

CHAPTER II

FINANCIAL RELATIONSHIPS

Brief Account of Development since 1950

Malaya, Sabah and Sarawak (together with Singapore and Brunei) have shared a common currency since 1950. The common currency was issued by the Board of Commissioners of Currency, Malaya and British Borneo, constituted under the 1950 Malaya British Borneo Currency Agreement.¹

The currency is backed by sterling assets to the extent of 100-110% and there is automatic conversion of Malayan dollars into sterling and vice-versa at a fixed rate of 2s 4d which has been maintained since 1906.

In response to the political and economic changes since 1950, there have been significant developments in the monetary system, although the essential features of the currency system, as outlined in the preceding paragraph has remained unchanged.

The main defects of such a currency system had been the absence of a central institution which would help to smooth out fluctuations in the money supply by absorbing foreign exchange when the Balance of Payments were favourable and sterilising the resultant increase in the cash reserves of Commercial banks. Another defect had been the lack of a money and securities market in which a central institution could operate and through which the flow of capital into local investment could be encouraged.

It was primarily to overcome these defects that steps were taken towards the formation of a Central Bank. Following a recommendation by the report of the International Bank Mission, the Watson-Gaine Committee² was set up. Acting upon its recommendations, the Central Bank of Malaya Ordinance,³ together with the Banking Ordinance⁴ was passed in 1958.

¹Currency Agreement 1950.

²G.M. Watson & Sidney Gaine. "Report on the Establishment of a central bank in Malaya"

³Central Bank of Malaya Ordinance, 1958

⁴The Banking Ordinance, 1958: No: 62 of 1958 (Kuala Lumpur, Government Printer)

By this time Malaya had already obtained independence and the establishment of the Central Bank was in keeping with its new political status. However, the changed political situation provided another instance where political barriers were allowed to negate convincing economic arguments for a joint Central Bank with Singapore. Singapore and Malaya have a common banking system apart from sharing a common currency and as such there were many advantages for having a joint Central Bank.⁵

In order that the 1950 currency agreement would reflect the new political status of Malaya, a new Currency Agreement was drawn up in 1960⁶. This agreement "provides basically for the continuance of the present currency arrangements"⁷ but with substantial amendments to the details of the 1950 agreement. These changes are:

(i) There is now a provision for withdrawal and for the liquidation of the currency board resulting therefrom. Any participating government may withdraw by lodging a notice of replacement which becomes effective 18 months after lodging.

(ii) The composition of the Board has been altered to reflect the predominant interest of the Federation in the currency. Sixty-three per cent of the currency issued by the board is in circulation in Malaya, indicating the predominant interest of Malaya in the currency⁸. But Malaya holds 6 out of the 13 votes which determine decisions in the Board. Moreover, in matters of major importance the agreement requires that there must be the unanimous concurrence of the participating governments.

(iii) The new agreement also provides for wider avenues for investment. Under the 1950 agreement the reserves of the currency board could only be invested in securities of the United Kingdom or such other securities approved by the United Kingdom Government. The new agreement allows for investment in non-sterling securities provided there is the unanimous consent of the participating Governments. But more significant is the fact that it provides for \$300 million of the assets

⁵For further information on the Currency question, refer to articles in the "Malayan Economic Review" especially those by King Sherwood, Wilson, Balogh and Caine.

⁶Currency Agreement 1960.

⁷Mr. Tan Siew Sin, on June 24th, 1960 in Dewan Ra'ayat.

⁸Mr. Tan Siew Sin, speech in Dewan Ra'ayat June 24th, 1960.

of the Currency Board to be invested in issued securities of, or guaranteed by the participating governments up to a maximum of \$100 million per year for the first three years. The \$300 million would be apportioned according to the amount of currency in circulation in each territory and thereby \$180 million of it would be for Malaya.⁹ Speaking on the Act in Parliament, the Minister of Finance pointed out that 24% of the reserves of the currency board would now be available for development finance.

Since Malaya, Sabah and Sarawak had been participating Governments in a common currency agreement since 1950; and since the currency system as such has not been altered although substantial changes in the details were affected by the new agreement in 1960, the formation of Malaysia brought no changes in the currency system. In fact the common currency was advanced as one of the factors which provided the economic basis for the formation of the new Federation.

The most important development as date, since the formation of Malaysia, was the passing of the Central Bank of Malaysia (Amendment and extension) Act, 1965¹⁰ and the Banking (Amendment and extension) Act 1965¹¹. These Acts amend the Central Bank of Malaysia Ordinance 1958 and the Banking Ordinance 1958 respectively and extend the operation of these ordinances, as amended, to all parts of the Federation.¹² This is a very significant advance in that it removes the anomaly of a Central Bank

⁹The value of the fund as at 31st December, 1959 was \$1,242.00 million

¹⁰Central Bank of Malaysia (Amendment and Extension) Act, 1965: Act of Parliament No: 16 of 1965.

¹¹Banking (Amendment and Extension) Act, 1965: Act of Parliament No: 17 of 1965 (Kuala Lumpur: Government Printer).

¹²Most of the amendments to the Central Bank Act, 1958 are of minor importance. One significant amendment, however, is the addition to section 30 the power of the Central Bank to "make advances for the purpose of assisting the growing or marketing of primary produce to authorities formed under any written law in the Federation and co-operative societies".

Two new conditions have been imposed by the amendments to the Banking Ordinance 1958. Banks cannot open a new branch, agency or office in any part of the Federation without the consent of the Central Bank and banks incorporated in Malaysia cannot extend their operations abroad without the consent of the Central Bank. Another stipulation is that in the event of Bank failures, local deposit liabilities should be given priority.

operating in only one section of the common currency area. This new development would permit the operation of a uniform monetary policy over the whole Malaysian economy.

Notwithstanding the separation of Singapore, the Central Bank has continued to exercise its functions and responsibilities in Singapore after August 9th so that there has been no substantial change in the position vis-a-vis Singapore. The separation has however brought into sharp focus the traditional economic and financial links between Malaya and Singapore. Negotiations are under way on the future of banking and currency arrangements between Malaya and Singapore and also with Brunei.

Since its establishment in January 1959, the Central Bank has not exercised its powers to issue currency and to maintain reserves safeguarding the value of the currency. However, on December 12th, 1964 the Central Bank lodged notice with the Currency Board of its intention to replace the Board by the Central Bank as the sole currency issuing authority in Malaysia. Under the terms of the 1960 Currency Agreement the Central Bank would assume currency issuing powers not later than December, 1966 and as such it is imperative that the reappraisal of the future financial relationships with Singapore and Brunei should be expedited.¹³ It would be pertinent, in this connection, to quote the observations of the Central Bank "... it would be appropriate for the Central Bank to point to the current world trend towards closer economic co-operation and to express the hope that the political separation of Singapore would not blur the obvious benefits ... of preserving the close economic and financial ties between the two countries..."¹⁴

The assumption of the currency issuing function by the Central Bank and the consequent dissolution of the present Currency Board would to some extent increase the scope for active monetary management and remove a system which is not in keeping with the independent status of Malaysia. However, it will be necessary to examine in greater detail the scope and extent of monetary management and the existing financial institutions in Malaya, Sabah and Sarawak.

Scope for Monetary Management

Firstly it is essential to note that the present system

¹³ Bank Negara Malaysia: Annual Report and Statement of Accounts 1965.

¹⁴ Since then the life of Currency Board has been extended by for a period of one year from June 12th, 1966. The Central Bank is thus due to assume the note-issuing powers on June 12th, 1966. This final agreement as to future currency agreements has not been reached amongst Brunei, Singapore and Malaysia.

of automatic convertibility into sterling and the 100% - 110% banking of the currency does not lend the system to be very amenable to monetary management. It has been argued that given this system, the fluctuations in employment and Income could be more efficaciously smoothed out by proper and timely governmental fiscal and taxing policies which should be supplemented by import and price controls. It has thus been asserted that monetary policy exercised through the Central Bank would be relatively ineffective in eliminating these fluctuations. It has further been asserted that without the preconditions of a developed money and securities market, the two traditional measures of Central Bank control over Commercial Bank Credit by open market operations and through the discount rate would be ineffective. As such, "the margin for monetary management without upsetting the balance of payments was very narrow in an economy heavily dependent upon foreign trade such as the Federation of Malaya, although monetary policy, exercised through the Central Bank could, within limits, help to ease the domestic adjustment of external fluctuation". Although this observation relates to Malaya, it applies with equal validity to Malaysia.

Barring any radical change in the currency system, the above arguments are substantially true. If the present interim arrangements whereby the Central Bank is continuing to exercise its functions in Singapore are changed, there would arise a further limitation on the scope of monetary management by the Central Bank. Out of a total of 44 Commercial Banks operating in Malaysia and Singapore, 23 have offices both in Malaysia and Singapore.¹⁶ This indicates how inter-locked the banking systems of the two countries is and in the event of the Central Bank jurisdiction being restricted to only Malaya, Sabah, and Sarawak, this fact would inhibit the powers of the Central Bank. Thus "the imposition of a minimum liquidity ratio, for example, for banks in Malaya only, may be ineffective in the case of banks which have their main offices and branches in Singapore. Similarly, any restraining influence on the extent and direction of bank loans and advances is restricted by the free transfer of currency and bank funds to banks in Singapore where no similar restraints have been imposed".¹⁷

Having noted these limitations it will not be necessary to examine the progress that has been made towards the building up of sound financial institutions which would widen the possibilities for monetary management by the Central Bank. As has already been noted, the assumption of currency issuing powers by the Central Bank by June 1967 would be a significant step towards this end. But/is the existence of a money market and sound

¹⁵ H.S. Lee, Minister of Finance in moving the 1958 Central Bank Act.

¹⁶ Bank Negara Annual Report, 1965. Page 37.

¹⁷ Bank Negara Annual Report, 1965. Page 3.

financial institutions which is really a determining factor and we will therefore proceed to examine this aspect.

Existing Financial Institutions

As in other economic aspects, Sabah and Sarawak have a less well developed Banking system than Malaya and this will be borne out by the following table:

TABLE 2-1

MALAYSIA AND SINGAPORE: COMMERCIAL BANKING OFFICES,
1964 AND 1965[†]

	Banks Incorp. in Malaysia		Banks Incorp. in Singapore		Banks Incorp. Elsewhere		TOTAL	
	1964	1965	1964	1965	1964	1965	1964	1965
Malaya	108	119	45	46	69	73	222	238
Sabah	4	4	1	1	13	13	18	18
Sarawak	9	10	2	2	9	9	20	21
Singapore	28	30	42	48	48	55	118	133

The average number of persons per banking office for Malaysia dropped from 35,600 in 1964 to 34,000 in 1965, indicating an expansion in Banking facilities, but there has been no significant change in this figure in the case of Sabah and Sarawak since there has been an increase of only 1 additional banking office in 1965 over 1964.

The total resources of the banking system in Malaysia and Singapore amounted to \$3,378 million compared with \$2,973 million at the end of 1964. But the capital and reserves of the 23 local banks amounted to only 5.5% of this total.

The less developed nature of financial institutions in Sabah and Sarawak is also brought out by a survey of other financial institutions. The Post Office Savings Bank exists only in Malaya and Sarawak. The Post Office Savings Bank has an important role to play in the mobilisation of non-bank savings in Malaysia but the amount of depositors balance in the Sarawak Post Office Savings Bank has stagnated since 1963.

[†]Source - Bank Negara Malaysia, Annual Report, 1965.

POST OFFICE SAVINGS BANKS[†]

	M A L A Y A			S A R A W A K		
	1963	1964	1965	1963	1964	1965
1. Amount of depositors balances (\$ million)	172.1	177.3	188.0	4.1	4.1	4.2
2. Number of depositors (thousands)	956.5	1,027	1,127	10	11	12
3. Average balance per account (\$)	180	173	167	379	357	345
4. Number of Offices	221	274	282	39	39	42

Taking into account the relative population figures it will be seen that in Malaya the number of deposits works up to approximately 14% of the total population whereas for Sarawak the figure is only about 1.2%. This gives a clear indication of the far wider spread of the Post Office Savings Bank coverage in Malaya.

The same is true of other savings institutions as well. The Employees Provident Fund exists only in Malaya where it was established since 1951. In addition, in Malaya and Singapore there were 234 other minor provident funds with assets totalling \$316 million while in Sarawak there are three minor funds (Government Employees Provident Fund, Local Authorities Employees Provident Fund and Teachers Provident Fund) with total assets estimated at \$12.5 million. In this respect Sabah is even more deficient than Sarawak since neither a Post Office Savings Bank or Provident Funds exist. To date there have been no concrete steps taken towards extending the coverage of Provident Funds and Post Office Savings Banks to Sabah and Sarawak.

With regard to Housing and Development Institutions the same observations hold true. In Sabah & Sarawak the Borneo Development Corporation has capital resources of only \$3.5 million while the Borneo Housing Development has capital resources of \$24.8 million. In Sarawak the Sarawak Development Finance Corporation, aimed at providing finance of rural development activities, has capital resource of only \$4 million while the Sabah Credit Corporation, which operates as a rural credit institution has a total resource of only \$1 million.

[†]Source - Bank Negara Malaysia, Annual Report, 1965.

These are relatively less significant when compared with institutions like the M.I.D.F.L., M.A.R.A., F.L.D.A., and F.A.M.A. which have larger capital resources and which have or will soon extend their activities to the Borneo territories. In the case of co-operative societies, the total working capital in Malaya in 1965 was \$189 million while the similar figures for Sabah and Sarawak were \$2.2 million and \$3.2 million respectively.

It will be thus seen that financial institutions are relatively less developed in the Borneo territories as compared to Malaya and the extension of the activities of Federal institutions like M.I.D.F.L., M.A.R.A., F.A.M.A., and F.L.D.A. to Sabah and Sarawak would make a significant contribution to the development of these territories. The stimulation of the growth of both bank and non-bank savings is another important task which should be pursued as there has been so little achieved in Sabah and Sarawak.

On examination of the Domestic Public Debt figures would be another indicator of the relative extents to which domestic savings have been mobilised by the government in the different regions. The total Domestic Debt of the Central Government stood at \$2,152 in 1964. Out of this Sabah's public Debt amounted to \$42.3 million while that of Sarawak amounted to only \$27.4 million. These low levels of the Domestic Public Debt of Sabah and Sarawak shows the very limited extent to which public loans have been floated by the respective Governments.

Having outlined the different degrees to which financial institutions are developed in Sabah and Sarawak, it would be necessary to return to the question of monetary management within this given framework.

The most significant step towards increasing the scope for monetary management was the expansion of the money market by means of the application of the Local Assets Ratio to Commercial Banks. This policy has resulted in the increased demand from Commercial Banks for Government securities and has thus greatly expanded the money market. This is demonstrated by the sharp increases in the amount of treasury bills which have been issued:

1963	\$39
1964	\$73
1965	\$228

Out of the increase in 1965, 93% was accounted for by Commercial Banks. The amount of Treasury Bills outstanding at

the end of 1965 was \$449 and 67.1% of this was held by Commercial Banks while the Central Bank held 8.7%.

Another indicator is that the percentage of the total domestic public debt held by the Commercial Banks and the Central Bank increased to 21.5% in 1965 from 14.1% in 1964.

The effect of this would not only be to expand the money market but would also reduce the depletion of the accumulated assets of the Government in order to finance its budgetary deficits. In this context it is necessary to note that the local assets ratio has applied to Sabah and Sarawak only since 1965 when the functions of the Central Bank was extended to cover these areas and that a large proportion of the assets of the Government and other financial institutions are still held in sterling securities. For example over 90% of the assets of the Sarawak Post Office Savings Bank and its Employees Provident Funds are held in sterling securities. The implementation of the local assets ratio would thus mean that there is wide scope for increasing the demand for Government Securities in Sabah and Sarawak.

In summary, we note that:

1. Malaya, Sabah and Sarawak have shared a common currency system and that the political unification has resulted in developments which have resulted in the closer integration and consolidation of that system. A vital foundation of overall economic integration is therefore already in existence.
2. Malaya is the predominant unit within the common currency area with approximately 60% of the total currency in circulation within its area.
3. That financial institutions in Sabah and Sarawak are as yet rudimentary in comparison to those in existence in Malaya and as such there is a wide scope for increasing the mobilisation of savings there through the development of these financial institutions. Such a development would be an important contribution to the economic development of these two states and would also assist to relieve the financial strains of the Central Government to a limited extent.
4. The extension of the activities established financial and development institutions based in Malaya to Sabah and Sarawak would accelerate the development of financial institutions and the savings habit in those states.
5. The overall development of financial institutions in Malaysia and the expansion of the money market is essential for increasing the defective scope for monetary management by the Central Bank of Malaysia.