CHAPTER 3
THE DEVELOPMENT OF FINANCIAL INTERMEDIATION IN MALAYSIA FROM YEAR 1970 TO 2000

3.1 INTRODUCTION

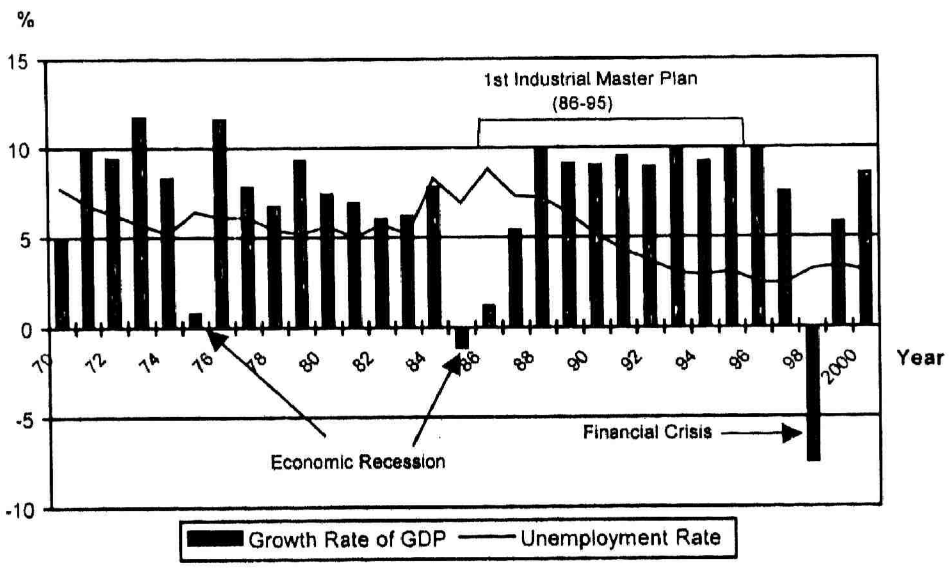
This chapter will examine the development of financial intermediation in Malaysia for the last three decades. In the first part of this chapter, the historical background of Malaysian economy will be discussed, including the growth of real GDP, unemployment rate, sectoral review, merchandise export and saving-investment gap. In the later part of the chapter, the development of Malaysian financial system will be explored. Topics that have been covered in this research paper comprise the evolution and structure of the financial system, the sources and uses of fund, and the change in lending practice of the financial system.

3.2 THE MALAYSIA ECONOMY : A BACKGROUND PERSPECTIVE

3.2.1 The Growth of Real GDP and The Employment

Figure 3.1 presented the growth rate of GDP at constant prices (real GDP) and unemployment rate from 1970 to 2000. Since Malaysia gained independence in 1957, the economic growth in this nation was sustained at high rate up to 1980 (except 1975), but the pace of growth slowed down in the first half of 1980s as economic activity was dampened by the prolonged global recession during that period. The growth rate of real GDP reached its trough in 1985, which was -1.1%. The economic recession forced the Government to undertake several anti-cyclical fiscal measures to sustain the growth momentum.

Figure 3.1 : Growth Rate of Real GDP and Unemployment Rate (1970 - 2000)

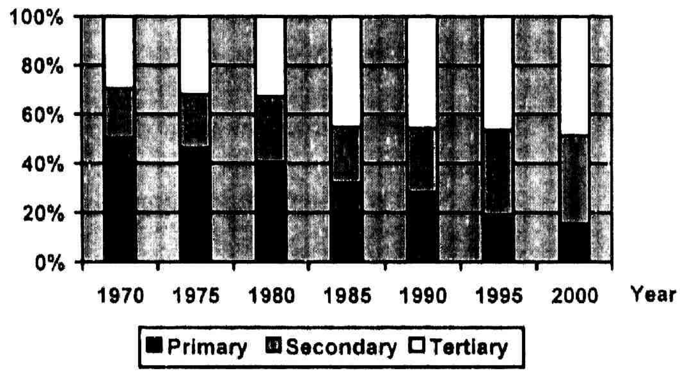


Source : BNM (1999), BNM Annual Report, 2000.

After recovered from the economic recession, the economy gained an average annual rate of 6.9% in the second half of the 1980s. The rapid growth during the period 1988 – 1997 was accompanied by further structural transformation of the economy, which reflected in the manufacturing, services and construction sectors as new investment and reinvestment were channeled mainly into these sectors.

The financial crisis, which started in mid-1997, was another challenge to Malaysian economy. The growth rate of real GDP was slackened dramatically from 10% in 1996 to -7.5% in 1998. However, the economy was recovered just within a short period mainly due to the significant progress made in the restructuring of the banking and corporate sectors. In addition, the strong growth of export and the increased domestic expenditure have also accelerated the growth of real GDP.

Figure 3.2 : Employment By Sector (1970 - 2000)



Source : Malaysia Plan, various issues.

From the aspect of employment, due to the structure adjustments in the economy in 1970s and 1980s (See Figure 3.2), the unemployment rate was maintained at high level during that period, which registered within the range of 5% to a peak of 8.8% in 1986. (See Figure 3.1) In 1990s, the expansion in economic growth had improved the labour market situation, reflected in the decline of the unemployment rate to the level below 4%. The financial crisis in mid-1997 did not increase the unemployment rate much but it resulted in the significant drop in foreign work force.

3.2.2 Sectoral Review

Table 3.1 and figure 3.3 show the GDP by industry of origin, which reflected the significant structural changes in production, particularly manufacturing and agriculture sector. As a whole, tertiary sector had been playing a major role in economic growth, which accounted for about half of the total GDP over the period 1970-2000. In 1970s, agriculture sector was a leading source of total output with its share of 32.1% in 1970 and 29.8% in 1975. However, its role decreased since 1980 and had been taken over by secondary sector, which mainly due to the rapid growth in manufacturing sector.

In 1990s, there were significant developments occurred in the services sector, reflecting the effort by Government to promote the economy into a high-technology driven and high value-added economy.[7]. The rapid growth in technological progress and the deregulation and deepening of financial markets have increased the interlinkages between the services sector and the other sectors of the economy. The share of the services sector in total GDP increased to 51.8% in 1997 before moderated to 50% in 2000.

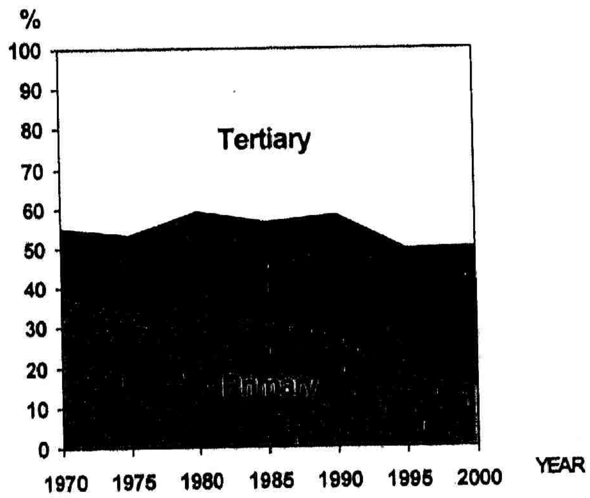
The development of these economic sectors indicated the general pattern of economic development, with the prominent role that shifted from agriculture sector to manufacturing sector, and then to services sector.

Table 3.1 : GDP by Industry of Origin, 1970-2000 (% of GDP)

Industry	1970	1975	1980	1985	1990	1995	2000
Agriculture	32.1	29.8	22.8	20.8	18.7	10.3	8.7
Mining & Quarrying	5.7	4.0	10.0	10.4	9.8	8.2	6.6
Manufacturing	12.2	14.4	20.0	19.7	26.9	27.1	33.4
Construction	4.5	4.6	4.6	4.8	3.6	4.4	3.3
Electricity, Gas & Water	2.3	2.6	1.4	1.7	1.9	3.5	3.4
Transport, Storage & Communications	5.7	7.2	5.7	6.3	6.9	7.4	8.0
Wholesale & Retail Trade, Hotels & Restaurants	13.3	13.6	12.0	12.1	11.1	15.2	14.9
Finance, Insurance, Real Estate & Business Services	7.8	7.2	8.3	9.0	9.8	10.4	11.8
Government Services	7.4	7.8	10.2	12.2	10.6	7.1	7.0
Other Services	8.2	8.1	2.3	2.3	2.1	7.7	7.5
Net Import Duties less Imputed Bank Service Charges	0.8	0.7	2.7	0.7	- 1.4	- 1.2	- 4.5
GDP	100	100	100	100	100	100	100
After adjusted for Import Duties less Imputed Bank Service Charges							
Primary Sector	38.1	34.1	33.7	31.4	28.1	18.2	14.7
Secondary Sector	16.8	19.1	25.3	24.7	30	31.2	35.3
Tertiary Sector	45.1	46.8	41	43.9	41.9	50.6	50

Source : Malaysia Plan, various issues.

Figure 3.3 : GDP BY THREE MAIN SECTORS, 1970-2000



Source : Malaysia Plan, various issues.

Merchandise Exports Review

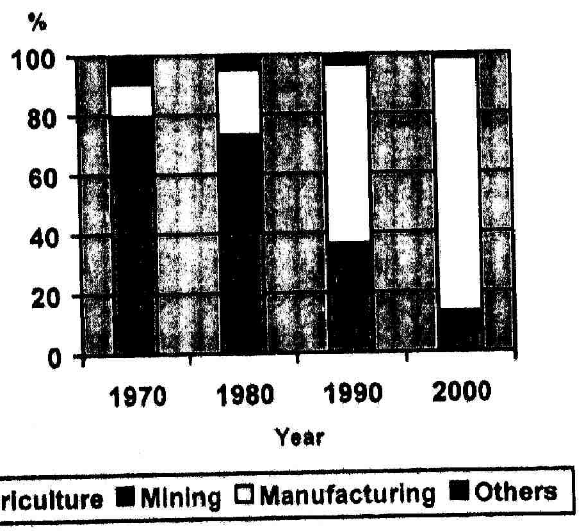
As a whole, the total export grew at an up-down-up trend during period 1970-2000, which registered an average growth rate of about 18.5% in 1970s, 10.9% in 1980s and 16.7% in 1990s. (See Table 3.2)

Table 3.2 : Merchandise Export, 1970-2000 (RM million)

Sector	1970	1980	1990	2000
Agriculture	2,932	11,374.7	15,099	22,914
Mining	1,177	9,214.4	13,767	26,801
Manufacturing	572	6,269.8	48,047	317,937
Others	482	1,312.7	2,635	5,655
Total	**5,163**	**28,171.6**	**79,548**	**373,307**

Source : Malaysia Plan, various issues.

Figure 3.4 : Merchandise Exports, 1970-2000



Source : Malaysia Plan, various issues.

Based on the percentage of each category to total exports as shown in Figure 3.4, there was a significant structural change in the total exports during period under review. In 1970, agriculture sector was the primary contributor to export earnings with its 56.8% contribution to the total export receipts.

With the success of industrialization policy and the increase of external demand for electronics and electrical products, manufacturing sector grew rapidly, reflected in its increasingly share in total exports from 22.2% in 1980 to 85.2% in 2000. Together with the decline in contribution of agricultural exports and mineral products to merchandise export, it indicates that Malaysian economy has been strongly depending on the manufactured exports in its total production as well as total exports over the last decade.

.2.4 The Savings-Investment Gap

During the period of 1970 – 2000, as shown in Table 3.3 that the Malaysian economy faced serious resource gap in the first half of both 1980s and 1990s, which registered –8.8% and –6.8% of GNP respectively. In 1970s & 1980s, particularly in the first half of 1980s, gross investment in public sector played an increasingly role in supporting the economic growth and the expansion of public enterprises towards economy's diversification into heavy industries. In view of the small portion of public savings, the public sector confronted with resource gap over that period.

Table 3.3 : MALAYSIA - SAVINGS AND INVESTMENT, 1971-2000

	1971-75	1976-80	1981-85	1986-90	1991-95	1996-2000
	% of GNP					
Public Gross Domestic Capital Formation	7.8	10.3	17.3	11.0	14.1	12.6
Public Savings	2.4	7.3	11.7	10.3	17.4	17.1
Deficit or Surplus	-5.4	-3.0	-5.6	-0.7	3.3	4.5
Private Gross Domestic Capital Formation	16.5	17.1	18.9	17.5	26.7	21.0
Private Savings	18.4	22.7	15.7	20.7	16.6	23.0
Deficit or Surplus	1.9	5.6	-3.2	3.2	-10.1	2.0
Gross Domestic Capital Formation	24.4	27.4	36.2	28.6	40.8	33.6
Gross National Savings	20.8	30.0	27.4	31.1	34.0	40.1
Balance on Current Account	-3.6	2.6	-8.8	2.5	-6.8	6.5

Source : BNM annual report, 1996
Eighth Malaysia Plan

In order to overcome the savings-investment gap, the Government had implemented some voluntary structural adjustments such as privatization programs to reduce its role in economic development. This resulted in a marked increase in private investment to 26.7% of GNP in 1991-95, compared with about 17% & 18% in 1970s and 1980s respectively. In addition, due to the reduction in savings level as a percentage of GNP at the same time, the private sector confronted with a serious deficit, which accounted for 10.1% of GNP. The deficit was financed mainly by foreign direct investment (FDI) and long-term borrowing from abroad.

In 1996-2000 period, the overall resource gap had turned around to show a positive position to 6.5% of GNP. During 1996-97, the gap had been narrowed down to about 5% in line with the completion of some of the large infrastructure projects as well as the slow down in the implementation of new ones with high import content by the public sector. On the other hand, the gross national savings grew to about 40.1% of GNP, which mainly due to the cautious attitude of consumers during the financial crisis, also contributed to the resource surplus in that period.

By the end of 2000, the strong growth in nominal income resulted in higher investment and savings. The high rate of savings had enabled the nation to get financing from domestic sources instead of the reliance on borrowings from abroad.

3.3 THE DEVELOPMENT OF FINANCIAL SYSTEM

3.3.1 The Evolution of Financial System

3.3.1.1 Financial Institutions

The development of Malaysian financial system in 1970s was basically an expansion of institutional building, particularly the domestic banking network. Prior to 1970, the financial structure in Malaysia contained primarily the commercial banks, which were highly foreign-orientated. Since 1970, the banking network had expanded widely to the small townships in the rural areas.

Figure 3. 5 : The Evolution of Financial System

1970s — **Expansion of Institutional Building**

↓

1980s — **Economic Recession**

↓

Strengthen BNM's Supervision & Regulation to Financial Institution / BAFIA

↓

1990s — **Economic Growth**

↓

IOFC, Islamic Banking & Electronic Banking

↓

Financial Crisis

↓

Consolidation and Restructuring of the Financial System

For finance companies, there were 25 finance companies with 130 branches in 1970, which were brought under the supervision of the Central Bank via Finance Companies Act in 1969. By the end of 1978, the total of finance companies had increased to 33 with 197 branch offices. This reflected the increasing financing need and attention by public to the financial system. The first merchant bank, which was established in 1970, had accelerated the growth of financial system to complement other banking institutions in wholesale banking and corporate financing. By the end of 1973, a total of five merchant banks had been set up in Kuala Lumpur.

In addition to the three main banking institutions, there was a growing range of other financial institutions in 1970s, including the National Savings Bank (1974), the housing finance institutions, the leasing companies (1974), the provident and pension funds, the insurance companies and development banks. During that period, the Banking Act, 1973 was implemented to empower the Central Bank with greater flexibility in the use of policy instruments to supervise and control the operation of an expanding banking system.

In 1980s, the development of financial system was adversely affected by the prolonged economic recession in mid-1980s. Furthermore, the incident of the deposit-taking co-operatives (DTCs) during 1985-89 had led to the suspension of 24 co-operatives for further investigation. In view of that, in the late of 1980s, policies were focused on strengthening the prudential regulations to promote financial stability. Hence, the enactment of the Banking and Financial Institutions Act (1989), which repealed the Banking Act (1973) and Finance Companies Act (1969), extended the power of BNM for supervision and regulation not only to banking institutions, but also the non-bank financial institutions.

In 1990s, one of the significant institutional developments was the establishment of Labuan International Offshore Financial Centre (IOFC) in 1990. With this offshore financial centre, the financial system will enhance its attractiveness as a regional financial centre with a variety of international banking, insurance and investment instruments.

On the other hand, the launching of the Interest-free Banking Scheme in 1993 provided the foundation for developing a comprehensive Islamic Banking System in Malaysia. Following the development of Islamic Banking, various measures were introduced in 1998 to further promote the Islamic banking sector. In addition, the development of electronic banking accelerated the growth of financial system in 1990s. Malaysian Electronic Payment System (MEPS), which was formed in 1997, played an increasingly crucial role in undertaking electronic funds transfer activities for payment of retail transactions. The use of Internet in banking activities also grew markedly over recent years.

Another landmark development in the financial system of Malaysia was the consolidation and restructuring of the financial system. The experience during the financial crisis in mid-1980s and the late of 1990s exposed the vulnerability of small banking institutions and created a need to strengthen the capacity and capability of domestic banking institutions to meet future challenges. BNM enforced the consolidation process by setting the deadline for the merging program involved the commercial banks as well as the finance companies. As at end of Jan 2001, there were only 29 commercial banks, of which 14 were domestic banks, and 12 finance companies (See Figure 3.6).

Figure 3.6 : LIST OF BANKING INSTITUTIONS (AS AT 31 JANUARY 2001)

Commercial Banks			
1	ABN Amro Bank Berhad	2.	Affin Bank Berhad
3	Alliance Bank Malaysia Berhad	4.	Arab-Malaysian Bank Berhad
5	Bangkok Bank Berhad	6.	Bumiputra-Commerce Bank Berhad
7	Bank of America Malaysia Berhad	8.	Bank of China (M) Berhad
9	Bank of Tokyo-Mitsubishi (M) Berhad	10.	Bank Utama (M) Berhad
11	Citibank Berhad	12.	Deutsche Bank (M) Berhad
13	EON Bank Berhad	14.	Hock Hua Bank Berhad
15	Hong Leong Bank Berhad	16.	HSBC Bank (M) Berhad
17	Malayan Banking Berhad	18.	OCBC Bank (M) Berhad
19	Overseas Union Bank (M) Berhad	20.	PhilleoAllied Bank (M) Berhad[a]
21	Public Bank Berhad	22.	RHB Bank Berhad
23	Southern Bank Berhad	24.	Standard Chartered Bank Malaysia Bhd
25	The Bank of Nova Scotia Berhad	26.	The Chase Manhattan Bank (M) Bhd
27	United Overseas Bank (M) Berhad	28.	Bank Islam Malaysia Berhad
29	Bank Muamalat Malaysia Berhad		
Finance Companies			
1	Alliance Finance Berhad	2.	Hong Leong Finance Berhad
3	Arab-Malaysian Finance Berhad	4.	Kewangan Bersatu Berhad
5	Asia Commercial Finance (M) Berhad	6.	Mayban Finance Berhad
7	Bumiputera-Commerce Finance Berhad	8.	MBf Finance Berhad
9	Delta Finance Berhad	10.	Public Finance Berhad
11	EON Finance Berhad	12.	United Merchant Finance Berhad
Merchant Banks			
1	Alliance Merchant Bank Berhad	2.	Perdana Merchant Bankers Berhad
3	Arab-Malaysia Merchant Bank Berhad	4.	Perwira Affin Merchant Bank Berhad
5	Aseambankers Malaysia Berhad	6.	Public Merchant bank Berhad
7	Commerce International Merchant Bankers Berhad	8.	RHB Sakura Merchant Bankers Berhad
9	Malaysian International Merchant Bankers Berhad	10.	Utama Merchant Bank Berhad

Source : BNM, Monthly Statistical Bulletin, Feb 2001.

[a] Merged with Malayan Banking Bhd on 01/03/2001.

3.1.2 Financial Market

In 1970s, there was a rapid growth in the money market, especially the growing inter-bank market, after the second discount house was established in 1971. After the termination of the currency interchangeability arrangements with Singapore and Brunei in 1973, Malaysia ringgit was allowed to float. This provided foundation to the development of the foreign exchange market in Malaysia and opened up new opportunities for the commercial banks to expand their foreign exchange operations. On the other hand, Kuala Lumpur stock Exchange (KLSE) was established in the same year. Following this development, formal regulations were also drawn up, including the enactment of Securities Industry Act, 1973.

In 1980s, the banking institutions have increasingly demand on non-deposit sources of funds to meet their short-term funding needs. This resulted in the rapid growth in the use of Repo, which can be seen by the increase of the outstanding repos of commercial banks from RM644 million in 1981 to RM3,752 million in 1988[5]. In mid-1980s, the equity market confronted its own unique challenge known as Pan-Electric Industries crisis[6], led to three-day suspension of trading in December 1985. Consequent to this crisis, KLSE had implemented numerous reforms to increase the monitoring on the listed companies and enhance the efficiency of trading system.

Besides that, BNM initiated the establishment of the Securities Commission (SC) in 1993 to regulate and supervise over capital market. The KLSE Composite Index grew rapidly in 1996 and 1997 before it was halted in mid-1997 due to the financial crisis. With the imposition of selective Exchange Controls and other measures such as the reduction in interest rate, KLSE turned around to continue on its upward trend. In order to promote the development of high-growth and technology companies in Malaysia, the trading on a new stock exchange, i.e. MESDAQ, were commenced in 1999. As at the end of Oct 2000, there were a total of three companies listed on the stock exchange.

[5] Source : BNM (1989)

The bond market, in the early 1980s, was mainly dominated by MGS issuance to finance Government development spending. However, the secondary trading of MGS was highly illiquid due to the statutory requirements for most financial institutions to hold MGS until maturity. In the second half of 1980s, reforms to promote the secondary trading of MGS were undertaken. By the end of 1999, there were 15 principal dealers for MGS. On the other hand, the commencement of operations by Cagamas Bhd in 1987 had turned around the private debt securities market to become the primary securities in 1990s.

In 1990, a computerised scripless trading system, SPEEDS[7] was introduced to further encourage secondary trading in the bond market. After nine years, it was then replaced by the Real Time Electronic Transfer of Funds and Securities System (RENTAS), which allowed real-time delivery versus payment (DVP) for electronic book-entry settlements. During the same decade, the establishment of the Rating Agency of Malaysia (RAM) and the Malaysian Rating Corporation Bhd.(MARC) had promoted greater market efficiency of the PDS issuance.

A significant development in derivatives market was the establishment of Kuala Lumpur Commodity Exchange (KLCE) in 1980, which involved in the transactions of exchange-traded derivatives. Kuala Lumpur Commodity Clearing

' The crisis due to a Singaporean incorporated publicly listed company, i.e. the Pan-Electric Industries, collapsed behind hundreds of million of dollars of debt and the problem of circulatory forward contracts.

House (KLCCH) was established to provide the clearing mechanism for transactions on the KLCE. In 1990s, the establishment of KLOFFE[8], MDCH[9] and MME had further developed the derivatives industry. In 1998, KLCE and MME[10] were merged to establish Commodity and Monetary Exchange of Malaysia (COMMEX).

3.2 The Structure of Financial System

As in other countries, the structure of the financial system in Malaysia may be divided into two parts, the financial institutions and the financial markets. The financial institutions can then be divided into the banking system and the non-bank financial intermediaries.

Figure 3.7 shows the structure of Malaysian Financial System. The banking system comprises the Central Bank, commercial banks, finance companies, merchant banks and others such as discount houses, representative offices of foreign banks and offshore banks in Labuan (IOFC). The non-bank financial intermediaries may be divided broadly into five groups of institutions, such as the provident and pension funds, insurance companies, development finance institutions, savings institutions and a group of other financial intermediaries.

Sistem Pemindahan Elektronik Untuk Dana dan Sekuriti.
Kuala Lumpur Options and Financial Futures Exchange, on which KLSE Composite Index Futures (FKLI) contracts are traded.
Malaysian Derivatives Clearing House Bhd., was established in 1995 to clear contracts traded.
[10] Malaysian Monetary Exchange, on which KLIBOR Futures contracts are traded.

Figure 3.7 : STRUCTURE OF MALAYSIA'S FINANCIAL SYSTEM

FINANCIAL INSTITUTION	FINANCIAL MARKETS
BANKING SYSTEM ❖ Bank Negara Malaysia ❖ Banking Institutions - Commercial Banks [1] - Finance Companies - Merchant Banks ❖ Others - Discount House - Representative Offices of Foreign Banks - Offshore Banks in Labuan IOFC	Money and Foreign Exchange Market ❖ Money Market ❖ Foreign Exchange Market Capital Markets ❖ Equity Market ❖ Bond Market - Public Debt Securities - Private Debt Securities
NON-BANK FINANCIAL INTERMEDIARIES ❖ Provident and Pension Funds ❖ Insurance Companies [2] ❖ Development Finance Institutions ❖ Savings Institutions - National Savings Bank - Co-operative societies ❖ Other Non-Bank Financial Intermediaries - Unit Trusts - Pilgrims Fund Board - Housing Credit Institutions - Cagamas Berhad - Credit Guarantee Corporation - Leasing Companies - Factoring Companies - Venture Capital Companies	Derivatives Markets ❖ Commodity Futures ❖ KLSE CI Futures ❖ KLIBOR Futures Offshore Market Labuan International Offshore Financial Centre (IOFC)

Source : BNM (1999)

[1] Including Islamic Banking.

[2] Including Takaful companies.

For completeness, there are four financial markets in Malaysia, comprising the money and foreign exchange markets, the capital markets, the derivatives markets and the offshore market.

.2.1 Financial Institutions

As shown in Table 3.4, the total assets of Malaysian financial system, which expressed in current prices, had increased to RM1,243 billion at the end of 2000, compared with just RM11.6 billion at the end of 1970. The banking system is the largest component of the financial system, accounting for about 70% of the total assets of the financial system. Commercial Banks are the largest group of financial institutions, with an average of about 40% of the total assets of the financial system over the period 1970 – 2000. Its total assets had grown significantly during the review periods to RM513.6 billion at the end of 2000, which is about 114 times of its assets at the end of 1970.

Finance companies are the second largest group of financial institutions after the commercial banks. These institutions registered RM531 million in their total assets at the end of 1970, but had grown to reach RM109.4 billion after thirty years. Merchant banks and discount houses are also the important groups of financial institutions, which registered RM36.9 billion and RM1.7 billion at the end of 2000.

Among the non-bank financial intermediaries, the largest group of which is the provident and pension fund. Employees Provident Fund (EPF) is the largest of the provident and pension funds, which accounted for about 75% of the total assets of this group. Besides EPF, these funds include Teachers Provident Fund, the Armed Forces Fund and the Social Security Organization. This group of non-bank financial intermediaries registered RM2.7 billion in total assets at the end of 1970, and had risen to RM217.6 billion at the end of 2000.

Table 3.4 : MALAYSIA - ASSETS OF THE FINANCIAL SYSTEM, 1970 - 2000

	As at end of							
	1970		1980		1990		2000	
	$m	%	$m	%	$b	%	$b	%
I. Banking System	7,455	64.1	54,346	73.3	227.0	68.9	829.9	66.8
Central Bank	2,227	19.2	12,994	17.6	40.9	12.4	148.9	12
Currency Board [1]	195	1.7	-	-	-	-	-	-
Commercial Banks [2]	4,460	38.4	32,186	43.4	130.7	39.7	513.6	41.3
Finance companies	531	4.5	5,635	7.6	39.4	12	109.4	8.8
Merchant banks	...	...	2,229	3.0	11.0	3.3	36.9	3.0
Discount houses	42	0.3	1,292	1.7	4.9	1.5	21.1	1.7
II. Non-bank financial intermediaries	4,167	35.9	19,807	26.7	102.4	31.1	413.1	33.2
a. Provident and pension fund	2,717	23.4	11,370	15.3	52.1	15.8	217.6	17.5
b. Insurance funds	439	3.8	2476	3.4	9.5	2.9	52.2	4.2
c. Development finance institutions	133	1.1	2,193	2.9	6.1	1.9	25.1	2.0
d. Savings institutions	645	5.5	2,463	3.3	8.5	2.6	32.3	2.6
e. Other financial intermediaries	233	2.1	1,315	1.8	26.1	7.9	85.9	6.9
Total	11,622	100	74,153	100	329.3	100	1243.0	100

[1] The currency Board ceased to function with effect from November 30, 1979.
[2] Include Bank Islam.
Source : BNM Annual Report, various issues.

Unlike the non-profit making provident and pension funds, the insurance companies are profit-motivated private enterprises. The insurance companies played an increasingly important role in financial system with its total asset amounting to RM429 million at the end of 1970 and increased to RM52.2 billion in 2000.

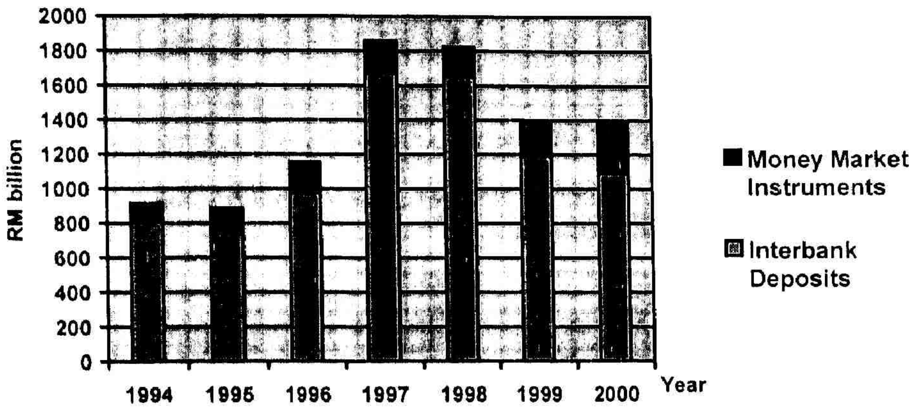
The development finance institutions is another group of non-bank financial intermediaries, which owned largely by the public sector. One of the largest of these institutions is the Malaysian Industrial Development Finance Bhd., which is the leading source of medium and long-term finance for industrial projects in the country. These institutions' total assets were registered RM133 million in 1970, but had risen rapidly to reach RM25.1 billion at the end of 2000, which are about 2% of the total assets of the whole financial system.

!.2 Financial Markets

Money and Foreign Exchange Markets

Money and Foreign Exchange Markets is the market where the lending and borrowing of short-term funds typically not exceeding 12-month take place. The operations of money market consist of interbank market and the purchase and sale of short-term securities, such as banker acceptances, treasury bills and negotiable instruments of deposit. The volume of transactions in the money market experienced a steady increase in 1990s to the peak in 1997, which amounted to RM 1,860.6 billion. (See Figure 3.8) The strong uptrend in the money market activities reflected the greater reliance of banking institutions on the money market to meet their short-term funding requirements. However, due to the financial crisis in mid-1997, the volume of transactions moderated to reach RM 1,385.4 billion in 2000.

Figure 3.8 : Volume of Transactions In Interbank Money Market (1994-2000)



Source : BNM (1999), BNM Annual Report, 2000.

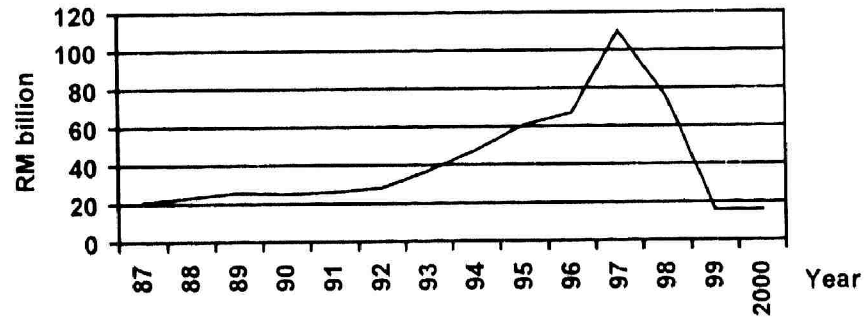
The Foreign Exchange Market serves as a place for the trading of foreign currencies against the Ringgit as well as other foreign currencies. It comprises spot market and the forward and swap markets. The average monthly volume of interbank foreign exchange transactions was less than RM300 million in the first half of 1973, but it grew rapidly to reach RM20.7 billion in 1987 and to a peak of RM 109.9 billion in 1997. (See Figure 3.9) The unusual high volume of transactions in 1997 was resulted from the financial crisis, which led to the speculative activities on ringgit and the panic selling activities by corporations, banks and mutual funds.

As a step to rescue the crisis, the selective exchange control was imposed and the ringgit was pegged to US dollar at a fixed exchange rate. Consequent to these measures, the volume of foreign exchange transactions declined by 36.1%

in 1998. Up to 2000, the transactions of US dollar against ringgit remained dominated the foreign exchange market.

Figure 3.9 : Average Monthly Volume of Interbank Transactions in Kuala Lumpur

Foreign Exchange Markets (1987-2000)



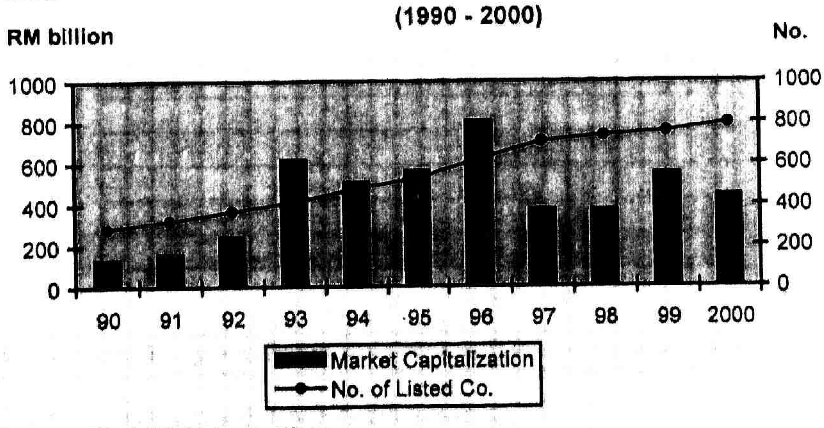
Source : BNM (1999), BNM annual report, 2000.

Capital Market

Capital market is the market for raising long term funds and it comprises the equity and bond markets. Equity market provides the place for corporations to raise funds by issuing shares. The secondary market trading in stocks and shares is conducted in KLSE and MESDAQ.

Figure 3.10 : Market Capitalization and No. of Companies listed in KLSE

(1990 - 2000)

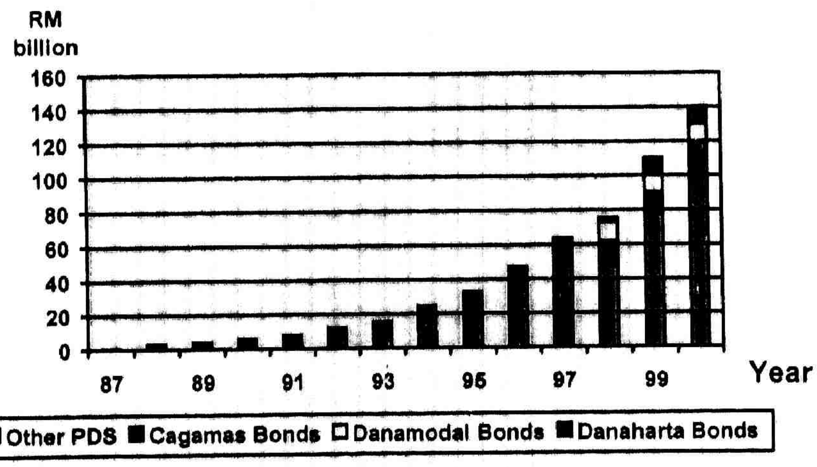


Source : 7th & 8th Malaysia Plans.

KLSE experienced significant expansion in 1990s with the market capitalisation increased from RM 73. 8 billion in 1987 to reach a peak of RM 891 billion on 25 Feb. 1997. However, the figure declined dramatically to a low of RM181 billion on 1 Sept. 1998 due to the financial crisis happened during that time. At the end of 1999, it rebounded to RM 552.7 billion before moderating to RM444.4 billion at the end of 2000. (See Figure 3.10)

Bond market is the market for issuing PDS and Government securities by private sector and public sector respectively. Secondary market trading for those listed bonds is operated through KLSE, whereas the unlisted bonds are traded through the over-the counter (OTC) market. The PDS market enjoyed the rapid growth with its total outstanding amount grew at an average rate of 57.1% over the period 1987-2000. The development was accelerated by the increased need to finance economic activities and low interest rate environment. (See Figure 3.11)

Figure 3.11 : The PDS Market (The Estimated Outstanding Amount)

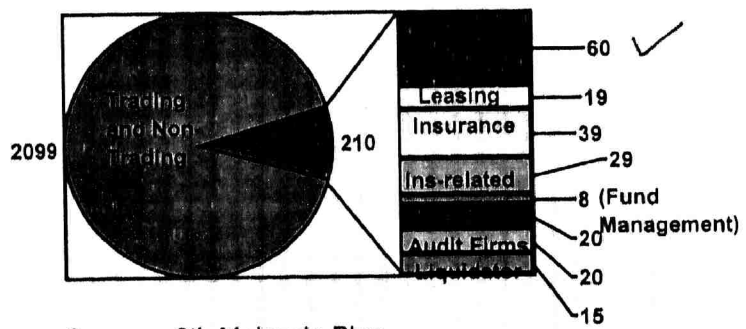


Source : BNM (1999), BNM Annual Report, 2000

Derivatives Market is the market for trading instruments, which provide contingent claims on underlying assets. In other words, the derivatives are mainly used to hedge against volatility in the price of the underlying assets, such as forwards, futures, options and swaps.

The offshore market was formed with the establishment of the Labuan IOFC in 1990. It is an integrated offshore centre which provides a variety of offshore products, including banking, insurance, trust business, fund management and investment services. The number of companies in this offshore financial centre is shown in Figure 3.12.

Figure 3.12 : Type of Companies Established in Labuan IOFC, As At Dec, 2000 (No. of Companies)



Source : 8th Malaysia Plan.

3.3 SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM

Table 3.5 presented the sources and uses of funds of the financial system in percentage of total funds for the period 1970-2000. It is clear that deposits assume the largest funds that mobilized by the financial system during the period of 1970-2000, which accounted for about half of the total resources. Besides that, the financial institutions also source funds from insurance, provident and pension funds, which contribute about 20% to the source of funds.

Table 3.5 : SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM, 1970 – 2000

YEAR	As at end of 1970 %	1980 %	1990 %	1995 %	1996 %	1997 %	1998 %	1999 %	2000 %
Sources of funds									
Capital and reserves	8.3	5.3	9.3	8.7	11.3	9.2	9.4	9.4	9.9
Currency	9.7	6.9	3.4	2.6	2.3	2.2	1.9	2.6	2.1
Deposits	43.4	53.5	44.8	47.9	49.3	49.2	47.9	47.9	47.1
Borrowings	2.2	2.2	2.3	0.9	0.7	2.8	1.3	0.7	0.6
Funds from other financial institutions	5.9	5.3	6.0	6.8	6.6	8.8	6.0	6.2	5.6
Insurance, provident & pension funds	24.8	16.5	18.5	17.3	16.3	15.1	17.3	18.2	19.4
Other liabilities	5.7	10.3	15.7	15.8	13.5	12.6	16.3	15.0	15.3
Total	100	100	100	100	100	100	100	100	100
Uses of funds									
Currency	0.8	0.6	0.4	0.3	0.3	0.4	0.3	0.7	0.5
Deposits with other financial institutions	8.3	9.4	15.3	18.6	17.0	19.3	13.9	15.4	15.0
Bills	5.7	5.1	2.0	2.2	2.0	1.9	1.3	1.4	1.3
Treasury	4.7	1.9	1.2	0.5	0.5	0.3	0.3	0.3	0.3
Commercial	1.0	3.2	0.8	1.7	1.6	1.6	1.0	1.1	1.0
Loans and advances	29.6	40.3	43	41.8	42.0	43.6	44.4	40.3	39.9
Securities	31.4	24.2	24.4	20.1	21.9	19.1	20.6	20.5	21.9
Malaysian Government	26.6	21.5	17.0	8.5	7.1	6.0	6.5	6.4	6.9
Foreign	1.7	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Corporate	3.1	2.7	7.4	9.7	13.5	12.4	13.0	13.4	14.3
Others	-	-	-	1.9	1.3	0.6	1.0	0.5	0.6
Gold and foreign exchange reserves	19.2	13.1	7.9	8.4	7.4	5.1	8.8	9.7	8.8
Other assets	5.0	7.3	7.0	8.6	9.4	10.7	10.6	12.0	12.5
Total	100	100	100	100	100	100	100	100	100

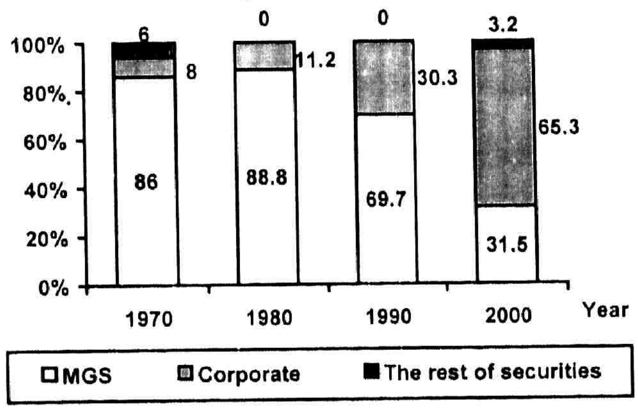
Source : BNM Annual Reports, various issues.

In addition, funds from other financial institutions also played an important role as source of funds, especially in 1997 due to the tight liquidity faced by financial institutions that resulted in more active trading in inter-bank money market. Among the remaining sources of funds, most of them had grown steadily from 1970-2000, except borrowings, which had been affected by the financial crisis in mid-1997. This indicates that the financial institutions had tried not to rely on borrowings to meet their funding requirement since 1990s.

In terms of their uses, the funds were mobilized to the economy mainly in the form of loan and advances, and investment in securities. Together they accounted for about 40% of the total uses of funds by the financial system. Since 1970s, loan and advances had registered an increasing growth of its proportion to the total uses of fund, which had increased from 29.6% at the end of 1970 to 39.9% at the end of 2000.

In terms of securities, in 1970s, the financial system played a significant role in financing the Government by holding Malaysian Government Securities (MGS), which accounted for 86% of the total securities invested by the financial system. However, there was a significant change of the share of the investment reflected over period 1990-2000. The investment in securities had been shifted a lot from public sector to private sector, which recorded 31.5% & 65.3% respectively to the total investment in securities at the end of 2000. (See Figure 3.13)

Figure 3.13 : The share of Investment in Securities (1970 - 2000)



Source : BNM Annual Reports, various issues.

This development reflected the reduction in the Government's borrowing requirements over the period, as a result of the implementation of privatization programs and an improvement in the Government's financial position. Besides that, the corporate securities had also become more and more important as a form of investment by the financial system mainly because of the increase participation by the financial institutions in the capital markets and the development of the unit trust industry. Furthermore, the changes to regulations towards financial liberalization had also stimulated the investment in corporate securities, particularly in shares and private debt securities.

.3.4 The Change in Lending Practice

For the period 1970-2000, there was a significant change in the direction and character of lending in the financial system, particularly from agriculture sector to manufacturing sector, reflected the change in financing needs in the economy. As shown in Table 3.6, in 1980, the credit extended to building & construction (including real estate) and the manufacturing sector had increased to 14.7% and 20.6% respectively of the total loans and advances extended to private sector. On the other hand, the credit extended to agriculture sector had declined from 16.1% in 1970 to 8.7% in 1980 and further to only 2.9% at the end of 2000.

Besides that, due to the rising demand for housing and the encouragement by the Central Bank in fostering an increasing commitment, the commercial banks and finance companies had heavily involved in housing finance. This resulted in an increase of the housing loans from 8.5% in 1970 to 18.2% in 2000.

Table 3.6 : LOANS AND ADVANCES EXTENDED TO PRIVATE SECTOR (1970-2000)

Sector	1970		1980		1990		2000	
	RM million	%	RM million	%	RM million	%	RM billion	%
Agriculture	598	16.1	2436	8.7	6898	5.1	13.3	2.9
Mining & Quarrying	56	1.5	288	1.0	1138	0.8	1.4	0.3
Manufacturing	569	15.3	5738	20.6	26915	19.7	57	12.6
General Commerce	632	17.0	5197	18.6	14300	10.5	19	4.2
Building & Construction (Include real estate)	260	7.0	4115	14.7	21717	15.9	82.2	18.0
Housing	315	8.5	3884	13.9	17657	12.9	83.1	18.2
Transport, storage & communications	213	5.8	671	2.4	2551	1.9	14.1	3.1
Finance, Insurance and business services	-	-	-	-	-	-	20.4	4.5
Purchase of shares	-	-	-	-	-	-	22.9	5.0
Consumption credit	-	-	961	3.4	11789	8.6	55.8	12.3
Others	1066[a]	28.8	4661[b]	16.7	33578[b]	24.6	86.2	18.9
Total	**3709**	**100.0**	**27951**	**100.0**	**136543**	**100.0**	**455.4**	**100.0**

Notes:
[a] Include loans for business services, consumption credit and other miscellaneous loans.
[b] Include loans for business services, lending to other financial institution and other miscellaneous loans.

Sources : BNM (1989), BNM (1994), BNM annual report, 2000.

In addition, the consumption credit had also recorded an increase in its share of total loans and advances extended to private sector, which accounted 3.4% in 1980 to 12.3% in 2000. The increase in financing for the purchase of private motor vehicles, which were mainly provided by finance companies, was deemed to accelerate the growth in consumption credit.