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A Comparative Study of Two Episodes of Banking Distress in Malaysia

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TABLE OF CONTENTS

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ABSTRACT

I	INTRODUCTION	1
II	BACKGROUND	4
	1. Brief History of the Banking System in Malaysia	4
	2. Banking Distress, Crisis and Bank Panic	6
	3. Episodes of Banking Distress in Malaysia	8
	4. Role of the Banking System	13
III	LITERATURE REVIEW	19
	1. Factors behind Banking Distress	19
	2. Nature and Fragility of the Banking System	23
IV	METHODOLOGY	25
V	RESULTS	28
	1. Growth, Liquidity and Credit Expansion	28
	2. Balance of Trade and Exchange Rate	32
	3. Loan and Deposit Growth of Commercial Banks	33
	4. Composition and Direction of Loans	35
	5. Annual Growth Rate of Loans to Selected Sectors	37
	6. Proliferation of Non-performing loans	40
VI	EVALUATION	42
	1. The 1985-1988 Distress	42
	2. The 1997 Distress	43
	3. Comparison between the Two Episodes	45
VII	CONCLUSION	49

REFERENCES

LIST OF TABLES

1a Growth rate in M2 and Domestic Credit over GDP between the period of 1983 – 85.

1b Growth rate in M2 and Domestic Credit over GDP between the period of 1995 - 97

2a The main direction of Banking sector Lending between the period of 1982-1997.

APPENDIX

Table 1 Macroeconomic Variables

Table 2 Macroeconomic & Bank Specific Variables

Table 3 Foreign Exchange Rate

Table 4 Kuala Lumpur Stock Exchange Movements

Table 5 Loans by Sector

Table 6 Loan Growth by Selected Sectors

Table 7 Non-performing Loans by Sector

Figure 1 Growth Indicators

Figure 2 Growth in Broad Monetary Aggregates (M2)

Figure 3 Annual Growth in M2

Figure 4 Domestic Credit and Private Sector Bank Debt / GDP

Figure 5 Changes in Reserves against the Current Account Balance

Figure 6 Total Loans vs. Total Deposits of Commercial Banks

Figure 7 % Change in Total Loans and Deposits

Figure 8 Growth of the Private Sector's Bank Debt

Figure 9 Loan/Deposit Ratio of Commercial Banks

Figure 10 Interest Rates of Commercial Banks

Figure 11 Bank Loans by Sectors

Figure 12 % of Total Loans by Selected Sectors

Figure 13 Loan Growth to Housing & Construction

Figure 14 Loan Growth to Manufacturing

Figure 15 Loan Growth to Financing, Stock Purchase & Consumption Credit

Figure 16 % of Non-performing Loans by Sectors

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Abstract

The pervasiveness and common occurrence of banking distress in both developed and developing countries in the last two decades has become a growing concern. The dominance of the commercial banking sector of a country's financial system means that any failure of the former will not only result in disaster for the latter but also have wide repercussions for the host country's economy. Malaysia has not been spared of such incidents with the latest two episodes of distress occurring in 1985 and 1997. Motivated by the relevance of such episodes this paper has attempted to search for the underlying forces behind the latest two distress episodes in Malaysia. Despite the uniqueness of each distress episode as suggested by most literature on the subject there appears to be commonalties between the two episodes. Although the triggering events, which sparked off the distress, were different between episodes the elements of liberal credit creation and poor composition of loans were evident in prior to both episodes. Factors such as monetary growth, capital inflows and various macroeconomic variables together with governmental influences were also examined for their relevance to credit creation and loan management.

I. Introduction

The banking system in Malaysia, which comprises of the country's central bank, Bank Negara Malaysia, commercial banks, finance companies, merchant banks and discount houses collectively constitute the largest financial intermediary in the country. At the end of 1997 this collective entity held 72.8% of the total assets found in the country's financial system. However, of a more substantial nature is the role that is played by commercial banks. Their dominance of the country's financial system is denoted by their "lion's" share of 43.6% of total assets in the country's financial system for the same period (Bank Negara Malaysia Annual Report, 1997). This effectively makes commercial banks the single largest, oldest and most important group of all the financial institutions in terms of aggregate assets.

The prominence of commercial banks in Malaysia and in most command and market economies elsewhere in the world does not detract from its fragility and susceptibility to episodes of distress or crises. Such episodes have in fact been on the increase as noted by several authors especially in the last two decades. Sundarajan and Balino (1996) and Demirguc-Kunt and Detragaiche (1997) have noted that neither developed nor developing countries have been spared whilst Costello et. al. (1996) describe similar episodes in countries with command economies. In their review of emerging economies, Goldstein and Turner (1996) have found that the commercial banking sector in at least two-thirds of all IMF country members have been afflicted by some form of financial distress between the period of 1980 to 1996. The list of afflicted countries is extensive with history repeating itself in several countries during the above period.

The latest crisis to afflict the commercial banking sector is the one being currently experienced by most Asian countries. In countries such as Thailand and Japan, the commercial banking system's crisis has spread insidiously throughout the host country's economy. Malaysia has not been spared in this latest incident. However, the country is no stranger to such occurrences with the latest recorded episodes of banking sector distress occurring between the period of 1985-1988 and more recently beginning in late 1997.

The origin of most banking sector failure is often complex and can often stem from the interplay of several factors (i.e. macroeconomic volatility, bank specific and political variables) rather than any singular causal factor. While the impetus behind such episodes may be varied and difficult to discern, the fallout from such episodes can be far-reaching and even catastrophic to a country's financial and economic foundation given the pervasiveness and prominence of the commercial banking system. It is this vital role and prominence of commercial banks and their very susceptibility to increasing episodes of distress that serves as the motivation of this paper. This paper will study the commonalties and differences between the banking distress experienced in Malaysia during the period of 1985-1988 and the most recent occurrence, which began in late 1997. It is hoped that these observations will provide a basis for inference into the likely causes behind banking distress in the Malaysian context. Furthermore, the detection of similar observations or conditions in the future may serve to alert concerned parties of the likelihood of a banking system distress. This will in turn provide an opportunity for the execution of actions to lessen the impact if not the adjustments to avert such episodes.

The paper has been organized into several sections beginning with a brief description of the evolution of the banking system in Malaysia in Section II. This section will also review the events that transpired during the two latest distress episodes followed by a description of the nature and roles of the banking system in Malaysia. A general review of some of the more recent literature on banking crisis including the fragility of the system will be given in Section III. The subsequent section, Section IV will detail the approach and variables employed in examining the two episodes of banking distress.

Section V consists of the findings of the study divided under six broad subsections, covering macroeconomic volatility, the composition and direction of loans and bank asset quality. The discussion that follows will be in Section VI, which is subdivided into three subsections to allow an individual treatise of each of the two episodes followed by a comparison of both based on the preceding findings. Finally, Section VII will house both concluding remarks and possible directions for future endeavors.

II. Background

1. Brief History of the Banking System in Malaysia

Commercial banking in Malaysia had its humble beginnings back in 1859 when the first bank, Chartered Mercantile Bank of India was established in Penang. The first local bank, Kwong Yik Bank appeared subsequently in 1903 (Iqbal, 1985). The early years of the country's commercial banking system tended to be dominated by foreign banks. This was because the driving force behind the initial growth of the commercial banking sector in Malaysia was provided by the colonial masters who needed to support the rapidly expanding foreign trade and investment in the region with Britain during the mid 1800's. As such the first local commercial banks in Malaysia tended to be outgrowths of the economy. The local banks which followed were predominantly Chinese owned and dialect divided.

Banks during this time were forced to maintain a highly liquid position given that a large majority of their loans and deposits were to the commodity sector. This liquidity was necessitated by the fluctuating export prices of tin and rubber. Thus a large proportion of the financing was of a short-term and self-liquidating nature (Bank Negara Anniversary Issue, 1985). Apart from the sector's susceptibility to the above externality, the banking sector was also susceptible to several other external shocks including the loss of assets when Japan invaded China during World War II and also the devaluation of the pound sterling following Britain's departure from the Gold Standard.

The commercial banking system in Malaysia has come a long way since then. Not only has the banking system grown in terms of assets, holding as much as 813.2 billion ringgit at the end of 1997 (or 43.6% of the total assets in the financial system) but also in its focus relative to its humble beginnings. The emphasis of commercial banks in Malaysia is now towards financing economic development moving away from its initial role of merely providing loans and deposits to the commodity sector or commodity related sectors. The growth of the manufacturing sector in the late 1960's and the Government's emphasis away from an agricultural based economy influenced both the direction of lending and also the traditional role of banks. This movement away from the financing of mainly foreign trade to manufacturing has also been influenced by moral suasion from Bank Negara Malaysia (Iqbal, 1985).

The traditional role of the banking system has even been enlarged to include socioeconomic goals. For example, the Government in their objective to eradicate poverty in special interest groups during period of the1970's extending into the1990's has engaged the banking system to assist in achieving this end.

The number of banks has also grown considerably albeit changing little since the late 1980's. As of end of May, 1998 the number of banking institutions stood at 36 being divided into Tier-1 and Tier-2 banks. The division of banks into two groups represents the effort of Bank Negara Malaysia (BNM) to establish a strong core of competitive banking institutions. The tier system would allow the rationalization of group operations

and the facilitation of cross-institutional business between eligible banking groups especially among banks in the Tier-1 group (BNM Annual Report, 1997).

2. Banking Distress, Crisis and Bank Panic

It is necessary at this juncture to clarify the definition of a banking system distress, crisis and panic. It is quite common to find the first two descriptions being used interchangeably in most literature on the subject matter. As for the purpose of this paper a distinction between banking distress and banking crisis is made. The definition employed by Sundarajan et. al.(1991) will be adopted as the definition of a banking crisis. A banking crisis as described by the above authors possesses one or several of the following elements:

(i) A demand for reserve money so intense that cannot be satisfied in the short run.

(ii) Liquidation of credits that have built up in a boom.

(iii) A condition of credit crunch where borrowers, who previously had easy access to capital, are now unable to borrow under any terms.

(iv) A forced sale of assets because liability structures held by the banks differ widely from market determined values. Such "fire sales" of assets by banks serve only to aggravate further a decline in asset values following the burst of an asset "bubble".

(v) A sharp reduction in value of bank assets resulting in apparent or real insolvency.

A banking distress on the other hand shares similar elements as a crisis though to a much lesser intensity. Episodes of banking distress are quite prevalent in developing economies

and are usually marked by one or several banks being insolvent but remaining in business (Caprio and Klingebiel, 1996). If one were to accept that a banking crisis is composed of a chronology of events rather than a distinct singular occurrence, banking distress would represent the start of a banking crisis. A banking distress if unchecked or unresolved would likely proceed to a full-blown crisis scenario and may eventually but not always culminate in a bank panic. A bank panic or run in this case would be the result of systemic or contagion effects. Thus the working definition of a banking distress as adopted by this paper would be one which shares some if not all the symptoms akin to a crisis as described by Sundarajan et. al. above though to varying degrees and the description used by Caprio and Klingebiel for banking distress.

Although the conditions experienced by banks during the period of 1985-1988 and in late 1997 in Malaysia were relatively serious, both situations have not reached the epic proportions seen in neighboring countries (Thailand, 1997 and Korea, 1997) or elsewhere in other developing nations (Mexico, 1994). For example, elements such as a fire sale of assets have not occurred on any notable scale in both episodes partially due to Government intervention. Furthermore, an examination of the major events that followed during these two recent episodes as elaborated below suggest it is arguably appropriate to label the situation experienced by banks in Malaysia during these two periods as a severe case of banking distress.

3. Episodes of Banking Distress in Malaysia

The 1985-1988 Episode

The recession that engulfed the nation around 1985 was considered the worst in Malaysia's post independence history (BNM Anniversary Report, 1995). The recession saw real GNP plunging to a low of -1.03% in 1985 and barely hovering above zero in 1986. This was in sharp contrast to the preceding 5 years, which registered an annual average growth in excess of 6% (Radzi, 1997, Thillainathan, 1997). Also prevalent during the recession was a decline in commodity prices worldwide. The third quarter of 1985 saw an annualized decline of 6% in export prices along with an annualized decline of 3.2% in gross exports (BNM Annual report, 1985). Other notable events included the deterioration in the stock exchange, the Straits Times Index then, which declined from an annual average of 426.78 points in 1984 to 272.03 points in 1986 (Investor Digest, 1989). It was under the specter of recession in which the 1985 episode of banking distress began.

Credit contraction as described above which often marks the presence of banking distress was evident when one compares the growth of loans in the 2 years preceding 1985 (see Table 2 and Figure 7 in the Appendix). An annual growth of loans of 24% and 18.3% in 1983 and 1984 respectively quickly fell to 12.6% and 6.8% in 1985 and 1986 respectively. The contraction of credit became even more acute as the growth of loans plunged to –0.3% altogether in 1987. Deposits mirrored the fall in loans though to a less drastic degree. Deposits fell from an annual growth of 12.4% and 14.7% in 1983 and 1984 respectively to a low of 7.7% in 1985 and eventually to a low of 2.5% in 1987.

The above trends were also reflected in the percentage change in bank debt to the private sector (Table 2 and Figure 8, Appendix). The deposit rate for both demand and time deposits also fell markedly during the distress period as compared to the 2 years running up to 1985 (Figure 10). Savings which registered a rate of 7.50% in 1984 fell to 3.50% in 1987 and 1988 while 12 month fixed deposit rates fell from 10.75% in 1984 to a low of 4.25% in 1987. The fall in deposit rates or real deposit rates on a sustained basis serves to reinforce the presence of a bank distress as it has been found to signify a credit crunch (Caprio and Klingebiel, 1996).

Even more alarming was the accompanying rise in non-performing loans (NPLs). Although the accurate reporting of NPLs were largely absent until 1988 the data on accumulated specific provisions for bad debts and interest-in-suspense rose from 3.9% in 1984 to a peak of 15.6% in 1988 (Thillainathan, 1998). The distress situation was largely prevented from progressing further into a crisis situation and very likely into systemic failure by the intervention of Bank Negara Malaysia. Empowered through additional legislative amendments, BNM instituted several remedial measures to avert the loss of investor and public confidence in the banking sector. Among some of the measures taken by the Central Bank were the injection of capital into three ailing banks (Sabah Bank Berhad, United Asian Bank Berhad and Perwira Habib Bank) and the control of the business operations of another bank (Oriental Bank Berhad).

This episode of banking distress eventually saw the merger of United Asian Bank with the Bank of Commerce and the capital reduction of Oriental Bank Berhad. Oriental Bank

Berhad was eventually absorbed into Malaysian Industrial Development Finance Berhad as a subsidiary. In 1992, BNM's stake in Perwira Habib Bank was relinquished to Affin Holdings.

The 1997 Episode.

In contrast to the 1985 episode this latest distress episode was preceded by a period of economic boom even right up until the commencement of the distress. GDP and GNP rose dramatically from 1993 onward as can be seen graphically in Figure 1 (Appendix). With a change of 5.1% in 1994 from the previous year, GDP grew at an astronomical rate of 28.4% in 1996 from 1995. As for real GNP, it remained comfortably in excess of 7.0% from 1993 up until the last quarter of 1997 (Radzi, 1997).

However, what began as abandonment of a fixed exchange rate by Thailand around July 1997 followed by a banking crisis (sparked largely by a burst of the "asset bubble" in the property market), set off a series of contagion effect rippling across the region. The Malaysian ringgit followed soon after enveloping the nation and the banking sector into a distress situation. Unlike the 1985 episode this distress episode was marked by a drastic decline in the FOREX rate. From an annual average rate of RM2.5279 to a US dollar in 1996 the exchange rate plunged to a rate of RM3.883 in the month of December 1997. The fall continued with the ringgit being traded at RM4.1750 to a dollar for the month of June 1998 (see Table 3 in the Appendix). In essence the ringgit had depreciated as much as 39.4% from 1996 until June 1998.

Mirroring the fall in FOREX was the plunge in Kuala Lumpur Composite Index (KLCI). The KLCI, which stood at 1,077.30 points in June 1997, quickly deteriorated to 594.44 points by December of the same year (BNM Monthly Report, 1998). By June 1998, the monthly turnover volume had shrunken to a mere RM 5,445 million from a monthly turnover of RM 34,364 million in June 1997 (Table 4 in the Appendix).

In the early phase of the distress in late 1997, credit contraction was less apparent relative to the 1985 episode (Table 2 and Figure 7, Appendix). Nevertheless, an examination of the loan growth throughout the four quarters of 1998 as they become available will likely indicate the strong presence of a credit crunch. Already the initial evidence is present as total loans by commercial banks as of June 1998 stood around RM 283 million (BNM monthly report, July 1998) relative to a total of around RM 276 million at the end of 1997 indicating a growth of only 2.5% for the half-year period. This modest growth is in sharp contrast to an annual loan growth of 26.8% in 1997. The disparity in loan growth is even more apparent when compared against a growth of 30.5% in 1995 (Table 2, Appendix).

What was more apparent however, was a feature that has been noted prior to a banking distress or crises and that is the inelastic demand for interest rate. Described as a situation whereby borrowers continue to borrow despite rising interest rates by Sundarajan et. al.(1991), this phenomena can be observed in the run up to the distress of 1997. The average lending rate rose steadily from 9.28% in 1995 until an all-time decade high of 11.51% in 1997 (Figure 10). This rapid rise in lending rates did little to stopgap the

annual growth rate of loans, which rose from 24.5% in 1996 to 26.8% in 1997 (Table 2, Appendix).

Annual growth of deposits has been less dramatic in comparison and in fact has fallen from 23.5% in 1995 to 19.5% in 1997. This reflects the relatively liberal spending habits of both the public and corporations prior to the distress. The expenditure of these two parties would have been likely to be buoyed by the exceptional economic growth in the 1990's and the expectations of future growth.

A more interesting feature to note is the rapid rise in interest rates for time deposits prior to the distress. The short-term fixed deposit rates (1-month) which stood at an average of 5.08% in 1994 rose sharply to a substantial 8.81% by 1997. The 12-month rate showed a similar trend though on a relatively less dramatic scale (see Figure 10, Appendix). This feature of rising deposit interest rates have been noted elsewhere to be a strong indicator of an impending banking sector distress as banks desperately bid up rates to remain afloat (Caprio et. al., 1996). It is very likely that the banks in Malaysia had adopted such measures for similar reasons.

As the distress progressed NPLs, which stood at 3.6% of total loans at the end of June 1997, increased to 5.7% at the end of 1997 (BNM Annual Report, 1997) and gave every indication of increasing further. Although no "fire" sale of assets was evident the increase in NPLs was already indicative of the deteriorating asset value of the banks.

As in the 1985 crisis, BNM again intervened in the banking sector. At the onset of the crisis BNM swiftly assured the public that it would stand as guarantors for all deposits placed in all financial institutions. While this allayed any immediate loss of confidence in depositors and consequently a run against the banking system it also raises the issue of moral hazard. Governments and Central banks while being able to quell a run against the banking system in most cases can also encourage the indulgence of both the banking system and investors in risky projects. This will be one of the causal factors of a qualitative nature, which will be discussed further in Section VI.

4. Role of the Banking System

Although it was the historical impetus of trade behind the development of the commercial banking system that has set the template for growth, it is the banking system's role in the economy that has a strong bearing on the strength and weakness of the system. The roles of the banking system are also shaped by Bank Negara Malaysia and ultimately the Government in their regulatory and mediating capacity. As such an understanding of the roles of the commercial banking sector in Malaysia as it pertains to the system's fragility represents an important starting point in order to identify and understand the likely causes behind the two episodes of banking distress in Malaysia.

Although the roles of commercial banks in Malaysia are not very different in nature relative to the roles played by banks in other market economies, the commercial banking sector as a whole does possess unique characteristics that sets it apart from other financial

intermediaries in the country. Ironically, it is some of these unique qualities that have a bearing on the banking system's susceptibility to distress or crisis situations. In a stable, well-functioning market economy banks are involved in:

(i) Credit creation.

A truly unique role confined to banks whereby through the opening of new deposits an original advance is multiplied (Iqbal, 1985). It is this ability to create and the extent of credit created that can sometimes predispose banks to a crisis situation stemming from economic turmoil. A further elaboration will be provided in Section VI.

(i) Payment system.

Banks provide a payment system mechanism for facilitating transactions via current account facilities.

(ii) Financial Intermediation.

Although this role is shared with other financial intermediaries, the sheer dominance of the banking sector in Malaysia and indeed elsewhere ensures that banks play a major role. Financial intermediation allows saving decisions of individual economic agents to be disassociated from the decisions of the investors (Costello et. al., 1996).

(iii) Risk Management.

Banks by assuming the roles as intermediaries or guarantors assess, assume and manage risk for many transactions in the business environment locally and overseas.

(iv) Macroeconomic stability.

The intimacy of the banking system and a country's economy is well noted in the literature of banking crisis. While banks can aid positively towards stabilizing the economy via the financial system the opposite is equally true given its prominence. Although the interdependence of these two systems have been established the debate as which acts as a precursor to the other remains (Caprio and Klingebiel, 1996). In some instances a banking system failure worsened an economic downturn and in others it was the opposite. Goldstein and Turner (1996) have recorded evidence that seem to favor the former while Demirguc-Kunt and Detragaiche (1997) have found the latter to be more evident with an economic downturn as one of the causal factors behind banking crises.

(v) Assistance in Corporate Governance.

By monitoring borrowers banks participate or assist in effective corporate governance of the enterprise sector. This has been carried out to varying degrees of effectiveness and sometimes yielding less than satisfactory results as will be illustrated in the Evaluation section.

(vi) Allocation of resources.

Banks facilitate the allocation of resources by channeling funds to its most effective use. This is achieved through the bank's discretion on awarding loans after it has carried out a supposedly sound assessment of economic variables. As with the responsibility of assisting in corporate governance, this function may not always be based on prudent judgement or on accurate assessments of the state of the economy. The elements of mismanagement by the top management of banks and the influence of the Government are another two potential sources behind poor lending decisions. Poor decisions on the acquisition of assets by banks and/or excessive vulnerability to a particular class of risks can often result in poor asset quality as found by Gonzalez-Hermosillo (1996). Such banks not only become susceptible to external shocks but may also serve to propagate speculative asset "bubbles". The current banking crisis in Thailand is one such example with banks overextending their loans to the property sector (The Economist, Sept. 1997).

(vii) Matching savings and investments.

Banks act as conduits whereby the savings of those with capital can be converted or mobilized into investments. In this respect banks also play a vital role in reducing asymmetric information. Asymmetric information as described by Mishkin (1996) describes a condition whereby one party to a financial contract has much less information than the other resulting in adverse selection and the practice of moral hazard. Banks can themselves be victims of asymmetric information especially when Governmental pressure is applied to banks to provide loans to otherwise less

than sound ventures. The presence of negative Governmental influence are believed to be one of the contributory factors behind the banking crises experienced recently in Thailand and Indonesia (The Economist, Sept. 1997) and certainly in the some of the episodes experienced by Baltic countries (Costello et. al., 1996).

The roles that are played by the commercial banking sector as opposed to those of other financial intermediaries as described above serve to show not only the uniqueness of the roles but also the banking system's intimacy to and pervasiveness in the country's economy. However, these very roles that make banks unique can predispose them to both endogenous and exogenous shocks. In some instances banking system distress may originate from the very actions of the bank themselves. For example, unbridled credit creation and poor judgement or mismanagement increases the banking system's fragility. Indeed banks in general tend to be more vulnerable to shocks relative to other sectors.

A description of the Malaysian banking system is not complete without a discussion on the role of Government and Bank Negara Malaysia as it pertains to the strength of the banking system. While the Government's effects on the banking sector tend to be a much broader and general scale via the effects of fiscal policies, that of BNM are more direct. As the country's banker and the sole source of money supply, BNM influence extends beyond that of being the sole issuer of operating licenses for all other financial intermediaries.

BNM has in its arsenal several measures to regulate the activities of the banking system. BNM activities are exercised through the Central Bank of Malaysia Ordinance, 1958, the Banking Act, 1973 and the Finance Companies Act, 1969. BNM is able to influence the operation of the banking system and other financial intermediaries through its policy instruments of statutory reserves, minimum liquidity requirements, discount and open market instruments (Iqbal, 1985). The use of statutory reserve requirements is a rather blunt instrument of monetary policy as its effects are pervasive while the minimum liquidity requirement maintained at banks act as a control to credit creation by banks to the private sector. Open market operations tend to have limited effectiveness in developing countries compared to developed ones since the market in Government securities in the former is at its infancy (Corsetti et. al., 1998, Iqbal, 1985).

Although the vast majority of BNM's policies such as the Banking and Financial Institutions Act (BAFIA) in 1989 and the reclassification of Non-performing loans in 1998 from six months to three months to be more in line with International standards are commendable and positive, there is still room for improvement. Its wisdom in the mediation of money supply as will be seen in Section IV and V and their degree of enforcement of standards are somewhat questionable. Banking standards especially as it pertains to classification of non-performing loans and the maintenance of a minimal capital adequacy ratio have only been instituted in the early 1990's and have yet to reach International banking standards. While striving to improve banking standards through improved regulation BNM together with the Government can potentially encourage moral hazard problems. The provision of safety nets as found in some countries while