evolution would arrive when the financial institutions move towards maturity. There would eventually emerge a whole complex of financial intermediaries, offering a variety of financial instruments as savings media for the surplus units as well as a varied range of credit and investment facilities to meet the financing requirements of the deficit units (BNM, 1989).

[4]he primary debt is the direct loans from surplus units to deficit units.

Figure 2.2 : THE FLOW OF FUNDS IN AN ECONOMY

SOURCES OF FUNDS Savings from surplus units		FINANCIAL INSTRUMENTS		FINANCIAL INTERMEDIARIES		FINANCIAL INSTRUMENTS		USES OF FUNDS Investments/Expenditure of deficit units
Households Enterprises Government Rest of the world	→ → → →	- Currency - Deposits - Bills - Loans - Bonds - Unit trusts - Share Capital - Foreign loans & investments - Insurance - Provident & pension contributions	→	- Deposit and credit institutions - Contractual savings institutions - Collective investment institutions - Securities markets - Informal financial enterprises	→	- Money at call - Overdrafts - Bills - Term loans - Hire Purchase - Leasing - Securities - Bonds - Debentures - External reserves	→ → → →	Households Enterprises Government Rest of the world

Source : BNM (1989)

The flow of funds as shown in Figure 2.2 illustrates a developed financial system, where each economic sector has different sources and uses of funds from the other sectors and behaves relatively homogeneously as a group, such as households, enterprises, Government and financial institutions. The household sector includes small, mainly unregulated firms and individuals. They as a group usually the major net surplus units in an economy, since they save a significant proportion of their income. Nevertheless, a significant proportion of the funds is also channeled to households by financial intermediaries in the form of consumer credit and housing loans.

Both the enterprise and the Government sectors are usually the deficit units in an economy as they always involve in the investment process in an economy. They use the financial system as a source of funding for current and capital spending. Governments have also used the financial system to serve development or other goals.

Pertaining to financial system, in addition to the central bank, most countries have five main classes of financial institution, namely the deposit and credit institutions, contractual savings institutions, collective investment institutions, securities markets, and informal financial enterprises. (World Bank, 1990) The financial intermediaries will mobilize the funds from surplus units to deficit units in the form of loan, bill and other financial instruments. Basically, financial intermediaries operate in two markets, i.e. the savings market and the credit market. In the savings market, they operate as borrowers, offering to meet the demand for financial assets by surplus units in the form of indirect financial claim, such as deposits, share capital and other savings media. In the credit market, they supply the financial resources required by the deficit units in the form of direct financial claim.

6 The Empirical Studies of Financial Intermediation in Malaysia

The literature on the development of financial intermediation in Malaysia is chiefly the work of Lee Hock Lock (1981, 1987) and Bank Negara Malaysia (1984, 1989, 1994 and 1999).

In the early years, the function of financial intermediation was primarily performed by the commercial banks, which were highly foreign orientated. Besides the banks, non-bank financial institutions were practically non-existent. Generally, the financing practices of the commercial banks were to support trading activities. As compared to foreign banks, the operation of the local banks was small as they lacked banking experience, especially in exchange dealings. However, they filled a gap in the credit market by catering mainly to the smaller domestic enterprises, which did not have sufficient access to the foreign banks (BNM, 1984).

The establishment of the Central Bank in 1959 marked a new epoch in the history of the development of financial system in Malaysia.

The principal objectives of the Central Bank are :

- to issue currency and to keep reserves safeguarding the value of that currency;
- to act as banker and financial adviser to the Government;
- to promote monetary stability and a sound financial structure; and
- to influence the credit situation to the advantage of the country.

In order to meet these objectives, the Central Bank was accorded with comprehensive legal powers to regulate and supervise the financial system. However, the Central Bank would exercise these powers only to the extent that their outcome would be consistent with the goals of Government policy. (Lee, 1981) The development of financial intermediation in Malaysia from 1970 to 2000 will be discussed in details in Chapter 3.

Besides that, Lin (1993) discusses Malaysia's experience in managing the savings-investment gap to achieve its main objective of sustained rapid growth with price stability. Last but not least, Sieh-Lee (2000) evaluates Malaysia's role in global strategies for several sectors including the financial sector.