CHAPTER 2

FISCAL AND MONETARY MANAGEMENT IN MALAYSIA

Malaysia is a nation with a small open economy which is based on trade and agriculture, especially in the early years after independence. The economy has undergone tremendous change and growth since then to emerge as a fairly successful nation. The shape of the present economy is attributed to sensible and prudent fiscal management and monetary governance throughout the years.

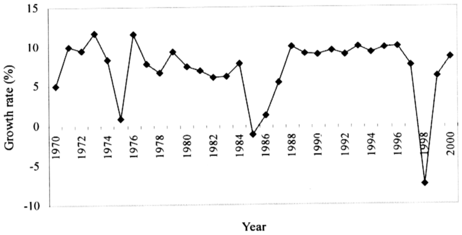
2.1 A General Overview of the Malaysian Economy

The Malaysian economy has come a long way since achieving independence in 1957. Initially, Malaysia was more of an economy relying on agriculture and mining. Agricultural sectors which contributed heavily to the GDP and employment were rubber plantations, palm oil plantation, rice, fishery and forestry (Okposin, et al; 1999). This was of course, aided by the fact that Malaysia was rich with natural resources. Besides that, Malaysia was also regarded as one of the more open economies in the world with a highly trade-oriented economy, albeit based on primary industries.

Malaysia's macroeconomic indicators also show that the economy is heading in the right direction. In terms of growth and structural change, Malaysia's track record has been quite good for a developing nation. As shown in Figure 2.1, Malaysia has been experiencing growth in terms of real GDP every year since 1970 except for 1985 and

1998. The growth rates were even consistently high in the late 80's and the 90's, averaging an impressive 9.26% during the 1988 – 1996 period until the Asian economic crisis brought the rates to an abrupt decline in 1998 before rebounding in 1999 and 2000.

Figure 2.1
Growth Rate of GDP at constant prices (1970 - 2000)

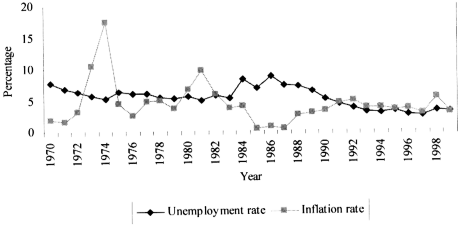


Source: BNM(1999)

The unemployment rate in Malaysia was consistently within the 5% - 10% boundary in the 1970 – 1990 period with the rates reaching its peak during the recession period of 1984 – 1986 (BNM, 1999). This is shown in Figure 2.2. After that, the rates have not exceeded 5%. This was because of the rapid expansion in the economy that created more job opportunities and kept the unemployment level low in the 1990's. According to BNM (1999), the economy had reached full employment status by 1992.

The inflation rate was also low, save for the 1973 – 1974 period which was attributed to the world inflation and in the early 1980's as a result of the global oil price shock. In fact, the inflation rate averaged just 2.92% for the 1985 – 1999 period and it never exceeded the 5% mark except for 1998. This can also be observed from Figure 2.2. The inflation rate rose that year as a result of the depreciation of the ringgit (BNM, 1999).

Figure 2.2
Malaysia: Unemployment and Inflation Rates,
1970 - 1999



Source: BNM(1999) & Economic Report, various years

2.2 Fiscal Management

2.2.1 Federal Government Revenue

Essentially, Federal government revenue consists of four main components; direct taxes, indirect taxes, non-tax revenue and non-revenue receipts. Direct taxes in turn mostly comprise income taxes from companies, petroleum and individuals income tax and stamp duties while indirect taxes consist of export, excise and import duties, sales tax and service tax. (See Table 2.1)

Table 2.1
Malaysia: Federal Government Revenue, 1994 – 2002
(RM Million)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Direct taxes	20160	22699	25851	30432	30015	27246	29156	42097	44351
Companies Income Tax	10562	11707	14166	16688	17294	15742	13905	20770	24642
Petroleum Income Tax	2211	2185	2203	3861	4046	2856	6010	9858	7636
Individuals Income Tax	4567	6203	6172	6429	6900	6419	7015	9436	9889
Stamp duties	2515	2192	2708	2714	1190	1566	1799	1650	1732
Others	305	412	602	740	585	663	428	382	451
Indirect taxes	17327	18972	21421	23195	15321	18100	18107	19395	22509
Export duties	1158	853	1041	1053	623	670	1032	867	803
Import duties	5615	5622	6132	6524	3868	4720	3599	3193	3668
Excise duties	4297	5280	5790	6054	3586	4723	3803	4130	4745
Sales tax	4131	4869	5473	6167	3845	4488	5968	7356	9243
Service tax	825	1016	1231	1475	1447	1459	1701	1927	2214
Others	1301	1332	1754	1922	1952	2040	1914	1922	1836
Non-tax revenue	11338	8469	10330	11421	10883	12674	14093	17304	15759
Non-revenue receipts	621	814	678	688	491	655	599	772	896
Total	49446	50954	58280	65736	56710	58675	61864	79567	83515

Source: BNM Monthly Statistical Bulletin

Predictably, government revenue has been growing steadily from RM 1.1 billion in 1960 to RM 21.12 billion in 1985. There was a slight decrease in revenue in 1986 and 1987. This was one of the reasons for the high deficits recorded in both these years. However, revenue has grown ever since to about RM 65.74 billion in 1997. Although there was a cutback in 1998, revenue allocated to the economy gradually increased since then and reached RM 83.52 billion in 2002.

Direct taxes have been the main contributors to the Federal government revenue, especially since the 1980s. The proportion of direct taxes has risen from 18% in 1960 to

44% in 1985 and 53% in 2002. The majority of these taxes were income tax from companies in Malaysia.

The proportion of indirect taxes, however, has been declining as the proportion of direct taxes rose. From being the main contributor in 1960 with 65%, the proportion of indirect taxes has declined since to 35% in 1985 and to 30% in 2002.

2.2.2 Priorities and Trends of the Federal Government Expenditure

Government expenditure in Malaysia has been growing ever since 1957 in the name of development and restructuring the economy. The direction of spending by the government has also undergone changes over time in line with policies and priorities. Generally, government expenditure in the country has been driven by two main objectives; eradication of poverty and restructuring the society by reducing and subsequently eliminating identification of race by occupation especially in the early stages of post-independence.

The development programmes began with the establishment of the New Economic Policy (NEP) in 1970. Besides aiming to achieve the main objectives mentioned above, the NEP is also aimed at shifting the nation's economic priorities from import-substitution to export-oriented industries, expanding industrial development and promoting human resource development (Okposin et al., 1999). The NEP was enacted under the First Outline Perspective Plan 1971 – 1990 (OPP1) which also spawned four major plans; the Second Malaysia Plan (1971 – 1975), the Third Malaysia Plan (1976 –

1980), the Fourth Malaysia Plan (1981 – 1985) and the Fifth Malaysia Plan (1986 – 1990) in continuing with the objectives of the NEP.

From 1991, the Second Outline Perspective Plan (OPP2), which consisted of the Sixth Malaysian Plan (1991 – 1995), Seventh Malaysian Plan (1996 – 2000) and then the concurrent Eighth Malaysian Plan (2001 – 2005) was drawn up. Besides maintaining the strategies of OPP1, OPP2 was aimed at promoting private-sector led-growth, diversify the economic base, increase efficiency and competitiveness and making science and technology an important aspect in developing the nation (Okposin et al., 1999).

All this while, the Federal government has spent more on operating expenditure than development expenditure. Operating expenditure has increased steadily every year since 1960 to meet the demands of the nation, especially in defense, education and debt service charges. Even though there were occasional cuts in spending by the Federal government, operating expenditure continued to grow and was not very much affected.

Development expenditure has also grown since 1960 but there were years that saw a decline, particularly in the 1980s. The development expenditure cut in 1982 was due to the monetary tightening stance of the Federal government in the wake of ballooning debts. As a result, development expenditures were reduced significantly from RM 11.5 billion in 1982 to RM 7.1 billion in 1985 (Ariff, 1991). In the subsequent years, development expenditure continued to rise (except for in 1991) rapidly in aiding the economy to become an industrialized and developed nation.

The budget allocated by the Federal government has risen almost two fold from RM 47 135 in 1994 to RM 93 724 in 2002 (Table 2.2). The allocation for operating expenditure has been about 70% of the budget since 1994 with the majority of it to be spent on emoluments and debt service charges. However, the percentage of the budget for emoluments has dropped from 26.5% in 1994 to 18.8% in 2002 while allocations for debt service charges have also been reduced from 15.6% of the budget in 1994 to 10.1% in 2002.

Allocations for development expenditure have been consistently focused on economic services. However, the share reserved for economic services has dropped from 15% in 1994 to 12.6% in 2002 and allocations for social services have increased from 6.8% in 1994 to 12.5% in 2001 and 11.7% in 2002.

Table 2.2
Malaysia: Federal Government Budget Allocations, 1994 – 2002.
(Percentage)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Total (RM)	47135	48798	55467	58982	64124	65095	78025	87546	93724
Development Expenditure	29.4%	29.5%	25.6%	29.2%	28.8%	27.7%	31.6%	30.7%	30.1%
Economic Services	15.0%	13.1%	10.4%	13.5%	13.7%	12.1%	13.9%	10.8%	12.6%
Social Services	6.8%	7.7%	6.9%	8.5%	9.2%	9.1%	9.3%	12.5%	11.7%
Security	5.4%	6.0%	5.7%	4.7%	3.8%	4.1%	3.4%	3.6%	3.2%
Others	2.2%	2.7%	2.6%	2.5%	2.1%	2.4%	5.0%	3.8%	2.6%
Operating Expenditure	70.6%	70.5%	74.4%	70.8%	71.2%	72.3%	68.3%	69.3%	69.9%
Emoluments	26.5%	25.6%	24.9%	25.3%	23.1%	21.5%	18.7%	19.3%	18.8%
Debt Service Charges	15.6%	14.8%	12.1%	11.2%	9.6%	13.9%	12.3%	11.6%	10.1%
Supply and Services	9.3%	10.7%	10.8%	10.0%	10.0%	9.5%	9.7%	11.5%	12.6%
Pension and Gratuities	5.0%	4.9%	7.2%	6.2%	5.6%	5.9%	5.3%	4.5%	4.9%
Grants and Transfers to State Governments	2.9%	2.9%	2.7%	2.6%	2.5%	2.7%	2.3%	2.4%	2.1%
Others	11.3%	11.6%	16.7%	15.5%	20.4%	18.8%	20.0%	20.0%	21.4%

Source: Economic Report, various years

2.2.3 *Brief Review of Budgetary Deficits in Malaysia*

The Federal government has always adopted prudent fiscal policies in managing the economy. The fiscal management of Malaysia has been counter-cyclical in nature, which was incurring higher deficits in downturns to boost spending and accumulating surpluses or reducing the deficit in better times to prevent excessive spending in the economy. These measures have managed to consolidate the foundation of the economy and sustain growth prior to the 1970's. Since 1960, the Federal Government has always been running deficits. The magnitude of the overall deficit rose gradually in the 1961 – 1966 period but declined slightly in the late 1960s.

However, as Malaysia embarked on a rigorous transformation towards industrialization, a more expansionary policy was embraced in the 1970's. The beginning of the 1970s saw a significant increase as deficits rose from RM 475 million in 1970 to RM 1.05 billion in 1971. This was due to the implementation of the New Economic Policy (NEP) and was especially so since annual government deficits had the tendency to rise as development expenditure increases (Jomo, 1990). Subsequently, deficits for the following years were in the range of RM 1.05 billion to RM 3.704 billion.

The highly expansionary fiscal policy continued to be adopted in the early 1980's to cushion the effects of the global recession. Budgetary deficits increased by 144% in 1981 (RM 9.02 billion) from RM 3.7 billion in 1980. The deficit then increased tc RM 10.42 billion in 1982. This counter-cyclical measure was used as the Federal government did not expect the recession to last. When the recession persisted, rapid expansion in expenditure caused both the Federal budget and current account to incur deficits of

17.5% and 14.1% of GNP respectively in 1982 (BNM, 1994). This is known as the twin deficits.

The policy proved to be unsustainable in the long term as external debt began to accumulate. To remedy this situation, 'the Federal government undertook a voluntary adjustment programme in mid-1982.' (BNM, 1999:4) This involved consolidating public finances by imposing budgetary control and encouraging the private sector in order to gradually reduce the role of the government to enhance growth.

After 1982, operations of non-financial public enterprises (NFPE) mushroomed in an effort to promote privatization and reduce the Federal government expenditure burden. Subsequently, fiscal austerity effectively narrowed the deficit margin of RM 10.42 billion in 1982 to RM 6.93 billion in 1983 and subsequently to RM 4 41 million in 1985.

Although budget deficits temporarily rose in 1986, there was a marked decrease in deficits from 3.8% of GNP in 1988 to 1.1% of GNP in 1992. There was no doubt that the cut in spending managed to improve the current account profile of the balance of payments but this could have lead to deflationary effects in an already slow moving economy coming to terms to the world recession (Ariff, 1991).

As Malaysia continued to enjoy healthy growth rates in the 1990's, the Federal government began to apply the conventional counter-cyclical fiscal policy of running a surplus (RM 0.35 billion) in 1993 for the first time since 1960. The budgetary surplus increased to RM 4.4 billion in 1994 but decreased to RM 1.9 billion in 1995 and RM 1.8

billion in 1996 before rising again to RM 6.6 billion in 1997 (see Table 2.3). This was necessary as the Federal Government took the opportunity of rapid growth to improve on its debt profile and curb excessive spending.

Table 2.3
Malaysia: Federal Government Revenue and Expenditure, 1991 – 2000
(RM Million)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Revenue	34053	39250	41691	49446	50954	58280	65736	56710	58675	61864
Expenditure *Operating*	28296	32075	32217	35064	36573	43865	44665	44584	46699	56547
Development (Net)	8397	8418	9120	9974	12520	12600	14445	17128	21462	25032
Total Expenditure	36693	40493	41337	45038	49093	56465	59110	61712	68161	81579
Overall deficit/surplus	-2640	-1243	354	4408	1861	1815	6626	-5002	-9486	-19715
% of GNP	-2.4	-1.1	0.3	3.1	1.2	1.1	3.6	-3	-5.3	-10.3

Source: BNM Monthly Statistical Bulletin

2.2.4 Measures in Dealing With the 1997 Crisis

The 1997 Asian financial crisis caused the rapid growth of the economy to a halt as many sectors were severely affected. The Government had to implement several fiscal policies to deal with the crisis in order to restore the economy as before.

Initially, a tight fiscal policy was adopted and expenditure was significantly reduced. Many infrastructure projects were also put on hold in view of the downturn.

These measures caused the aggregate demand to fall and there was a rapid contraction in the economy which worsened the situation (BNM, 1999).

Then, the government decided to reverse these policies and adopted a counter-cyclical approach in 1998. With the establishment of the National Economic Action Council (NEAC), the Federal government allocated RM 7 billion for development expenditure to boost the economy, generate demand and increase competitiveness.

Besides that, the Infrastructure Development Fund was established to help finance large public infrastructure projects such as highways, ports and mass-transit rail transportation. An initial sum of RM 5 billion was allocated for this fund. The Federal government also introduced various duty exemptions for financing loans, tax incentives to promote domestic tourism and duty abolitions on electrical products as an impetus to jump start the economy. As a result, the Federal Government incurred budgetary deficits of RM 5 billion in 1998 and subsequently rose to RM 9.49 billion in 1999 and RM 19.72 billion in 2000, which is an increase of about 108%.

2.2.5 The Debt Profile

Until the mid-1980s, the government relied on external borrowing, especially foreign loans, to finance the deficits (Jomo, 1990). As the debt accumulated and became unsustainable, the government gradually resorted to domestic borrowings. These sources included the Employees Provident Fund (EPF) and Government bonds.

Total government debt has been growing steadily every year since 1960 until 1991. Government debt of RM 1.47 billion in 1960 rose to RM 23.44 billion in 1980 and to RM 99.07 billion in 1991. However, the total debt began to decline for the first time in 1992 (see Table 2.4) and this continued until 1996 when total debt stood at RM 89.68 billion. This was due to the rapid growth Malaysia enjoyed in that period and as the Federal government drew surpluses, total debt was reduced. In 1998, government debt escalated to RM 103.12 billion and grew ever since to RM 164.96 billion in 2002 as the economy aimed to recover from the Asian financial crisis.

Table 2.4
Malaysia: Federal Government Debt, 1990 – 2002
(RM Million)

	Domestic Debt	External Debt	Total
1990	69988	24725	94713
1991	73655	25418	99073
1992	76083	20922	97005
1993	76536	19363	95899
1994	78260	14819	93079
1995	78038	13331	91369
1996	79211	10470	89681
1997	76968	12952	89920
1998	88197	14924	103121
1999	93750	18369	112119
2000	106805	18821	125626
2001	121396	24328	145725
2002	128680	36283	164963

Source: BNM Monthly Statistical Bulletin

Domestic debt, which consists of Treasury bills and Government securities also consistently grew from RM 1.23 billion in 1960 to RM 18.58 billion in 1980 and RM 78.26 billion in 1994. It declined slightly in 1995 to RM 78.04 billion before rising to RM 79.21 billion in 1996. After declining again in 1997, domestic debt rose to RM 106.81 billion in 2000 and RM 128.68 billion in 2002.

External debt rose from RM 0.36 billion in 1960 to RM 4.86 billion in 1980 and RM 28.31 billion in 1986. The amount declined in the next three years and increased again in 1990 to RM 24.73 billion. In accordance with the total government debt, external debt also began to decline in 1992 at RM 20.92 billion to RM 10.47 billion in 1996. For the next six years, the amount of external debt predictably increased and reached RM 36.28 billion in 2002.

2.3 Interest Rates Developments in Malaysia

A comprehensive monetary management in Malaysia began in 1959 with the establishment of the Central Bank of Malaysia (Bank Negara Malaysia). Securing stable interest rates was one of the main priorities for the Central Bank. As part of the interest rates reform, rates were set after consulting the banking community. Since then, interest rates varied in accordance to meet targets from time to time.

Prior to October 1978, the Central Bank of Malaysia had adopted an administered interest rate regime. Interest rates charged on bank loans and the rates of interest offered for bank deposits were regulated as a means of instrument in monetary management. The rationale behind regulating interest rates was to enhance the growth of banks by preventing unhealthy competition between them and safeguard the balance of payments from interest rates differentials between Malaysia and the rest of the world (BNM, 1994).

Changes in interest rates were frequent before October 1978 but have always stayed between 6% and 8% per annum for loans against stocks, shares and Government securities. Later on, the Central Bank began to gradually embrace a 'market-oriented system of interest rate determination to reflect the true cost of funds and reduce distortions in the market' (BNM, 1994: 131). Commercial banks were allowed to set the interest rates for deposits and loans to their prime customers. However, interest rates for loans to the priority sectors continue to be regulated.

In the early 1980s, economies worldwide suffered from inflation and extremely high interest rates as a result of the world recession. Hence, the Central Bank had to maintain 'a selectively restrictive stance in monetary policy' (BNM; 1994: 461) and allowed interest rates to rise. As the global interest rates declined in 1982, the rates in Malaysia also followed suit. This continued in 1983 as the rates abroad moved in a downward trend.

In November 1983, the base lending rate (BLR) was introduced for commercial banks and the lending rates of all banks were required to be pegged to the BLR. This was to overcome the problem of lending rates spiraling downwards together with falling interest rates (BNM, 1994). The BLR was later freed from administrative control in February 1991 and all interest rates were to be determined by market forces except for rates on priority sector lending. This was a move of deregulation to enhance efficiency in money market operations in Malaysia.

In the mid-1980's, deterioration in trade and fiscal contraction caused deflationary effects in the economy. In light of this, the Central Bank turned to a more expansionary monetary policy to ease bank liquidity and prevent interest rates from rising. On top of that, the Central Bank also had to consider that high rates mobilize savings but lower rates stimulate investments.

As the monetary and banking sectors began to stabilize and the liquidity situation improved in 1987 and 1988, the Central Bank developed measures that allowed banking institutions to manage their funds with more flexibility. This included removing pegs that were previously set for interest rates and more flexible requirements for their liquidity ratios. Besides that, the Central Bank also took this opportunity to modernize and consolidate the financial structure.

Prior to the mid-1990s, the Central Bank has always adopted a monetary policy based on targeting monetary aggregates. The effectiveness of this policy began to wear thin as indicated by the developments in the economy and the financial system in the 1990s. Hence, the Central Bank began to adopt a different approach and shifted its focus to interest rate targeting.

Interest rate targeting was adopted because of the 'globalization of financial markets and global economic integration' (BNM, 1999:144). Globalization in financial markets meant that movements of interest rates abroad and domestic rates have to be monitored to consolidate the effectiveness of monetary policy.

2.3.1 *Management of Interest Rates during the Asian Crisis*

As with the fiscal side during the Asian financial crisis, the financial sector also suffered major setbacks during the 1997 – 1998 period. Interest rates were initially raised to curb speculative attacks on the ringgit. It was intended to be temporary as it was believed that high interest rates for a short period would restore stability.

However, the rates were subsequently brought down to the level before the crisis in light of the adverse effects on several sectors of the economy. The pre-crisis rates were maintained until late September 1997. After September 1997, interest rates were gradually raised to enable the depositors 'to earn a positive real rate of return' (BNM, 1999: 592) as inflationary pressures grew.

In early 1998, the economy faced further setbacks when inflation rose sharply as a result of the immense pressure on the ringgit. In fear of further depreciation of the ringgit that could cause it to freefall, interest rates were raised to 11% although some quarters suggested that interest rates be kept low following the economic contraction (BNM, 1999).

As the inflation rate and ringgit exchange rates began to stabilize, interest rates were gradually reduced as a move to rejuvenate the economy. The rates were reduced to 9.5% in August 1998 and were further reduced to 5.5% in August 1999.

2.4 The Money Market

In Malaysia, money market activities are considered to be vital as they are intermediaries for short-term funds. Money market papers consist of Treasury bills, bills of exchange, promissory notes and Government securities.

The growth of money markets in Malaysia has been greatly influenced by the legal requirements on commercial banks. These requirements, known as the liquid asset requirement, were meant to maintain a minimum amount of liquid assets in banks and could be used to 'influence the monetary situation in the country' (BNM, 1994: 154). This also means that commercial banks would be directly involved in the financing of the Federal government's budget. These requirements have been changed and adjusted over time to different demands and needs of the economy.

Before 1959, most of the banks' lendings were used to finance external trade and were denominated in foreign currency. Therefore money markets, where financial assets were traded in domestic currency, did not hold much significance. By October 30, 1959, commercial banks were required to hold at least 20% of their 'eligible liabilities' (EL) base in the form of liquid assets such as the three-month Malayan Treasury bills besides bank deposits and bills of exchange in Sterling and Singapore dollars (BNM, 1994). The EL base consists of deposit liabilities, net amount due to other banking institutions, net repurchase agreements and net amount of negotiable certificates of deposit issued. In 1962, the liquid asset ratio was raised to 25%, whereby 5% of the deposit liabilities could consist of Malayan Government securities of longer than three months (BNM, 1994).

This was followed by developments in 1965, when the liquidity ratio was again reverted to 20% of their EL base but this time only Malaysian liquid assets were eligible as liquid assets. This marked an important step towards the development of money markets in Malaysia. Beginning from 1969, 'half of the liquid assets which the banks were obliged to maintain against all deposits other than savings deposits must be in actual liquid assets' (BNM, 1994: 345). The composition of actual liquid assets include cash, clearing balances with the Central Bank, net balances with other banks, money at call, Treasury bills and Government securities with a remaining maturity of one year or less. Other assets that could be included in the total ratio were bills discounted or purchased, bills receivable, and longer-term Government securities. The minimum liquidity ratio was again raised to 25% of their EL base in 1973 but it was reduced to 20% in 1979 and subsequently to 18.5% and 17% in February and October 1986 respectively (BNM, 1994).

Beginning from June 1990, commercial banks were not required to adhere to the 5% primary liquid asset ratio but the total requirement ratio of 17% of their EL base remained. On top of that, commercial banks were allowed to set its requirement ratio between the range of 15% to 19% and requirement ratio could be observed by taking averages of eligible liabilities over a two-week period instead of as single base day (BNM, 1994).

Finance companies and merchant banks were also required to maintain at least 10% of their deposit liabilities in liquid assets beginning from April 1971 and March 1979 respectively. The liquid assets include Malaysian Treasury bills, other Government securities and deposits with commercial banks and discount houses.

2.4.1 *Treasury bills*

The developments of legal provisions concerning the maintenance of minimum holdings of liquid assets led to a significant increase in the holdings of Treasury bills and other Government securities by these institutions over the years as a result of rapid expansion in the deposits of commercial banks and finance companies. The amount of Treasury bills on offer rose from RM 791.9 million in 1970 to RM 1490 million in 1980 and to RM 4320 million ever since 1988.

Banking institutions, especially commercial banks have been the major holders of Federal Treasury bill papers. Since 1967, commercial banks have consistently held more than 50% of the Treasury bills on offer. However, in the 1989 – 1993 period, there has been a huge drop in the holding of Treasury bills by commercial banks.

The share of commercial banks dropped drastically from 56% in 1991 to 32% in 1992 and 23% in 1993. This was due to the cut in government spending to promote privatization. On top of that, large purchases by foreign investors as 'a result of restrictions imposed by the Central Bank on the swap transactions which made the Treasury bills an alternative source of investment for foreign funds in the country' (BNM, 1994: 346) also caused the drop in Treasury bill holdings. All together, banking institutions' (commercial banks, finance companies, merchant banks and discount houses) share dropped from 75% in 1991 to 35% in 1992 and 32% in 1993 (Table 2.5). After 1996, banking institutions once again held the majority share of the Treasury bills.

Before August 1973, Treasury bills were only issued on demand. On the recommendation of the Central Bank, the discount rates for these bills were predetermined by the Federal government. On August 20, 1973, the Central Bank made some changes to the determination of the rates, whereby the discount rates were determined by open tender in the money market. This was to promote greater competition in the market and attract a wider range of potential investors. Figures 2.3I, 2.3II and 2.3III show the Treasury bill discount rates from 1980 to 2002 for three different maturities; three months, six months and twelve months. All three Treasury bill rates showed a similar trend with relatively low rates in 1987 and steadily rising to its peak in 1992 before declining. In 1996, the rates rose again before dropping to 1999 and continued to decline to less than 3% from 2000 onwards.

Table 2.5
Treasury Bills Holders, 1990 – 2002 (RM million)

End of period	*Treasury bills*			
	Total	*Central Bank of Malaysia*	*Banking Institutions*	*Others*
1990	4320	-	3677	643
1991	4320	89	3238	903
1992	4320	-	1512	2808
1993	4320	-	1377	2943
1994	4320	-	2550	1770
1995	4320	-	2604	1716
1996	4320	-	1849	2471
1997	4320	34	3925	361
1998	4320	-	3678	642
1999	4320	-	3720	600
2000	4320	-	4166	154
2001	4320	-	4014	306
2002	4320	-	3744	576

Source: BNM Quarterly Statistical Bulletin

Figure 2.3I
Treasury Bill Rates: 3-Month Maturity, 1980 - 2002

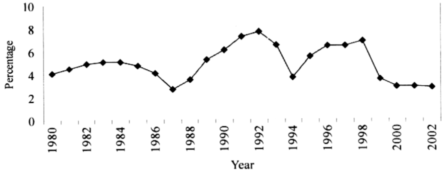


Figure 2.3II
Treasury Bill Rates: 6-Month Maturity, 1980 - 2002

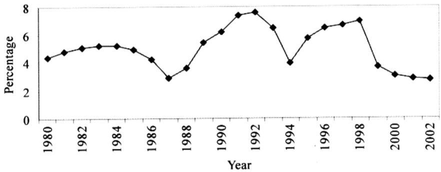
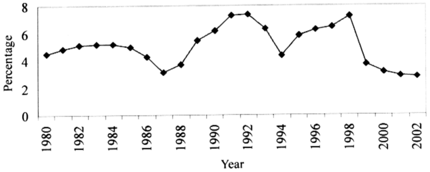


Figure 2.3III
Treasury Bill Rates: 12-Month Maturity, 1980 - 2002



Source for Figures 2.3I, 2.3II and 2.3III: BNM Monthly Statistical Bulletin

Besides that, rediscounting facilities were also offered by the Central Bank at market rates in an effort to increase dealings in Treasury bills. On top of that, the Central Bank utilized the Treasury bills and other Government securities to stabilize the market by selling and buying at the appropriate moment.

2.4.2 Discount houses

Generally, the initial role of discount houses in Malaysia was to mobilize short-term funds for investment in various money market instruments such as the Treasury bills and other securities such as the Malaysian Government Securities (MGS), negotiable certificates of deposit (NCD), bankers acceptance (BA) and Cagamas bonds. Prior to 1989, discount houses were an important source for selling and buying short-term papers (BNM, 1999).

Discount houses were made sole principal dealers for Treasury bills from January 1989 onwards as part of several financial reforms by the Central Bank. Besides that, discount houses were also given the exclusivity to invest in longer-term securities with remaining maturity of up to five years. These measures can also be viewed as compensatory because discount houses no longer hold the monopoly of money makers in short-term government securities (BNM, 1994).

As a result of these developments too, the holdings of Treasury bills by discount houses increased significantly in 1989. However, from June 1990, discount houses were no longer the sole principal dealers for Malaysian Treasury bills. Further financial reforms and unaccommodating monetary policies in the early 1990s also affected the performance of discount houses (BNM, 1994). From 1992 onwards, holdings of discount houses in Treasury bills were no longer significant in amount. As of 1999, there are seven discount houses with assets totaling RM 18.8 billion (BNM, 1999).