

THE MALAYSIAN MONETARY POLICY AND
ITS RELATION TO FINANCIAL SYSTEM

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INTERNATIONAL ISLAMIC UNIVERSITY
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وَتَشْرِيفَتِي إِسْلَامًا أَنْبَارًا تَجَسَّيَا مُلَمِّتِيَا

THE MALAYSIAN MONETARY POLICY AND
ITS RELATION TO FINANCIAL SYSTEM

by

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SYNOPSIS

This project paper is an attempt to analyze the structure of financial system in Malaysia and its relation to Malaysian monetary policy. Special emphasis on monetary policy would be given. Nevertheless, instruments of monetary management which are being used by Central Bank of Malaysia would also be discussed. Effectiveness of monetary policy would be given greater emphasis, which include the aspects of reserve money, development of money supply and selected economic indicators. It would be examined in the sense that, to what extent the objectives of economic policy in Malaysia have been achieved which include economic growth, level of employment and unemployment, price stability, balance of payment and equity in the distribution of income and wealth. Quantitative analysis would be used to identify the effectiveness of the policy. Finally, the overall discussion would be viewed from Islamic perspective.

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CHAPTER 1

INTRODUCTION

1.1 Introduction

The financial system encompasses the instruments, institutions markets, and rules governing the conduct of trade that expedite the routing of funds from buyers to sellers and from savers to lenders¹. Monetary policy would include specification of policy goals, setting policy instruments and targets to achieve the goals and using a monitoring system to assure the authorities that their action are working in the desired directions².

The structure of financial system with special emphasis on monetary system is made up of the Central Bank (Bank Negara Malaysia), Commercial banks, the Credit Guarantee Corporation (CGC), Finance companies and Merchant banks. The

1 Kaufman, George, The U.S. Financial System, 3rd.ed. Prentice-Hall, New Jersey, 1986, p.3.

2 Siegel N. Barry, Money, Banking, and The Economy , A Monetarist View, Academic Press, Inc. (London) Ltd., 1982. p. 209.

Commercial banks form the core of the system with the Central Bank as its apex. The commercial banks are the largest group of the financial institutions in the country, accounting for \$48,946 millions or 46 per cent of the total assets of the financial system at the end of 1982³. The growth of the commercial banks stemmed from the growth of their deposits base, which rose by an average annual rate of 17.8 per cent over the period 1960-80 and accounted for 11.5 per cent of the bank's total resources of the end 1982. The other financial institutions include the National Saving Bank, Discount Houses, Provident and Pension Funds, Insurance companies, Rural Credit Institutions, and Urban Credit Institutions. They are supervised by various government departments and agencies.

Monetary policy is concerned with the determination of policy or policies that basically plays the function of determination of money in the economy. Changes in monetary policy are initiated by the Economic Research and Statistics Department and Banking Department of the Central Bank of Malaysia. These departments are responsible for monitoring movements in monetary

3 Pang Yok and Savarimuthu, Banking in Malaysia, Heinemann (Malaysia) Sdn. Bhd. Kuala Lumpur, p. 1.

aggregates and various aspects of banking developments. The Central Bank has been instrumental in the establishment of new financial institutions geared towards economic growth and redistribution so that the economy imbalances between the people are reduced⁴. The monetary policy and the lending guidelines of the Central Bank give the same effect. Further, the Central Bank regulates the volume of money and the generation of Credit by the commercial banks, merchant banks, and finance companies through a wide range of monetary instruments.

The bank has so far relied on the use of statutory reserves, liquidity ratio, interest rate, credit control and moral suasion as the prime instruments of monetary management because the narrow scope of the domestic money and capital markets has so far precluded the effective use of other classical instruments, such as variations in the bank rate and open market operations.

Looking at the Malaysian economy, it is not unrealistic to say that it has achieved certain percentage of growth, price stability, high level of employment and a more equitable distribution of wealth and income.

4 Ibid, p. 6.

How these can be achieved? Do they have strong and positive correlation to monetary policy? The answer would be obtained after analysis the above subject matter in the quantitative approach. What will happen if interest rate is abolished and instead profit sharing is replaced? Do the above objectives can still be achieved?

Finally, the subject matter is looked from the Islamic view point. Islam does not prohibit the financial system and monetary policy as long as they are in conformity with the Islamic principles and injunctions. Thus, interest which is against Islam has no place in financial system and monetary policy. The prohibition of interest is clearly stated in, al Quran, Al Bakarah:275 which means 'Those who takes usury shall rise up before Allah like man whom satan has demented by his touch ; for they claim that usury is like trading. But Allah has permitted trading and forbidden usury.

1.2 Project Procedure

1.2.1. Objective of the Study

As the Nation's monetary authority, the Central Bank is responsible to the government for ensuring monetary stability and to influence the credit situation to help the achievement of the Nation's overall economic objectives. The bank is obliged to ensure that the supply of money and the volume of credit are sufficiently 'elastic' to meet the demands in the domestic economy. It regulates the volume of money and the generation of credit by commercial banks and finance companies through various instruments including quantitative and qualitative controls. By virtue of the statutory powers given to the bank through various banking laws, the Central Bank is placed at the peak of the financial system, to develop and safeguard the system. In essence, the investigation represents an attempt the effectiveness of monetary policy through Central Bank in achieving the Malaysia economic objectives.

Specifically, the objectives of this study are:-

- a. To evaluate the effectiveness of monetary policy in achieving the economic objectives.
- b. To show that Central Bank can still control money supply without being involve in interest.
- c. To study the structure of the financial system with special emphasis on monetary system.
- d. To study the instruments of monetary management.
- e. To identify the instruments which are suit to Islam.

1.2.2. Hypothesis

Within the framework of the objectives contended that :-

- a. Instruments of monetary management are reliable.

Instruments of monetary management can be used effectively by the authority for the expansionary and contractionary of money supply in the economy through the financial system when needed.

- b. The monetary policy helps the economy to achieve a reasonable level of growth.

Monetary policy has effectively control the money supply in the economy which lead to the increment in the investments as well as productivity. These lead to the rise of GNP⁵. Growth is viewed from the macro and GNP aspects.

5 Gross National Product.

- c. The monetary policy helps the economy in the creation of a reasonable rate of employment.
- d. The monetary policy has maintained the stability in the price level.
- e. Monetary policy leads to a healthy balance of payment as a result of the increased in investment whereby export has increased relatively to import.

1.2.3. Scope of Study

This project paper would give greater emphasis on the effectiveness of monetary policy in achieving the economic objectives through controlling the money supply in the economy through monetary instruments. The role of fiscal policy in achieving the same objectives would not be analyzed. Similarly, the traditional approaches of controlling money supply namely open market operations and the like would not be discussed.

Furthermore, the approach of the study in this project paper is more at the practical aspect. Therefore, the theoretical aspect for instance the analysis of IS-IM curve would not be included. Similarly, the debate between Monetarists and Keynesian on monetary policy would also not given place in this study.

1.2.4. Organization of Chapters.

This project paper is devided into eight chapters. Chapter one is on the introduction of the study which explains the relationship between the financial system and monetary policy, the objectives of the paper, hypothesis, the scope of study as well as organization of the chapters. Chapter two describes the methodology used in obtaining the relevant data and informations. It also contain the problems and limitations encountered while doing the study. Chapter three of the paper is to review the literature made on relative areas especially those relating to the aspects of financial system and monetary policy. Chapter five will study the formulation of monetary policy and the monetary instruments used to control the money supply. Chapter sixth is the core of the study, which analyses

the effectiveness of present monetary policy. Money multiplies and reserve money as well as its determinants would also be discussed. Chapter seven deals with the shortcomings of the monetary policy in achieving its objectives as well as the overall review of the study from Islamic point of view. Chapter eight will give a brief concluding remarks, presenting the summary and some suggestions or policy changes and recommendations.

METHODOLOGY

2.1 Methodology

The study of this paper is carried out through various methods, namely :-

2.1.1. Library Research

Quantitative materials were particularly, obtained from a series of Annual Reports released by Central Bank. These Annual Reports are important to analyze the development and progress of Monetary Policy and its effectiveness in achieving economic objectives. The statistical year books published every year by the Statistics Department also provide the informations on statistical data pertaining to employment, balance of payment, growth, personal income of different groups and the level of price. Unpublished manuscripts such as dissertations made by previous researchers which are relevant to study are also analyzed and included. All the data used in the paper are mostly cover a period of ten to fifteen years especially for regression purpose. Most recent data are used whenever possible.

2.1.2. Personal Interviews.

The investigation was also carried out through personal interviews with the Central Bank's officers. The interviews were made with the Public Relation Officer at the Personnel Department and officer in Economics Department. These interviews were carried out in order to obtain a deeper understanding about every aspect that are being investigated particularly to know how monetary policy is formulated and the exact instruments of monetary management used by Central Bank.

2.1.3. Additional Informations.

Additional informations were also obtained from journals, bulletins, magazines as well as seminar papers. The theoretical aspects of the monetary policy and financial system were mainly obtained from books. This is to make the study as comprehensive and informative as possible.

Finally, Quran and Hadith also being referred to obtain the information pertaining to the Islamic principles on this area.