

## **THE IMPACT OF FINANCIAL LIBERALIZATION ON BANK SPREADS IN MALAYSIA**

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By adapting the two-stage regression framework first introduced by Ho and Saunders (1981), the article aims to examine the impact of financial liberalization on bank spreads in Malaysia. It reviews the existing literature in order to identify the major determinants of bank spreads and, broadly speaking, finds that the key determinants of such spreads are both bank-specific and macro-economic variables. However, unlike previous empirical research, the article also finds that government, through its intervention policies, remains a major determinant of bank spreads in the banking industry in Malaysia. Contrary to the predictions of popular theory, such government interventions do have efficiency-enhancing effects for Malaysian banks.

### **1. INTRODUCTION**

There has been a great deal of research interest focusing on financial liberalization and its macro- and micro effects<sup>1</sup> since the publication of the McKinnon (1973) and Shaw (1973) hypothesis<sup>2</sup> on financial repression and, to date, the overall consensus seems to be two-fold. First, that the various forms of government intervention in a country's finance sector create financial repression which discourages financial savings and investment. Second, that to remedy the adverse effects of this financial repression, governments should liberalize their finance sectors, which effectively means that they should eliminate all forms of

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<sup>1</sup> See Williamson and Mahar (1998) for a detailed review of this literature.

<sup>2</sup> Consistent with the McKinnon (1973) and Shaw (1973) hypothesis, the freeing of controls on interest rates through financial liberalization increases competition and therefore efficiency in the banking system of the liberalizing country.

intervention and involvement in the country's finance sector. What however remains to be understood is whether government intervention can go hand in hand with financial liberalization and, if so, what implications does this have for bank spreads?

Greatly influenced by the theoretical attractiveness of the McKinnon-Shaw hypothesis on financial repression, and particularly given the growth-retarding effects of financial repression, Malaysia has joined a number of countries towards financial liberalization to gain the promised net benefits from these reforms by overhauling a number of regulations and restrictions in its financial system. Unlike a number of countries that adopted the conventional shock therapy approaches to financial sector reforms, the monetary authorities in Malaysia adopted a gradualist approach to liberalizing the country's financial sector arguing that the conventional shock therapy approach<sup>3</sup> to financial liberalization has thus far only led to increasing numbers of banking troubles.

The monetary authorities in Malaysia further argue that, in order for the benefits of financial sector liberalization to be realized, a gradual and progressive approach to financial liberalization, that is consistent with the capacity and ability of the country's banks to absorb those changes without necessarily undermining the overall stability of the country's banking industry, is more prudent (Bank Negara Malaysia, 1999). The sequencing of the various financial sector reforms under Malaysia's gradualist approach meant that financial liberalization was only implemented *after* the domestic institutions and regulatory structures were put in place and this was then followed by the gradual opening of the financial system.

Consistent with these policy objectives, the central bank of Malaysia carries out a series of well coordinated institutional-building measures in the belief that markets, when left to their own devices, will produce less-than optimal results and hence the need for some form of government intervention to correct the apparent market failures and attain some distributional objectives under the country's affirmative action programme.

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<sup>3</sup> The instant deregulation of prices and the introduction of currency convertibility (Popov, 2000).

Thus, under this gradualist approach to financial liberalization, the monetary authorities in Malaysia also intervenes heavily in the country's finance sector by directing subsidized credits to the country's 'priority sectors', where these are defined to include Bumiputera (indigenous people) businesses, low-cost housing and small-scale businesses. Relatively high statutory reserve requirements are also used extensively. In addition, foreign banks are still not allowed to open new branches, which also include off-premises Automated Teller Machines and the government has not issued new banking licenses since the early 1970s. Foreign banks can acquire interests in a local banking institution provided that the aggregate foreign shareholding does not exceed 30 percent for each bank.

According to the critics, these repressive measures undermined Malaysia's reform efforts and created an uncompetitive and inefficient banking industry in the country since, according to them, financial liberalization and government intervention cannot take place simultaneously. Critics further argue that although the overall objective of Malaysia's reforms were meant to increase competition and efficiency in the country's banking industry, suggestive evidence to date indicate that these financial reforms have had limited desired impacts on bank spreads because the continued government involvement in the finance sector have undermined the reform efforts. In particular, they assert that despite the various financial liberalization measures, the structure of the banking industry remains highly concentrated and continues to show limited signs of competition given the various entry restrictions maintained by the government.

The purpose of the article is to examine the impact that Malaysia's approach to financial liberalization has had on the country's bank spreads. This broad objective will be achieved in two ways: First, through the analyses of the impact of financial liberalization on bank performance, and second, by investigating the determinants of bank spreads. To achieve the first objective, the article uses the difference between two means approach, whereas the second objective is achieved by adapting and further extending the two-stage regression framework first introduced by Ho and Saunders (1981). In both approaches, a new variable, the government intervention index, will be used to capture the pervasive nature of government involvement in Malaysia's financial system and the effects that this has had on bank spreads. The article

hypothesizes that, despite periodic government intervention, the series of financial liberalization that have been introduced in the Malaysian financial system will enhance competition, which in turn will lower bank spreads.

The article proceeds as follows: Section 2 outlines and discusses the recent financial liberalization measures; Section 3 describes the various forms of government intervention in the Malaysian financial system; Section 4 introduces the methodology, describes the variables and data sources; Section 5 presents the analysis of the empirical results and Section 6 presents the conclusions and policy implications of the article.

## **2. RECENT FINANCIAL LIBERALIZATION MEASURES**

Like a number of other countries, Malaysia too was greatly influenced by the McKinnon (1973) and Shaw (1973) hypothesis which, as highlighted earlier, argues that financial repression lowers the incentives for savings and, therefore, investment which in turn lowers the rate of economic growth. Starting with the 1978 interest rate liberalization, a series of financial sector reforms were also introduced into the financial sector in Malaysia aimed at creating a competitive and efficient financial sector including the banking industry. However, unlike the approach taken by a number of other countries, Malaysia adopted a gradualist approach to liberalizing its financial sector under which the role and significance of the government intervention in directing the volume of bank credit to 'priority sectors' as well as in forcing banks, through the use of the statutory reserve requirement, to set aside non remunerated deposits with the country's central bank, are still prevalent.

Under the gradual approach to financial liberalization, the government dictates the cost of credit and maintains a strong influence as to the volume and direction of the total credit from the banking industry to each sector of the economy that it deems a priority sector. To this end, the central bank of Malaysia issues periodic credit guidelines for the banking industry to provide the banks with policy guidelines defining the priority sectors of the economy and determining the cost and volume of credit to be supplied to them. These financial polices are implemented at the same time as the institutional set-up is being developed and phased in over time.

The rationale for this approach, according to the monetary authorities in Malaysia, is to avoid the costly mistakes made by countries that adopted the big bang financial liberalization, which entailed the sudden removal of all forms of financial repression, while at the same time avoiding the adverse consequences of financial repression.

As part of the first major financial liberalization measure implemented in the Malaysian financial system, interest rates were freed from the administrative control of the central bank, Bank Negara Malaysia, on 23<sup>rd</sup> October 1978. In October 1991, the highly regulated deposit-taking in the banking industry was liberalized enabling finance companies and merchant banks to enter the deposit market. Prior to this reform, finance companies and merchant banks were not allowed to accept deposits from the retail depositors. The restrictions against the non-bank financial institutions were seen by critics of public policy implementation in Malaysia as one of the major impediments to the rapid increase in the number of non-banking financial institutions which in turn contributed to the creation of a non-competitive banking industry in the country.

In February 1992, banks and non-monetary financial institutions were authorized to hold stocks in non financial institutions such as Tenaga Nasional, which is Malaysia's main energy body, and PROTON, the country's national car company. As can further be observed from the Appendix, the rules on investment in shares for commercial banks and merchant banks were relaxed in October 1990, to allow these financial institutions to invest in some government-linked corporations such as *Syarikat Telekom Malaysia* (STM) and *Edaran Otomobil Nasional* (EON).

In addition to the above-mentioned reform measures and under Malaysia's gradualist approach to financial liberalization, a number of bodies have been established as part of the broader financial liberalization process to help promote the rapid development of the money and capital markets and, by extension, the encouragement of further competition in the country's financial system. For example, a number of Acts of Parliament were enacted to promote the accelerated development of various capital market institutions and instruments in the country's financial system that aimed to facilitate and accelerate the development of a competitive and efficient financial system in the country.

The establishment of the Securities Commission in 1993 was a key step towards further developing alternative sources of capital to the banking industry under the 1993 Securities Act. A number of other legislations such as the Securities Industry Act, 1983, the Futures Industry Act, 1993, and Securities Industry (Central Depositories) Act, 1991, were also enacted to provide the necessary institutional framework to the capital market in Malaysia. Among other things, these capital market developments were aimed at strengthening and increasing the level of competition and financial intermediation in the Malaysian financial system as outlined in the country's 2001 Financial Sector Master Plan. A well-developed and functional capital market provides a competitive alternative to the banking industry by providing competing sources of funding for investment purposes (Financial Sector Master Plan, 2001). Higher levels of competition would in turn place a downward pressure on bank spreads and overall profits.

A major liberalization measure introduced by Bank Negara Malaysia included the May 2, 1989 realignment of the statutory reserve requirements for commercial banks, merchant banks and finance companies to a standard ratio of 4.5 percent. The aim was to enable all the players in Malaysia's financial system to compete in a more levelled playing field (Bank Negara Malaysia, 1989).

Another financial liberalization measure was the removal of numerous barriers to entry into Malaysia's banking industry that allowed for the first time domestic finance companies and merchant banks to participate in the provision of financial products and services that, prior to the reforms, only banks were allowed to offer.

In particular, the new method of computing the statutory reserve requirement was to level the playing field for the various financial institutions, which in turn was expected to enhance efficiency and flexibility in fund management and eliminate the inherent distortions in short-term interest rates (Bank Negara Malaysia, Money and Banking in Malaysia, 1994). With regard to the liberalization of the capital adequacy framework, the objective was to level the playing field and enhance competition for the various banking institutions in Malaysia.

Malaysia's central bank asserts that the basic objectives of all these financial liberalization measures were to create a competitive banking industry and, by extension, to lower bank spreads. The other liberalization measures are outlined in the Table A-1 in the Appendix.

### **3. GOVERNMENT INTERVENTION IN THE MALAYSIAN CONTEXT**

Despite the above-mentioned financial liberalization measures, the government, through the country's central bank, continues to exercise a considerable degree of influence over the banking industry in Malaysia. Thus, even after the various financial liberalization measures outlined in the Appendix have been introduced into the financial system, some government intervention continues to remain in place because there are no formal competition policies for the country's banking industry. Rather, what existed, and still continues to exist, is a set of lending guidelines for banks which seeks to regulate both the volume and direction of bank lending. The focus of these guidelines is not on the level of competition within the Malaysian banking industry because it does not address the market concentration and, therefore, market power, nor does it deal with matters pertaining to collusive behaviour on the part of banks. Rather, the aim of these government directives is to ensure that banks lend prescribed percentages of their total loans to the 'priority sectors' so that the volume of credit in favour of these sectors continue to grow.

The continued role of the government in the structural evolution of Malaysia's banking industry is demonstrated by the high level of government restrictions with regard to both entry and exit, particularly for foreign banks and their branching activities. In addition, Malaysia's central bank still has to vet the appointment of senior management teams in Malaysian incorporated banks (Lopez, 2005).

More importantly, the banking industry in Malaysia is used by the powerful politicians and the State for wealth re-distribution under the country's New Economic Policies/National Development Policies affirmative action policies in favour of the ethnic Malays and other indigenous Bumiputeras in order to achieve some stated official policy objectives of wealth re-distribution (Gomez and Jomo, 1997). In the majority of cases, policy biases in Malaysia mean that financial resources are directed toward politically well connected cronies. In most cases soft loans from state-owned banks are directed to these crony Bumiputera-controlled conglomerates and to other priority sectors of the economy (Gomez and Jomo, 1997). However, in Malaysia, it is not only the Bumiputera-controlled conglomerates and other ethnic Malays who

benefit from the widespread political patronage that has come to characterise the Malaysian economy. According to Gomez and Jomo (1997), a number of other major corporate entities controlled by non-Bumiputeras who had very close ties with the politically powerful Malaysian politicians also benefited from the political patronage.

As a result of the strong nexus that exists between the State and the banking system in Malaysia, the critics to the country's gradualist approach to financial liberalization argue that this only facilitates the use of the banking industry by the government to achieve its political objectives of ensuring that the bulk of the country's financial resources is directed to what it deems to be the 'priority sectors' of the economy. Under this scenario, Gomez and Jomo (1997) go on to contend that huge loans continue to be granted to the politically well-connected and do not have to go through the proper procedures and are in most cases granted for speculative rather than for productive purposes.

Government also controls the volume of credit through its periodic lending guidelines to banking institutions. Each year since October 1976, the Malaysian Government issues lending guidelines to the banking industry under which these financial institutions are required to provide credit to what is considered the 'priority sectors' of the economy at below market rates of interest. The objective of these directed credit programmes is to promote a 'fair distribution' of bank credit, which is in line with the country's affirmative action policy that aims to achieve inter-ethnic parity, stimulate private sector investment, support faster economic growth and ensure that the 'priority sectors' have ready access to bank credit at reasonable cost (Chin and Jomo, 2000; Bank Negara Malaysia Annual Report, 1990:124).

Although government intervention and ownership also take place in countries such as France, Italy and Taiwan and do not appear to cause adverse effects on the banks, as soon as government-owned financial institutions are used to dispense political patronage or to implement social welfare programmes does such government involvement create uncompetitive and inefficient financial institutions, which effectively leads to insolvency (Fry, 1995). This is because a great deal of bank credit under this government-controlled banking environment is given on political rather than commercial basis, which in turn gives rise to an increase in the size of lower quality bank assets. This has further led



critics to question the economic justifications for the role of the State in an economy, arguing that direct government intervention in a country's economy can only add to the lack of effective competition and inefficiency and to corruption and crony capitalism (Qian, 2001). The monetary authorities in Malaysia, however, continue to argue that financial markets are by nature inherently unstable and government intervention is therefore needed to prevent market failure. As pointed out earlier in the article and consistent with this view, the financial liberalization measures introduced in the financial sector in Malaysia have tended to follow the gradualist pattern in which the government plays an increasing role.

The above interventionist policy measures in Malaysia suggest that, rather than decreasing, the government has continued to play an undiminished role even after financial liberalization. As observed by Fong (1989), the government sees the Malaysian banking industry as a strategic industry which needs to be protected from outside competition because it not only controls the flow of funds but also ultimately determines to a considerable extent the growth of the other sectors of the economy.

#### **4. METHODOLOGY, DESCRIPTION OF THE VARIABLES AND THE DATA SOURCES**

In this Section, the impact of financial liberalization on the bank spreads and profits will be investigated with special reference to the drivers behind the changes in these performance indicators over time. The investigation will focus on the determinants of bank spreads and profits and assess how these have changed since some of the major financial sector liberalization measures have been introduced in the Malaysian financial system.

According to the conventional practice in the literature, the following definitions of bank spreads and profitability will be adopted for this study:

- (1) Narrow definition of bank spreads
  - i.  $SPN0 = (\text{interest received on loans only} / \text{loans}) - (\text{interest paid on deposits only} / \text{deposits});$
  - ii.  $SPN1 = (\text{interest received} / \text{loans} - \text{interest paid} / \text{deposits});$

- (2) Wide definition of bank spreads
  - i.  $SPW0 = (\text{interest received} - \text{interest paid} / \text{total loans})$ ;
  - ii.  $SPW1 = (\text{interest received} / \text{all interest-bearing assets}) - (\text{interest paid} / \text{deposits} / \text{interest-earning liabilities})$ .
- (3) Profit1 = after tax profits/total assets
- (4) Profit2 = total revenue/total loans.

Given the restrictive nature of the entry conditions for the banking industry in Malaysia under the regulatory framework of the Banking and Financial Institutions Act (BAFIA), 1989, the critics of the financial liberalization programmes in Malaysia have argued that commercial banks face less competition and, therefore, are expected to earn larger spreads and profits. The article follows the two-stage regression approach first proposed by Ho and Saunders (1981). It focuses on the Malaysian experience with reforms to its finance sector in order to address the following research question: If Malaysia's banking industry faces less competition as critics seem to suggest, does it then mean that the existing restrictive regulatory frameworks under the country's Banking and Financial Institutions Act (BAFIA) of 1989 are a major contributor to large bank spreads and profits? To answer this question, a regression of bank spreads is run for a cross-section of banks on bank-specific variables including operating costs, provisions, market share of domestic banks and market share of foreign banks. The variable, Govi Index, will also be used to proxy the extent of government intervention in Malaysia's banking industry. As in Brock and Suarez (2000), the constant term in these regressions is a measure of the 'pure' bank spread for Malaysia's finance sector. This 'pure' spread is the portion of the bank spread that cannot be explained by bank-specific characteristics (Brock and Suarez, 2000). In the second stage of the regression, the constant terms are regressed against key macro-economic variables such as government debt, gross domestic product and the changes in the level of industrial activity. As noted by Brock and Suarez (2000), the constant term captures the effects of market structure on the determination of the 'pure' bank spread, i.e. the portion of bank spreads that is neither a bank-specific characteristic nor a macro-economic variable.

The panel data for the article were obtained from the annual balance sheets and income statements of 15 commercial banks incorporated in Malaysia during the period 1999-2004. Other data set sources were collected from the annual reports of Malaysia's central bank during the same period. In order to overcome the problem of errors being correlated over time for each bank in the sample and the likelihood of the OLS approach producing inconsistent parameter estimates, pooled OLS was used instead.

Following the literature-wide standard practice, the various definitions of interest rate spreads and profitability given above will serve as dependent variables. As highlighted in Brock and Rojas-Suarez, cited in Chirwa and Mlachila (2004:104), there are distinct differences between narrow and wide definitions of interest rate spreads because of the way in which fees and commissions are treated in relation to the loan and deposit transactions (Chirwa and Mlachila, 2004).

A number of empirical studies have investigated the determinants of bank spreads in the context of financial sector liberalization and there is a growing consensus that the key factors that influence these spreads are the operating cost, the degree of competition, the lending to the priority sectors, the quality of bank loans, etc. More recently, Brook and Rojas-Suarez (2000) carried out a study on the determinants of bank spreads in a sample of countries in Latin America. In that study, they used the two-stage multiple regression approach similar to the one used in Ho and Saunders (1981) and found that the persistence of high interest rate spreads in the studied countries was due to the high operating cost as well as to the high levels of non-performing loans in the banking industries of those countries.

The above-mentioned two-stage regression framework will be used to determine the impact of financial liberalization on bank spreads in Malaysia. As in Brook and Rojas-Suarez (2000), the first stage regression is run for a cross-section of banks on bank specific variables such as operating cost, bank provisions and market share of domestic and foreign banks. Brook and Rojas-Suarez (2000) define the constant term derived from such a regression framework as the "pure" spread for financial system, which is used as a proxy to measure the portion of the spread that bank-specific variables are unable to explain.

Although various liberalization measures have been implemented in the Malaysian financial system, the government continues to intervene extensively particularly in the banking industry, because of market failures, by directing credit to priority sectors of the economy, placing controls on interest rates on loans to the priority sectors and making periodic increases in the statutory reserve requirements. As a result, a variable that captures the effect of government intervention on bank spreads, the government intervention index (Govi Index), will be used.

The said index is constructed as the ratio of the sum of the directed credit to the total loans of the banking industry. It provides a quantitative measurement of the level of government interference in the financial system, including the banking industry. The value of the government intervention index ranges between 0 to 1, with 0 indicating a completely liberalized financial system where there is no form of government intervention, and 1 indicating a completely repressed financial system under which the government intervention is pervasive and its ownership of the country's banking industry is widespread.

The value of the Govi Index will therefore change according to the extent to which market failure is perceived by the monetary authorities in Malaysia to exist and which, therefore, necessitates the government to intervene for the correction of the apparent market failure. According to this view, during periods of market failure or during periods when wealth needs to be re-distributed as was the case in Malaysia at the time the country introduced the New Economic Policy, the value of the Govi Index will increase as the government increases its role in correcting market failure and re-distributing the wealth. An increase in the Govi Index is, therefore, one indication that the government involvement in the country's economy is extensive.

In order to determine the "pure" spreads that neither bank-specific variables nor economy-wide factors can account for the Malaysian case, the constant terms are in turn regressed, as in Ho and Saunders (1981) and Brook and Rojas-Suarez (2000), against macro-economic variables including government debt, gross domestic product and the changes in the industrial productivity index.

In all the above definitions, bank spreads and profitability have a functional relationship with both bank- and industry-specific variables, as well as economy-wide variables. As part of the bank-specific

variables, the provision for bad and doubtful debts, as a ratio of total loans (PROV), will be used as a measure of the quality of the asset portfolio of individual banks in the sample. Additionally, the ratio of non-interest expenses to total assets is used to provide a measure of the extent to which these operating costs (OPCOST) impact on the bank spreads. The OPCOST is defined to be the ratio of non-interest expenses to total assets. As in the existing literature, it is to be anticipated that a positive relationship will develop between these provisions for bad and doubtful debts on the one hand and the bank spreads on the other.

Despite the fact that a number of financial reform measures have been introduced in the financial system of Malaysia, entry for foreign banks remained restricted and the only form of limited entry into the country's banking industry has been granted to the domestic non-bank financial institutions, which include finance companies and merchant banks. This has prompted critics of Malaysia's approach to financial sector liberalization to argue that the country's banking industry continued to be highly concentrated and, therefore, increasingly less competitive.

The inclusion of the LM<sub>Domestic</sub> and LM<sub>Foreign</sub> variables will help capturing the degree to which competition in Malaysia's banking industry exists. A large and statistically significant co-efficient for the LM<sub>Foreign</sub> variable will confirm that competition does exist despite the pervasive government interventions in the banking industry. On the other hand, if the variable LM<sub>Domestic</sub> is found to be insignificant statistically, then the efficacy of the financial liberalization in being able to create a competitive banking industry in Malaysia is questioned given the limited extent to which domestic banks are able to compete with foreign banks. The economy-wide variables included in the analysis include the growth rates in Malaysia's gross domestic product (GDP) as well as the government's financial obligations (Debt) and the changes in the level of industrial activity (IPI).

#### **4.1. Relationship between bank spreads and profits with interest income and income expense**

Table 1 presents the correlation between the various categories of spreads and profits with interest income and interest expenses. The evidence shown in Table 1 indicates that interest income, rather than interest expenses, is strongly correlated with spreads and profits which suggests that continued government protection of the banking industry

in Malaysia helps banks to extract large spreads and profits since, in the absence of effective competition, banks are able to raise their lending rates and lower their deposit rates and, therefore, earn higher interest incomes and lower interest expenses.

**Table 1**  
**Correlation of bank spreads and profits**  
**with interest income and interest spread**

	<b>Interest income</b>	<b>Interest expenses</b>
<b>SPW1</b>	0.623	0.201
<b>SPW0</b>	0.847	0.422
<b>SPN1</b>	0.831	-0.259
<b>SPN0</b>	0.895	-0.305
<b>Profit1</b>	0.902	0.047
<b>Profit2</b>	0.791	0.022

Notes: SPW1 = (interest received /all interest-bearing assets) – (interest paid/deposits/interest-earning liabilities); SPW0 = (interest received – interest paid/total loans; SPN1 = (interest received/loans – interest paid/deposits; SPN0 = (interest received on loans only/loans) – (interest paid on deposits only/deposits; Profit1 = after tax profits/total assets; Profit2 = total revenue/total loans.

## 5. ANALYSIS OF THE EMPIRICAL RESULTS

A major objective of the series of financial liberalization measures outlined in the Appendix is to enhance competition in the banking industry in Malaysia. If this is achieved, it is anticipated that bank performance would increase whereas bank spreads would decline in the period following financial liberalization.

### 5.1. Impact of financial liberalization on bank performance

It can be seen from the Appendix that on May 2, 1989, the statutory reserve requirement of the banking institutions was re-aligned to a standard ratio of 4.5 percent. This was aimed at placing the commercial banks, finance companies and merchant banks in a position to compete more evenly. Tables 2, 3 and 4 present the test results of the behaviour

of key variables that are used in the analysis of the impact of the 1989 reform measure using the difference between two means approach.

Under this approach, data is divided into two sub-categories: (i) before financial liberalization (1978-1989) and (ii) after financial liberalization (1990-2001), followed by calculating the averages in these sub-samples before testing the difference between the two means. This serves two purposes: (i) to confirm the statistical significance of the observed changes in the behaviour of the selected variables; and (ii) to facilitate the comparison in the selected variables, both before and after the 1989 liberalization.

The results in Table 2 show that financial deepening, measured as a ratio of money supplied to gross domestic product, has increased significantly after the implementation of the financial liberalization measures in 1989. For example, the ratio of M1/GDP increased from 23.6 percent before key financial liberalization measures were implemented to 29.7 percent after the 1989 liberalization. It is also evident from Table 2 that all other measures of financial deepening have increased in the period following the liberalization. These results suggest that the reforms promoted the development of the financial system in Malaysia, which in turn had positive knock-on effects on the level of financial intermediation.

**Table 2**  
**Financial deepening (%)**

Variable	Before liberalization	After liberalization	t-value	Change
<i>Financial deepening</i>				
<b>M1/GDP</b>	23.6	29.7	2.121**	positive
<b>M2/GDP</b>	75.81	101.34	3.356*	positive
<b>M3/GDP</b>	90.23	101.53	2.134**	positive

Source: Computed.

(\*) significant at 1%; (\*\*) significant at 5%.

Table 3 presents the results of the changes in the different definitions of bank spreads and profits and it is clear that bank spreads have declined following the financial liberalization in 1989. This finding is consistent with the theoretical predictions. By increasing the level of competition, financial liberalization will, in general, lead to declining bank spreads. However, whether bank spreads actually fall depends to a large extent on a number of factors. As Chirwa and Mlachila (2004) noted, lending rates relative to deposit rates may increase or decline depending on the changes made to the statutory reserve requirements, the level of competition and, therefore, the cost structure in the banking system, the level of sophistication of the banking system as well as the macro-economic environment in which banks operate.

More importantly, there is evidence to suggest that government intervention continued even after financial liberalization. It is observed from Table 4 that the government intervention index increased from 32.14 percent before financial liberalization to 33.22 percent following the reforms. This is in sharp contrast to what the financial liberalization theory predicts. Under Malaysia's gradualist approach to financial liberalization, government involvement in the country's finance sector continues to help consolidate the gains from the reforms.

## **5.2. Empirical findings from the panel regression**

In their study, Brook and Rojas-Suarez (2000) adopted the two-stage regression approach first introduced by Ho and Saunders (1981) to compare the results for their sample of countries with each other as well as with the industrial countries. This article will also use this two-stage regression approach to explain the determinants of bank spreads in the Malaysian context. Unlike Brook and Rojas-Suarez (2000), however, this article introduces the government intervention index in order to gauge the effects of government involvement in the financial system in Malaysia. Such a novel approach will facilitate a comparison between the various micro and macro variables on the one hand and the various definitions of bank spreads and levels of profits on the other hand and to determine whether government remains a determinant of bank performance.

The emerging consensus on the causes and consequences of higher bank spreads in the banking industry of developing countries is that, in the aftermath of financial liberalization, bank spreads are expected to



**Table 3**  
**Changes in bank spreads and profitability (%)**

Variable	Before liberalization	After liberalization	t-value	Change
<b>Bank spreads</b>				
<b>SPN0</b>	16.55	14.10	1.99**	positive
<b>SPN1</b>	21.07	19.47	2.01**	positive
<b>SPW0</b>	35.96	20.43	2.33**	positive
<b>SPW1</b>	30.88	22.48	3.07*	positive
<b>PROFIT1</b>	28.91	29.11	1.99**	positive
<b>PROFIT2</b>	30.44	27.23	1.87**	positive

Source: Computed.

Notes: SPW1 = (interest received /all interest-bearing assets) – (interest paid/deposits/interest-earning liabilities); SPW0 = (interest received – interest paid/total loans; SPN1 = (interest received/loans – interest paid/deposits; SPN0 = (interest received on loans only/loans) – (interest paid on deposits only/deposits; Profit1 = after tax profits/total assets; Profit2 = total revenue/total loans.

(\*) significant at 1%; (\*\*) significant at 5%.

**Table 4**  
**Changes in the degree of government intervention (%)**

Variable	Before liberalization	After liberalization	t-value	Change
<b>Govi Index</b>	32.14	33.22	2.001*	positive

Source: Computed.

Notes:

Govi Index = Government Intervention Index

(\*) significant at 5%.

fall because of the lower lending rates and higher deposit rates, which is a consequence of the ensuing competition among banks. Lower bank spreads are thus an indication of increasing efficiency in financial

intermediation. On the other hand, high bank spreads are indicative of a lack of competition and pose a challenge to the development and the expansion of the financial intermediation because they discourage savings given the low returns on deposits (Barajaz *et al.*, 1999). The empirical results from the first and second stage regressions are presented in Table 5. Generally speaking, the results from the first-stage regression indicate that in some of the definitions of bank spreads and profits, the provisions for bad and doubtful debts can be seen to have positive effects on bank spreads and the level of profits in the banking industry in Malaysia. For example, a look at Table 5 indicates that, except for when bank spreads are defined in terms of SPN0 and profits in terms of PROFIT1, the coefficient for the loan quality (PROV) can be seen to be positive and statistically significant, which suggests that banks are capable of transferring the adverse effects of poor loan quality to their customers. This finding is also consistent with the earlier findings of Chirwa and Mlachila (2004) and Barajas *et al.* (1999) whose respective studies showed a positive and statistically significant relationship between bank loan quality and bank spreads. The liquidity ratio of banks can also explain bank spreads and profits. In almost all definitions of bank spreads and profits, it is observable that relatively larger amounts of bank liquidity are able to account for how well the banks in Malaysia have performed in terms of their spreads and profits. Given that central bank liquidity ratios are forms of taxation on banks, these banks respond to increases in central bank liquidity ratios by increasing the margins between the lending and the deposit rates (Chirwa and Mlachila, 2004). In addition, the operating costs are seen to be positively correlated with bank spreads, which is consistent with the predictions of the article. This indicates that the high operating costs are among the key factors that explain large bank spreads. More importantly, the empirical results from the first-stage regression also indicate that the level of government interventions (Govi Index) is negatively correlated with almost all of the definitions for bank spreads and profits. As indicated in Section 3, directed credit policies in Malaysia tend to go to the 'priority sectors' of the economy. Furthermore, interest rates for these loans are repressed and set at below market-clearing levels. This means that banks are unable to charge higher lending rates to these 'priority sectors', which also suggests that banks will receive lower spreads and hence increase efficiency. This result further shows that governments have a corrective role to play during the process of financial liberalization and that this role can

enhance the efficiency level of banks. This view is given theoretical support by the market-enhancing view which argues that financial markets have inherent and built-in instability characteristics and that, in the absence of interventionist government policies, these markets are prone to crises (Singh, 1994). The proponents of government intervention further note that it provides a conducive and enabling legal framework for banks and other financial institutions to operate by reducing transaction costs and, hence, the need to charge higher lending rates. A major conclusion that can be made, therefore, is that contrary to the theoretical predictions of neo-classical economics, government involvement in a country's finance sector can go hand in hand with the implementation of financial liberalization programmes.

The coefficient for the market share of foreign banks is negatively associated with bank spreads and these are statistically significant. This suggests that despite the existing restrictive framework in Malaysia's banking industry, foreign banks have been able to make their competitive presence felt by their domestic counterparts. These results further show that the internal liberalization that allowed domestic finance companies and merchant banks to compete with the conventional banks has increased competition in the banking industry in Malaysia.

As can be seen from the results of the second-stage regression, the macro-economic variables adequately explained the conditions of the 'pure spreads'. From Table 5, it can be seen that both GDP growth rates and the changes in the industrial production index (IPI) are positively correlated with the 'pure spreads'. This suggests that increases in these macro variables can lead to increases in bank spreads in Malaysia. This finding is contrary to the result in Brock and Suarez (2000) who found that higher growth rates in GDP resulted in lower bank spreads and attributed this to the fact that higher economic growth generally raises the value of firms and reduces the cost of lending by lowering default risks.

**Table 5****Panel data regression estimates of determinants of bank spreads**

(Dependent variables: spread SPN0, SPN1, SPW0, SPW1, PROFIT1, and PROFIT 2)

*(1) First-stage regressions*

	SPN0	SPN1	SPW0	SPW1	PROFIT1	PROFIT2
<b>Govi Index</b>	-0.032	-0.064	-0.206	-0.153	-0.008	0.193
	(1.013)	(2.198**)	(2.308**)	(3.003*)	(4.103*)	(3.209*)
<b>OPCOST</b>	2.279	0.098	0.068	0.120	0.321	0.762
	(1.17)	(2.012**)	(1.701**)	(1.254)	(2.706**)	(3.006*)
<b>PROV</b>	-1.99	2.765	1.953	0.625	-0.05	1.87
	(1.097)	(1.047)	(2.682**)	(3.065*)	(1.131)	(2.549**)
<b>LMDomestic</b>	0.042	-0.074	0.285	0.202	0.024	0.649
	(2.153**)	(2.128**)	(1.895**)	(1.212)	(1.978**)	(2.273**)
<b>LMForeign</b>	-0.089	-0.131	-0.227	-0.656	-0.022	-0.023
	(1.527**)	(1.733**)	(1.967**)	(2.231**)	(3.086*)	(1.854**)
<b>Lratio</b>	0.023	0.063	0.043	0.032	0.006	0.026
	(1.009)	(2.109**)	(2.03**)	(1.105)	(2.544**)	(1.997**)
	F = 2.995		F = 4.932	F = 9.217	F = 0.876	F = 4.047
	Prob>	Prob>	Prob>	Prob>	Prob>	Prob>
	F=0.007	F=0.000	F=0.012	F=0.000	F=0.010	F=0.002

*(2) Second-stage regressions on time effects*

<b>Debt</b>	-0.004
	(2.309**)
<b>GDP growth</b>	0.024
	(3.407*)
<b>IPI Changes</b>	0.008
	(2.186*)
<b>Constant</b>	0.158
	(0.01)
	F=159.68
	Prob>
	F=0.058
<b>Adjusted R-sq.</b>	0.65

Notes: The Govi Index is the government intervention index = the ratio of loans to the priority sectors to the total loans of the banking industry; OPCOST = the ratio of non interest expenses to total assets; provision for bad and doubtful debts as a ratio of total loans; LMDomestic = domestic bank share of loan market; LMForeign = foreign bank share of loan market; and Lratio = liquidity ratio and defined as the ratio of total cash and readily marketable investments by total assets. Debt = government domestic borrowing from the banking industry (in millions of Malaysian ringgits; GDP = gross domestic product (in millions of Malaysian ringgits; IPI = industrial productivity index, which is measured by the changes in production between two different periods of time.

The numbers in parenthesis are t-statistics. (\*) significant at 1%; (\*\*) significant at 5%.

## 6. CONCLUSIONS AND POLICY IMPLICATIONS

The article used the traditional two-stage regression approach in order to explain the determinants of bank spreads in Malaysia. The results of the first-stage regression indicate that, in some of the definitions of bank spreads and profits, the provisions for bad and doubtful debts, operating costs, the market shares of the two lead banks can all be seen to have positive effects on bank spreads and the level of profits in the banking industry in Malaysia. Economy-wide variables including the national debt, national income and the level of industrial activity have also been seen to explain the fall in bank spreads. Additionally, the national debt, which provides a measure of the level of government borrowing from the country's banking industry, has a negative effect on bank spreads. The descriptive statistics show that bank spreads decreased significantly following the financial liberalization and this decline is attributable mainly to the financial liberalization.

This suggests that, despite the level of government intervention, financial liberalization continues to have efficiency-enhancing effects. As shown throughout the article, government intervention continues to be pervasive even after financial liberalization. A key part of this government intervention is the directed credit policy under which the volume and direction of bank credit as well as the interest rates applicable to these loans are decreed by the government. In most cases, the loan rates for these 'priority sector' loans are subsidized and often at levels below market-determined rates.

The general lesson that can be drawn from the Malaysia experience with financial liberalization is that, contrary to popular theory, government intervention in the form of directed credit policies should be an essential part of policy-making particularly in the context of developing economies that are characterized by weak institutions and where markets, as conventionally defined, are either absent or non-functioning. These, thus, necessitate government intervention to correct their failure. It was shown in the article that both the level of government intervention and the degree of financial deepening, which is a proxy for financial liberalization, all increased. This finding suggests that the processes of financial liberalization and government intervention need not be mutually exclusive and can take place simultaneously. These results will

be useful for other developing countries that wish to implement successful financial liberalization programs.

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## APPENDIX

### **Financial liberalization measures introduced in Malaysia: 1978 to 2004**

**23 October 1978:** New interest rate regime. Banks are now allowed to determine the interest rates, which, they will offer for deposits, and the lending rate, which, they will charge their prime customers. However, the maximum interest rates which banks can charge to special groups and the priority sector will continue to be regulated by Bank Negara Malaysia.

**1984-1986:** Dispersion in the ownership of equity in financial institutions. This liberalization measure was intended to provide for a wider distribution of shareholders so that no one party would dominate the ownership of a single financial institution. The maximum holding of an individual, including family holding companies in the equity of a financial institution is 10%, while any company or cooperative may not hold more than 20%.

Powers to Bank Negara Malaysia to lend against shares of, and purchase equity in, ailing financial institutions. This would enable Bank Negara Malaysia, in the event of (or threat of) insolvency or illiquidity of a bank or finance company, to lend to the financial institution in difficulty, if necessary against the pledge of that financial institution's shares, or to inject additional equity into the problem institution in order to rehabilitate it thereafter, to sell its shares to the public.

(The above measures enabled the Government to own large blocks of shares in commercial banks in Malaysia).

**1985:** Section 20 of the Finance Companies Act was amended to allow finance companies to participate in the inter-bank money market.

**October 1985:** The Association of Banks and Finance Companies agreed to align their deposit rates (for deposits of up to 12 months maturity only) to the rates of the two lead banks, Malayan Bank and Bank Bumiputera, in order to prevent competitive bidding from raising unduly the level of deposit rates. The maximum differentials set between



the deposit rate of the lead banks and the other banks was 0.5% and the finance companies, 1.5%.

**January 1 1987:** Permission was no longer required for external borrowing by residents in foreign currency of up to the equivalent of US\$5 million (US\$ 100,000 previously) , while non-resident controlled companies operating in Malaysia were allowed to borrow freely, without prior permission for loan amounts not exceeding US\$ 10 million each (US\$ 500,000 previously) for non self-liquidating short-term facilities. Liberalization measures were also introduced to reduce the documentation (paper work) for exports.

**February 1 1987:** To provide a more active secondary market for negotiable certificates of deposits (NCDs), six merchant banks with a minimum capital of RM 30 million each were allowed to issue NCDs.

**February 1 1987:** Pegged interest rate arrangement dismantled following the emergence of ample liquidity in the market. This liberalization of interest rates would provide the competing institutions with greater flexibility in determining their own deposit rates with the ultimate aim of improving efficiency in the mobilization of funds in the Malaysian economy.

**October 1 1987:** Finance companies with shareholders' funds (unimpaired by losses) of less than RM50 million each at all times, and which did not have serious inspection findings, were allowed to participate in the domestic inter-bank money market with the aim of adding depth to the inter-bank market and to help improve the management of liquidity by the finance companies.

**May 2 1989:** The statutory reserve requirement of the banking institutions was re-aligned to a standard ratio of 4.5 percent. This was aimed at place the commercial banks, finance companies and merchant banks in a position to compete more evenly with each other.

**September 1989:** All banking institutions (including finance companies) were required to observe a uniform capital adequacy framework, which according to the Bank for International Settlements, calls for a minimum risk-weighted capital ratio of 8 percent.

**March 1 1990:** Finance companies to issue negotiable certificates of deposits. To level the playing field and to enhance competition, finance companies with shareholders' funds of not less than RM 30 million each were allowed to issue negotiable certificates of deposits.

**March 1990:** The wholesale funding avenues for all eligible finance companies were liberalized with the limit that used to be imposed on the amount of inter bank borrowings by eligible finance companies raised to RM 100 million or up to the full extent of the finance companies shareholders funds, whichever was lower.

**October 1990:** Rules on Investment in shares for commercial banks and merchant banks. Commercial banks and merchant banks were allowed to invest in the shares of Syarikat Telekom Malaysia (STM) and Edaran Otomobil Nasional (EON) subject to the following conditions:

- Investment in STM and EON shares should not exceed 10% of the paid-up capital of the respective corporation or 10% of the bank's paid-up capital and published reserves (or net working funds in the case of a foreign bank), whichever was lower;
- Total investment in trustee shares and shares of STM and EON should not exceed 25% of the bank's paid-up capital published reserves (or net working funds in the case of a foreign bank);
- The investment was permitted subject to the condition that STM and EON would pay dividend in future. In case these corporations were not able to pay any dividends, the banks would be required to divest their investments in these corporations.
- A bank's investments in shares including those in STM and EON, and fixed assets should not exceed 50% of its capital base (net of investments in subsidiaries and in other financial institutions).

**February 1991:** Freeing of the Base Lending Rate (BLR) from the administrative control of the Bank Negara Malaysia. Each commercial bank and finance company was free to declare its own BLR on the basis of its cost of funds, including the cost of holding statutory reserves, meeting the liquid assets requirements and managing administrative and

overhead costs but excluding the cost of provisions for bad and doubtful debts. Key features of the newly freed BLR include:

- No banking institution shall lend at a rate below its declared BLR, except for loans where interest rates are prescribed by Bank Negara or by law, or when lending is negotiated on a cost-plus basis;
- The maximum spread of 0.5 percentage points between the BLR of the two lead banks and the other commercial banks and the same spread between finance companies (with direct access to the inter-bank money market) and other finance companies were removed.
- The maximum spread between the actual lending rate and the declared BLR was maintained at 4 percentage points.
- Bank Negara Malaysia would continue to fix the ceiling rates for loans to the priority sectors as follows:
  - (a) Individual loans for houses valued at RM 100, 000 or less each: the ceiling was set at 9% or 1.75 percentage points above the declared BLR of each commercial bank or finance company, whichever was lower;
  - (b) Loans under the Principal Guarantee Scheme of the Credit Guarantee Corporation: 1.5 percentage points above the BLR of each commercial bank.

**October 1991:** Finance companies and merchant banks allowed by Bank Negara Malaysia to accept deposits.

**October 1991:** Inter-bank Money Market Activity. No limit was imposed on the finance companies participating in the inter-bank money market. Similarly, no inter-bank money lending limit was imposed on discount houses. However, the finance companies were required to ensure, as in the case of the commercial banks, that their net inter-bank borrowings did not exceed 20% of their respective sources of funds. The restriction of net inter-bank borrowings to 20% of sources of funds was subsequently removed with effective from 28 October 1991.

**1991:** Finance companies authorized to provide money-changing facilities and financial and performance guarantees.

**February 1992:** Investment in shares. Commercial banks, finance companies and merchant banks were allowed to invest in the shares/interest in shares of Tenaga Nasional and Perusahaan Otomobil Nasional (PROTON). Such investments were subject to the following limits:

- a) Investments in such shares/interest in shares should not exceed 10% of the paid-up capital of the respective corporation or 10% of the respective banking institution's paid-up capital and published reserves (or net working funds in the case of foreign banks), whichever was lower;
- b) The aggregate value at cost of all investments in trustees/interests in shares of Malaysian Airline System/Malaysian International Shipping Corporation/Tenaga Nasional/PROTON should not exceed 25% of the banking institution's paid-up capital and published Reserves (or net working funds in the case of foreign banks).

**1993:** The Principal Guarantee Scheme under the Credit Guarantee Corporation, which previously was only available to the commercial banks, was extended to all the finance companies. Under the Principal Guarantee Scheme, loans to the small-scale enterprises from the commercial banks and finance companies were to be guaranteed so that these enterprises could have access to credit even without collateral. This effectively increased the number of participants in the Scheme and implicitly the number of competitors.

**March 1994:** The liberalization of the Exchange Control System, which saw the transformation of the pegging of the Malaysian ringgit to a basket of currencies to floating and market-based exchange rate regime. The aim of this liberalization measure was to provide investors greater access to credit facilities in order to expand productive capacity in the country and to simplify export procedures.

**1994:** Approval granted by Bank Negara Malaysia for commercial banks in Malaysia to invest in corporate bonds.

**April 1996:** The two-tier regulatory system previously only accorded to the commercial banks was accorded to the finance companies under which they were allowed to participate in a broader range of activities such as the provision of factoring services and remittance services inside Malaysia including bankers cheques, demand drafts, payments and telegraphic transfers. Tier-1 finance companies were also allowed to offer unsecured business loans, participate in venture capital financing and issuance of negotiable instruments of deposits.

**December 2000:** The maximum total credit facilities that could be obtained by non-resident controlled companies (NRCCs) from foreign-owned banking institutions in Malaysia was increased from 40% to 50%.

- Licensed Offshore Banks in the Labuan International Offshore Financial Centre (Labuan Offshore Banks) would be allowed to invest in ringgit assets/instruments in Malaysia for their own accounts, though not on behalf of their clients.
- Licensed commercial banks, including the foreign-owned banks, and Bank Islam Malaysia Berhad in Malaysia (licensed banks) were allowed to extend in aggregate an intra-day overdraft facility of not exceeding RM200 million and an overnight facility of not exceeding RM10 million to non-resident stockbroking companies and non-resident global custodian banks to finance funding gaps due to inadvertent delay in relation to settlement for trade on the Kuala Lumpur Stock Exchange (KLSE). In addition, they can also enter into short-term currency swap and/or outright forward contracts to cover for purchase of shares on the KLSE.

**1 January 2001:** Foreign-owned banking institutions were allowed to set up communicative websites.

- Banking institutions (including the foreign-owned banks) in Malaysia were allowed to extend credit facilities in ringgit to finance the purchase and/or construction of one immovable property for non-residents who participate in the Silver Hair Programme implemented by the Immigration Department of Malaysia.

- Financial institutions (including the foreign-owned banks) were allowed to extend up to three credit facilities in ringgit to non-residents to finance the purchase or construction of any property in Malaysia (excluding for the purchase of land), subject to their own internal credit assessment guidelines.
- Banking institutions (including the foreign-owned banks) in Malaysia were allowed to effect transfers involving External Accounts and another External Account and/or Resident Account of different account holders by way of:
  - (a) Automated Teller Machine transfer up to RM 5,000 per person/company, per day, per bank for any purpose;
  - (b) Internet-bank transfers up to RM 5,000 per person/company, per day, per bank for any purpose; and/or
  - (c) Cheques up to RM 5,000 per cheque for any purpose.

**1 January 2002:** Foreign-owned banking institutions were allowed to offer transactional internet banking from

- Internal credit lines used solely to facilitate drawing against uncleared cheques, granted by licensed banks (including the foreign-owned banks) to NRCCs, were excluded from the computation of the NRCC's total domestic credit facilities. Licensed banks were also permitted to allow NRCCs to overdraw their current accounts for amounts of up to RM500,000 per account for a period not exceeding 2 working days.
- Banking institutions (including the foreign-owned banks) in Malaysia were allowed to extend additional ringgit credit facilities to any non-resident up to an aggregate of RM5 million per non-resident to finance projects undertaken in Malaysia. Prior to this, credit facilities in ringgit to a non-resident, for purposes other than purchases of three immovable properties or a vehicle, were limited to RM 200,000.

**1 April 2003:** Licensed banks (including the foreign-owned banks) in Malaysia were allowed to extend overdraft facilities in ringgit not exceeding RM500,000 in aggregate to a non-resident customer, provided such overdraft facilities are covered by fixed deposits placed

by the non-resident customer with the licensed banks in Malaysia. These overdraft facilities were in addition to all ringgit credit facilities allowed to be extended freely by banking institutions since 21 November 2002.

- The 50% limit on the maximum total credit facilities that could be obtained by NRCCs from foreign-owned banking institutions in Malaysia was removed.
- The overnight limit for foreign currency account (FCA) to retain receipts arising from export of goods (export receipts) for Approved Operational Headquarters (OHQ) was increased to US\$70 million from US\$10 million. The maximum overnight limit on export FCA of other resident exporters was also raised to US\$70 million.
- Residents may invest in investment products that are linked to foreign currency denominated derivatives that are offered by licensed banks (including the foreign-owned banks) in Malaysia. The foreign currency funds used for the investment that are utilised from the residents' FCA will be earmarked and computed as part of the aggregate overnight balances of the FCA of the residents.
- Allow up to three new Islamic banking licences to qualified foreign players.

**2004:** To enhance cash flow management for supporting value chain expansion in Malaysia, licensed banks (including foreign-owned banks) can retain higher amount of foreign currency funds for residents in FCA:

- Up to a maximum of US\$100 million (previously US\$70 million) of export receipts.
- Any amount of non-export receipts for residents with domestic borrowing (previously need approval).
- Up to US\$150,000 for education/employment purpose (previously US\$100,000).
- Labuan Offshore Banks are allowed to maintain FCA for residents:

- Up to US\$0.5 million of non-export receipts for residents without domestic borrowing (previously need approval).
- Up to US\$150,000 for education/employment purpose (previously US\$100,000).
- Any amount overseas foreign currency funds for resident individuals.

To enhance access to ringgit funds for business requirements in Malaysia, the various limits for banking institutions lending to non-residents in ringgit have been consolidated to one single aggregate limit of RM10 million for use in Malaysia for any purpose (excluding stockbroking company, custodian bank and correspondent bank).

The extension of property loans in ringgit by residents, including licensed banks, to non-residents now includes the purchase of land (previously not allowed).

Licensed banks are allowed to extend an aggregate overnight overdraft facility of RM200 million (increased from RM10 million) to a non-resident stockbroking company or a non-resident custodian bank to facilitate settlement for purchase of shares listed on the KLSE.

Resident individuals employed or staying abroad with foreign currency funds sourced from abroad are allowed to invest in any foreign currency assets, including those offered by licensed banks, approved licensed merchant banks and Labuan Offshore Banks.

Multilateral Development Bank and foreign multinational corporation issuers of ringgit denominated bonds in Malaysia may enter into forward foreign exchange contracts with onshore licensed banks to hedge their currency risks arising from the issuance of the ringgit denominated bonds. Non-resident investors subscribing to these issues can also hedge their foreign exchange risks.

Source: Bank Negara Malaysia Annual and Monthly Reports, various reports and dates; Bank Negara Malaysia – The Central Bank and the Financial System in Malaysia, 1989 to 1999; and Ariff and Khalid, 2000: 94-95.