

IS THERE THE NEED FOR A FINANCIAL SECTOR?

By

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I OVERVIEW

As more economies from time to time, both developed and developing, plunged into a macroeconomic crisis emanating from the financial sector, the role of the financial sector in the economic growth and development of a country has increasingly being called into question. Specifically, the sector has been demonized for the woes that it created for the real economy. To refute the notion that financial sector development is not indispensable, this lecture will elucidate the important role played by the sector in the economic development and macroeconomic stabilization of a country. The discourse is set against the backdrop of the Malaysian experience in order to facilitate appreciation of the subject.

Generally, financial sector development is a pre-requisite to growth and development of countries. It is the over-rapid and haphazard development of the financial sector that causes it to have a de-stabilizing impact on the real economy. This is characterized by the volume of trading in the financial sector that far exceeds trading in the real sector. The subsequent sections will highlight two useful roles that the financial sector especially if it is well-regulated could play in the development and stability of economies. The roles include intermediation between savers and borrowers and macroeconomic stabilization.

II FINANCIAL INTERMEDIATION

Generally countries strive for economic development to improve the welfare of their citizens. The role of capital accumulation both physical and human in the process cannot be over-emphasized. Massive investments are needed to sustain the process. The presence of a financial sector would enhance the quality and quantity of capital formation. Hence the welfare of the society hinges upon the efficiency of that sector in boosting the productive capacity of the economy and in relieving the borrowing and lending constraints of individuals in order for them to smooth their lifetime consumption patterns (Mishkin, 2013). Incidentally, the life-cycle theory does hold in Malaysia (Tan, 2009). In fact, as early as the 1960s apart from Gurley & Shaw (1956), other economists such as Patinkin (1961) and Brainard & Tobin (1963) also recognized the quality and quantity of services offered by financial intermediaries as being crucial to macroeconomic performance.

There are two ways of connecting savers to investors viz.

- 1) Intermediation via the banks*
- 2) securities market intermediation*

Financial sector development is usually kick-started by the establishment of banks. As the sector becomes more advanced, securities market intermediation may come into the picture. Securities market intermediation is generally more efficient as there is no need for middlemen. Thus, bank

intermediation is more common amongst emerging financial markets. In more advanced economies, the financial system would consist not only of banks, but also securities firms, specialized intermediaries such as finance companies and mortgage brokers, institutional investors such as insurance companies, pension funds and mutual funds. This could encourage and mobilize private savings which could then be channeled to their most productive use. Individuals would then have a more diverse menu of saving and investment options of varying degrees of risk and maturity.

If the financial system of a country is underdeveloped, the following phenomena could prevail (McKinnon, 1973):

- 1) Greater dependence on self-financing. Processes of saving and investment are not specialized or distinct. Generally availability of external financing is a crucial determinant of whether high productivity investment projects do take off or otherwise. Hence, those entrepreneurs who do not have access to external financing can be entangled in a low-level equilibrium trap, characterized by the use of inferior technology and lower consumption in both the present and the future;*
- 2) If a country's financial system is rudimentary such that it is only constituted by banks, there would only be a narrower spectrum of financial assets viz. interest and non-interest bearing deposits of the banking system and currency available to savers. Primary securities would be held largely by financial institutions rather than by ultimate savers. Thus very little direct contacts exist between primary borrowers and ultimate lenders;*
- 3) Fragmentation of real interest rates due to the absence of perfect capital markets;*
- 4) Presence of a large self-financed household or "unorganized" sector alongside an imperfectly financed corporate or "organized" sector. The organized banking sector does not cater to the economic hinterland of the LDCs;*
- 5) Exhaustion of loanable funds of the banking system by government deficits. Private borrowers may then have to resort to moneylenders, pawnbrokers and cooperatives; and*
- 6) Low real rates of interest that do not reflect the opportunity cost of scarce capital, resulting in mal-allocation of resources. The banks' inability to earn high equilibrium rates of return in a repressed financial regime would imply unduly low returns to depositors that may turn out to be negative in real terms in times of high inflation. Savers may then reduce their holdings of near monies to below some socially optimal level.*

It is common amongst LDC governments to suppress the development of their financial systems as they perceive suppression as healthy for economic development. There are six possible ways that a government could repress its country's financial system (Beim and Calormiris, 2001):

- 1) Setting a ceiling on interest rates payable by banks to depositors to stave off excessive competition for deposits thus raising their profitability, safety and soundness. However, the rents that accrue to banks are borne by savers and borrowers that do not enjoy preferential treatment from the government. In the case of Malaysia, the administered interest rate regime prior to October 1978 was motivated by the desire to promote the development of indigenous banks by limiting competition between domestic and foreign banks on the interest rate front as foreign banks were much more established in the trade;*

- 2) *Imposing high reserve requirements on banks. Statutory reserves are effectively a source of revenue for a government that could pare down the size of its interest-bearing debt thus reducing its debt service cost. Zero interest reserve requirements are an implicit tax on banking. Banks may then have to charge higher interest rates on loans given out to the public and offer lower interest rates to depositors;*
- 3) *Directing loans or bank credit to industry. Winners are handpicked;*
- 4) *Owning and or micromanaging banks, leaving them with little autonomy;*
- 5) *Restricting entry into the financial industry, especially of foreign banks. This could be based on nationalistic considerations or doubts of whether foreign financial institutions have any interest in the well-being of the local economy. They could also be barred from setting up new branches if they have already gained a foothold in a country. Another form of restriction is restricting the development of the securities market. The rationale for this restriction could be that the availability of alternatives to bank lending could undermine a government's ability to regulate capital flows across the country; and*
- 6) *Restriction of international capital inflows and outflows. Domestic firms may then have to face higher interest rates due to higher baseline (riskless) interest rates and risk premiums.*

Hence, financial market liberalization is advocated in order to remove the shackles of self-finance and other problems associated with the absence or underdevelopment of the financial system.

Financial liberalization encompasses measures aimed at freeing interest rates from any regulatory and institutional constraints, promoting the development of financial institutions and secondary markets for financial instruments, enhancing credit and deposit facilities, formalizing the unorganized financial sector and boosting competition amongst financial institutions (Awang Adek, et. al, 1992). Market determination of interest rates could boost savings as interest rates are moved from a below equilibrium level in a financially repressed setting to an equilibrium level under a competitive regime. With a larger pool of funds available, more lumpy investments could be undertaken. Moreover low yielding and inefficient investment projects could be rationed out of the financial market via the interest rate mechanism. This could result in an enhancement of the overall investment efficiency and national income.

There are a number of yardsticks for measuring financial sector development or its obverse financial repression (Beim and Calormiris, 2001). They include the:

- 1) *Effective reserve ratio;*
- 2) *Real interest rates;*
- 3) *Ratio of liquid liabilities to GDP e.g. M3/GDP;*
- 4) *Fraction of domestic credit granted to the private sector. To capture the importance of private lending;*
- 5) *Ratio of commercial bank assets to the sum of commercial banks and central bank assets; and*
- 6) *Relative size of the stock market – Banks dominate the financial systems of virtually all developing economies (Market capitalization/GDP).*

In fact, financial sector development and economic development can reinforce each other. This can be illustrated by considering the interaction between savings and growth. While financial sector development could stimulate economic growth by enhancing propensities to save and the quality of capital accumulation, a reverse causality can also be envisaged. This is in view of the possibility

that a booming economy could also raise the propensity to save, driving demands for more financial assets. Following McKinnon (1973), this virtuous circle can be portrayed by the following modified Harrod-Domar growth framework.

$$\text{Let's assume a simple production function: } Y = \gamma K \quad (1)$$

$$I = dK/dt = sY \quad (2)$$

$$\overset{\circ}{Y} = \gamma s \quad (3)$$

$$s = s(\overset{\circ}{Y}; \varphi) \quad (4)$$

where $0 < s < 1$; $\partial s / \partial \overset{\circ}{Y} > 0$ and $\partial s / \partial \varphi > 0$

$$\overset{\circ}{Y} = \gamma s(\overset{\circ}{Y}; \varphi) \quad (5)$$

where economic growth also depends upon its portfolio effect on savings.

In order to forestall any harm that the financial sector could unleash on the real economy and for it to confer advantages on the latter, what is needed is a sound and stable financial system. The elements of a good financial system (Beim and Calormiris, 2001) may include:

1. The existence of a set of laws that can be fairly and uniformly enforced to safeguard the rights and interests of savers and investors;
2. The availability of infrastructures for information gathering. Examples include the role of information gathering by banks and credit rating agencies and the institution of mandatory disclosure rules such that a certain minimum amount of information must be released to the investing public by firms;
3. A sound currency. This requires a responsible government that regulates its own spending such that it does not incur an unsustainably large fiscal deficit. Otherwise, the deficit may have to be monetized. Overprinting of money could lead to the collapse of the domestic currency through high inflation. Empirical results do suggest that fiscal deficits could have an inflationary impact on the Malaysian economy if there is monetization (Tan, 2006);
4. Limiting government regulations that tax banks. For example, too high a statutory reserve requirement particularly when statutory reserves are interest-free could undermine the profitability and thus the efficiency of banks;
5. Effective and prudential regulation and supervision of banks. Regulatory discipline involves screening of banks via licensing procedures, imposition of capital adequacy requirements, periodic inspections, etc. However, they are only effective if the regulators possess integrity.

Generally, the soundness of the banking system could be maintained via:

1. Barring banks from extending loans to parties connected with them so that they would be maintaining better-diversified asset portfolios. This can be effected by subjecting them to mandatory disclosure rules and monitoring;

2. *Imposing capital adequacy requirements on banks to curb moral hazard behavior amongst them. If they have a higher net worth, they will have more to lose from making bad lending decisions. Therefore they would be more cautious in their risk assumptions. Similarly compensation or remuneration packages must be designed in such a way that would not result in moral hazard on the part of bank employees especially loans officers; and*
3. *Governments can refrain from providing deposit insurance schemes to depositors and bailout prospects to banks and firms.*

Not unlike other developing countries, Malaysia has also been striving to develop its financial system so as to mobilize savings, allocate credits and supply financial services efficiently to the country. In Malaysia, financial reforms have only been undertaken gradually over the years (Awang Adek, et.al 1992). It was especially in the 1980s that the Central Bank began to intensify its reforms of the financial system via a program to strengthen the financial infrastructure and to relax and simplify rules and procedures. The computerization of banking operations started in full force in the 1980s.

Broadly, the Malaysian financial system can be divided into two sectors – banking and non-banking (Bank Negara Malaysia, 1984). In the banking sector, the major components are the Central Bank (at the apex of the system), commercial banks, finance companies and merchant banks. Altogether they command a large portion of the total assets of financial system. Of all these institutions, commercial banks collectively form the biggest institution. On the other hand, the non-banking financial sector is constituted by provident and insurance funds, development finance and savings institutions, and other financial intermediaries such as unit trusts, building societies, credit and charge card companies, factoring and leasing companies and several quasi-government investment and financial institutions such as the Pilgrims Management and Fund Board, the National Mortgage Corporation (Cagamas, Ltd), the Credit Guarantee Corporation (CGC), the Malaysian Export Credit Insurance Ltd (MECIB, and the Employees Provident Fund.

Parallel with the rapid development of the Malaysian banking system has been the development of the Malaysian capital market which was practically non-existent prior to the early 1960s. It is now constituted by markets for financial assets such as public and private debt instruments, corporate stocks and shares and commodity futures. The tendency for companies to substitute equity capital for bank borrowings has also grown over the years. Hence, the traditional reliance on commercial banks as a source of borrowings has waned though still important. In terms of market capitalization, the Kuala Lumpur Stock Exchange (KLSE) is fairly well established with an estimated market capitalization of 146.5% of GDP. Two local credit-rating agencies have also been set up so far to facilitate the issuance of private debt securities namely, the Rating Agency of Malaysia (RAM) and the Malaysian Rating Corporation Berhad (MRCB).

The Malaysian financial system is governed by the Banking and Financial Institutions Act (BAFIA) that provides for an integrated supervision and regulation of the Malaysian financial system.

III Administration of Monetary Policy

Monetary policy is commonly relied upon for macroeconomic stabilization though monetary authorities face a challenging task in the administration of monetary policy. For policy efficacies, they need to have a precise knowledge of the timing and impact of their policies on the economy. Financial liberalization and innovation processes which the Malaysian financial system has been undergoing could present a tough challenge to the conduct of monetary policy (Tan, 1995; and Tan, 1997). Specifically, the existence of long and variable lags in the effects of monetary policy on the economy could rather imply a potential threat of the policy to macroeconomic stability.

Inflation is viewed widely as a monetary phenomenon. Hence, the rate of growth of money supply in a growing economy must be appropriately set such that it does not yield any inflationary or deflationary pressure (Hossain, 2009). It is imperative that money has a stable value for it to serve effectively as a storehouse of value. Thus price stability is crucial. Is this the case of Malaysia?

There are a number of monetary policy transmission mechanisms by which the effects of monetary policy changes can be transmitted to the macroeconomic goal variables of prices, output and employment. But I shall look at four that could demonstrate the need for a financial system for them to operate. They can be referred to as the portfolio balance transmission mechanism, the wealth transmission mechanism, the credit availability transmission mechanism, and the exchange rate transmission mechanism (see e.g. Pierce & Tysome, 1985).

First, the portfolio balance transmission mechanism. A portfolio is an array of assets and liabilities with differing yields, risks, maturities and other characteristics. Money is one of the assets that exists in the portfolio. The demand for an asset would vary directly with its own yield but inversely with the yields on all other assets.

Hence when the monetary authority changes the stock of money, it would trigger a process of portfolio adjustments. The portfolio adjustments would eventually affect the aggregate demand in the economy. For example, if the monetary authority conducts an open market operation that results in the hike in bond prices, the yield on bonds will fall. This would raise the demand for physical capital and hence investment expenditure as the opportunity cost of investing in real capital assets has fallen with the yield on bonds. Generally, when money supply is in excess of the volume that people are willing to hold, people will be motivated to switch out of money into near-money assets. The switch to other assets would induce an increase in their prices which then depress their yields. This in turn would induce a further switch to other assets next along the spectrum with similar consequences on their yields. The "ripple" would eventually affect the demand for stocks and thus raising their prices and reducing their yields. The increase in their prices would be perceived as an increase in the valuation of the existing stock of physical assets relative to their replacement cost as in the Tobin's q theory. This would render newly produced physical assets relatively cheaper, thus inducing the demand for the newly produced assets. Firms will be motivated to issue stocks at a high price that would enable them to acquire new physical assets at a lower price. The process can be summarized by the following schema:

$M \uparrow \rightarrow R's \downarrow \rightarrow q \uparrow \rightarrow I \uparrow \rightarrow AD \uparrow$

The process of portfolio adjustment in fact could also affect the demand for non-durables. With the fall in asset yields effected by the process of portfolio adjustment, two opposing effects on the saving decision can be envisaged. One is the substitution effect while the other is the income effect. The substitution effect arises when the fall in asset yields constitutes effectively a reduction in the

opportunity cost of consumption thus raising consumption of non-durables. The income effect would however be negative on such consumption because a fall in asset yields would imply a fall in interest income. Thus the net effect of the portfolio adjustment on the expenditure on non-durables would depend upon the preponderance of which of these two effects. Schematically,

$R's \downarrow \rightarrow C \uparrow$ (substitution effect) $\rightarrow AD \uparrow$

\rightarrow If $SE > IE \rightarrow C \uparrow \rightarrow AD \uparrow$

Otherwise $AD \downarrow$

$\rightarrow C \downarrow$ (income effect) $\rightarrow AD \downarrow$

Next is the wealth transmission mechanism. The process of portfolio adjustment could also give rise to the 'Keynes' windfall effect. This windfall effect could in turn affect aggregate demand in the economy and this could be analyzed by reference to the money market, asset market and the goods market. With respect to the money market, the increase in wealth might simply induce people to hold more money. Thus the additional stock of money might be partly absorbed as idle cash balances. The unabsorbed part may then be channeled to the asset market or the goods market, boosting the levels of demand in these markets.

With regard to the asset market, the way it is being influenced could be similar to that of the portfolio transmission mechanism. As to the goods market, two possibilities arise. An increase in wealth might drive people to expend more of their current income rather than save. The other possibility is that the additional money balances may be used to finance increased consumption expenditure if the actual money balances are more than the desired amount that people wish to hold. The wealth transmission mechanism can then be depicted as follows:

Portfolio adjustment $\rightarrow W \uparrow \rightarrow M^d \uparrow$ (Excess will be channeled to the asset and goods markets)

$\rightarrow A^d \uparrow$

$\rightarrow C \uparrow \rightarrow AD$

On to the credit availability transmission mechanism, to certain quarters, it is the availability of credit in the economy rather than the stock of money in existence that matters to firms in their investment-making decisions. In other words, it is the supply of loanable funds that matters rather than the cost of credit.

Suppose the central bank boosts money supply via an open market purchase of government bonds from the banking system. The supply of bank loans could be affected in two ways. One, as the cash reserves of the banking system is augmented by the open market operation, banks would be in a position to extend more loans to firms and consumers. Two, banks would also prefer to lend more to the public as the yield on government bonds declines with the open market operation.

However In an economy, credit is not being extended merely by banks but by non-banks too. So whether an increase in the supply of loans by banks would imply an increase in the overall supply of

loans in the economy would depend on whether bank and non-bank sources of credit are substitutes or complements of one another or neither. If the two sources are unrelated or are complementary, then an increase in bank credit would undoubtedly increase the overall availability of credit in the economy. However if they are substitutes, whether the overall credit supply increases or falls would depend on the degree of substitutability between the two. Hence if indeed there is an increase in the overall supply of credit in the economy following an expansionary monetary policy, then aggregate demand would be positively affected. This mechanism can be sketched as follows:

$M \uparrow \rightarrow BL \uparrow \rightarrow \text{no change in } NBL \rightarrow TL \uparrow \rightarrow AD \uparrow$

$\rightarrow NBL \uparrow \rightarrow TL \uparrow \rightarrow AD \uparrow$

$\rightarrow NBL \downarrow \rightarrow \text{If } BL \uparrow > NBL \downarrow \sim TL \uparrow \rightarrow AD \uparrow$

Otherwise $TL \downarrow \rightarrow AD \downarrow$

The credit availability transmission mechanism is potentially of major importance by virtue of the following factors:

- 1) The increase in loanable funds arising from an expansionary monetary policy would allow banks to extend more loans to firms particularly the small ones which are dependent upon bank loans rather than the debt securities market for financing;
- 2) Increase in the stock prices following a loose monetary policy could enhance the net worth of firms thus alleviating the problems of adverse selection and moral hazard associated with lending to these firms. Thus they are able to have easier access to bank loans as a higher net worth would also imply greater collateral availability; and
- 3) A low interest rate environment brought about by a loose monetary policy stance may motivate low-risk firms to borrow from the banking system. Hence, the proportion of low-risk borrowers in the loans market will be higher. Hence, banks will feel more secure in their lending operations. Banks in Malaysia are also found to embrace equilibrium credit rationing as a matter of policy (Tan, 1996).

All this would enhance investment spending that would entail an increase in aggregate demand. Generally, banks are better positioned to overcome the adverse selection and moral hazard problems inherent in the financial market. They possess the expertise to gather information about firms and are capable of screening borrowers and monitoring the loan performance at relatively low cost (Diamond, 1984; Bernanke, 1986 & Vale, 1992). Gerschenkron (1968) maintains that bank credit contributed significantly to the industrial development of Germany during the industrial revolution. This may be true also in the case of Malaysia. By applying the VAR technique, commercial bank credit has been found to exert a greater influence than M1, M2 and the lending rate on the Malaysian GDP (Tan, 1995).

The fourth mechanism which I am going to dwell upon is the exchange rate transmission mechanism which is particularly relevant to open economies. The transmission mechanisms that were elaborated earlier were applicable to both open and closed economies. This mechanism is workable given that in an open economy, the wealth portfolios of individuals do not merely consist of domestic assets but foreign assets as well. So when there is a policy-induced increase in money supply that triggers off a chain of portfolio adjustments, the chain will at some point in time lead to an increase in the demand for foreign assets. This would cause a depreciation of the domestic currency. The currency depreciation

could then affect domestic prices and output. The domestic price level is set to rise because the currency depreciation would cause i) a hike in the domestic prices of imported consumer, raw, intermediate and capital goods; ii) an increase in aggregate demand as exports would be stimulated given that locally produced goods have become cheaper abroad in terms of foreign currencies and as local consumers switch from using imported to the locally produced goods. Such expansion in aggregate demand would exert additional inflationary pressure on the economy; and iii) a hike in domestic wage levels as trade unions demand wage increments for their members due to rising cost of living. If such demands are accommodated, then producers would pass on the burden of the wage increase to consumers, thus aggravating the inflationary condition.

As for the effect of the depreciation on output, the extent of output gains would vary inversely with the degree of success of the authorities in containing inflation. If inflation is well-managed at a low level, then a favorable impact on the output level can be envisaged. Otherwise, a run-away inflation could cause disruption to the production process as inflation particularly of high rates is pernicious to economic growth and development. The schema of this transmission mechanism may be stated as follows:

$M \uparrow \rightarrow R's \downarrow \rightarrow FA's \uparrow \rightarrow s \uparrow \rightarrow \Pi \uparrow \rightarrow Y \uparrow$ if Π is well-managed
 $\rightarrow Y \downarrow$ otherwise

Monetary policy falls under the purview of the Central Bank of Malaysia which was inaugurated on January 24, 1959 (Bank Negara Malaysia, 1984). Its principal functions include:

- 1) Issuance of currency and to maintain reserves for safeguarding the value of the currency;
- 2) Acting as a banker and financial advisor to the Government;
- 3) Promoting monetary stability and a sound financial structure; and
- 4) Influencing the credit condition in the economy to the national advantage.

To enable the Bank to discharge these duties, it is vested with comprehensive legal powers to regulate and supervise the financial system. Over the years, stable economic growth, a high level of employment, stability of the local currency, poverty eradication and socioeconomic restructuring, a high living standard and a reasonable balance in the country's external payments position have been recognized as national economic objectives which the Bank has to tend to.

Though the Bank was established in 1959, it was not until the 1970s that monetary policy became a tool for macroeconomic stabilization. In the 1960s, monetary policies were merely designed for the purpose of strengthening and developing the domestic financial system as it was the Bank's first priority then. The task of macroeconomic stabilization was then largely assigned to the fiscal arm of the government only to be complemented to some extent by monetary policy. Moreover there was then a lack of indigenous banks and the predominance of foreign banks stifled the effects of monetary policy as they had all the ways and means of circumventing the regulatory mechanism of the Bank.

The full assumption of the sole currency-issuing power by the Bank in 1969 and the floating of the Malaysian currency in 1973 helped set the stage for monetary policy to play a greater role in macroeconomic stabilization. A number of monetary policy instruments, both of the general impact

variety and of the selective impact variety are at the Central Bank's disposal. They include statutory reserve requirements, minimum liquidity requirements, discount operations and open market operations which have a global impact on the economy. The others like interest rate regulation, credit control and guidelines on lending and moral suasion have a selective impact.

As an alternative to the traditional OMOs, the Central Bank can also engage in swap transactions with commercial banks as an avenue for easing any tight inter-bank money market condition. Such transactions usually involve the trading of the Malaysian currency against a foreign currency with a pre-commitment to reverse the transactions at some predetermined future date and exchange rate. These are usually short term transactions varying from 1 month to 3 months.

Moral suasion has also occasionally been deployed by the Central Bank to achieve a desired situation in a more 'voluntary' spirit. For instance in the 1960s, banks were urged to re-orientate their operations by holding more domestic against foreign assets. In the 1970s and early 1980s, they were discouraged from lending for speculative purposes and urged to be more development-oriented. It was perceived that banks could assist in national development by providing longer term financing on the basis of project viability rather than purely on the ability to furnish the right collateral. The numerous calls on commercial banks to step up lending to the priority sectors are another example of the use of moral suasion.

Past experiences reveal that monetary measures have a more immediate impact on the production of goods and services than on wages and prices. This supports the notion of wage and price stickiness in macroeconomics, pointing to the monetary policy effectiveness rather than policy ineffectiveness proposition. Based upon a monetary model constructed for Malaysia, a restrictive monetary policy could be an effective way for improving the balance-of-payments position and checking inflation while an expansionary monetary policy can be relied upon to boost economic growth in the short run without any fear that it would fuel inflation "excessively" (Tan, 1987). The Malaysian economy has generally been resilient to external shocks, particularly shocks in the US and Europe due to pursuits of counter-cyclical macroeconomic policies (Tan and Tang, 2016).

IV. CONCLUSIONS

Hence, the crucial role that the financial sector plays can never be overstated. In fact, the important role of the financial sector is acknowledged by the Central Bank of Malaysia in the Financial Sector Master Plan, 2001-10. According to the Plan document, the financial sector has been instrumental in Malaysia's economic success over several decades. The Malaysian financial system has become increasingly diversified, competitive and resilient over time. It has witnessed institutional capacity building, infrastructure development, regulatory reforms and ever increasing use of technology. It is further pronounced in the Financial Sector Blueprint 2011-20 that Malaysia's vision of becoming a developed nation by 2020 spearheaded by the private sector is underpinned by a strong, comprehensive and progressive financial system. New measures will be instituted to enhance the competitiveness and dynamism of the financial sector.

Moreover financial inclusion is a development agenda of the World Bank. It is its conviction that financial inclusion could contribute to poverty alleviation and greater prosperity. Specifically, it aims to achieve Universal Financial Access (UFA) by the year 2020. Presently, more than 2 billion adults do not have access to financial services while more than 200 million formal and informal micro small and

medium enterprises (MSMEs) in emerging economies lack adequate financing due to lack of credit history and collateral.

In fact, the global financial crisis that emanated from the US sub-prime crisis and its aftermath further highlight the importance of money, banks and the financial system in general to the economic well-being of nations (Mishkin, 2013). In 2007-9, the world economy experienced the most severe financial crisis since the Great Depression in the 1930s.

The role of conventional monetary policy tools cannot be belittled by their seeming failure in recent years. These tools that increase money supply and lower interest rates that could stabilize an economy in normal times may not work during a full-blown financial crisis situation for two reasons (Mishkin, 2013). First, the financial system might seize up in times of crisis such that it fails to allocate funds to productive uses, resulting in a collapse of investment rates and the general economy. Second, the adverse shock to the economy could give rise to the zero lower-bound problem, a problem characterized by the inability of the monetary authority to further reduce short term interest rates as they have hit the floor of zero. Nominal interest rates cannot be negative as people are able to earn more by holding bonds rather than cash. Hence, a monetary authority may have to resort to non-conventional monetary policy instruments to revive the economy. Such tools could assume the forms of liquidity provision, asset purchases or commitment to future monetary policy actions. An example of the third option is a pledge to maintain low short term rates for an extended period of time in order to keep the long-term interest rates low by virtue of the expectations theory of the term structure of interest rates. The zero lower-bound on the policy rate may however be less binding if a higher inflation rate target is set in countries practicing inflation targeting.

Most of the advanced countries are still tampering with these policies at this juncture. In recent years, the global economy has been experiencing multiple shocks, one after another that marred the effectiveness of monetary policy. The need to deleverage after a massive build-up of public and private debts, labor-saving technological innovations that have contributed to workers' redundancy, soft commodity markets owing to expanded supply after a period of high prices that drove capacity expansion, China's slowdown that has shaved off demands for a broad range of commodities and weak oil prices have contributed to the lackluster performance of the global economy. Hence it is not that monetary policy is inherently blunt.

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