TABLE OF CONTENT

References included on page 16.

1.0 INTRODUCTION

1.1 Financial Market

In varying degrees, all businesses operate within the financial system, which consists of a number of institutions and market serving business firms, individuals, and government. When a firm invests temporarily idle funds in marketable securities, it has direct contact with financial markets. Most firms use financial market to help finance their investment in assets. In the final analysis, the market price of a company's security is the test of whether the company is a success or a failure. While business firms compete with each other in the product markets, they must continually interact with the financial markets.

Financial assets exist in an economy because the savings of various individuals, corporation and governments during a period of time differ from their investment in real assets. By real assets, we mean such things as houses, buildings, equipments inventories and durable over all period of time, there would be no external financing, financial assets, money or capital assets . Each economic unit would be self sufficient. Current expenditures and investment in real assets would be paid for out of current income. In fact, a financial asset is created only when the investment in real assets exceeds its savings and it finances this exceeds by borrowing or issuing stock. Of course, another economic unit must be willing to lend. This interaction of borrowers with lenders determines interest rates.

In the economy as a whole, saving surplus units provide funds to saving deficit. This exchange of funds is evidenced by investment instruments, or securities, representing financial assets to the holders and financial liabilities to the issuers.

The purpose of financial markets in an economy is to allocate savings efficiently to ultimate users. If those economic units that saved were the same as those engaged in capital formation, an economy could prosper without financial markets. In modern economies, however, most no financial corporation use more than their total savings for investing in real assets. Most household, on the other hand, have total savings in excess of total investments.

Financing is important in an economy because some sectors of the economy save more than the other sector. Therefore, a mechanism is needed to facilitate the transfer of savings from those economic units that have a saving financial surplus in which those that have saving deficit, which is the financial market.

1.2 Financial market subtypes

First type is known as capital market which consist of stock market and bond market. This market place is used widely to market securities. Regardless of government or company, the firm can raise long term fund from the issued securities. Stock market is much popular and reaches most people faster than bond market. Stock market can be also defined as equity market. Here is where they trade the company stocks at an agreed. These prices will be listed on the stock exchange such as NASDAQ (National Association of Securities Dealers Automated Quotations), NYSE (New York Stock

Exchange), and KLSE (Kuala Lumpur Stock Exchange). New issued stocks only sold in primary market while they can be traded actively in secondary market. As a member of this same capital market, bond market is also known as debt, credit or fixed income market. Government will often use this market to raise fund but not limited to them. Companies will also sell these debt securities but often concerned about the lack of credit risk, liquidity and sensitivity to interest rate.

Secondly, commodities market where the raw products are traded or exchanged. It covers physical products as such food, metal, and electricity. These sales will be often standardized and contracted. The best example would be the government themselves who trade raw materials such as unprocessed oils and metals. The amount will be large and trading are often secured or guaranteed in term of value and price because they normal has long term contract which ensures stable trading.

Third is the money market where it is purely on money. The easiest method of getting money is through borrowing. In money market, it's all about borrowing or lending money from in short-term in the form of treasury bills, commercial paper and bankers' acceptances. This is solid global financial market as it involved bankers and easy to trade around the world. Although in some case, the number of bank branches and popularity will be a limitation to mention it as 'global'.

Other subtypes are derivatives markets, futures markets, over-the-counter markets, insurance markets and foreign exchange markets.

1.3 Malaysia as study subject

In Malaysia in the recent decades the financial market structure has undergone a dramatic shift away from a bank-based system towards a capital market-oriented one. These trends were well underway prior to the Asian financial crisis of the late 1990s but they were consolidated and accelerated by that event and its aftermath. Capital markets have played such a dominant role in transferring funds and mobilizing industrial financing in the two economies that their overall financial structures have now become more market-oriented than those in the UK and the US.

Financing or financial issues are always being talked about; we can hear about it anywhere through the Electronic Media, from the television or radio, newspapers, till the internet and even the colleges or schools are not left out. The Government of all nations, including Malaysia, takes it with real concern and devises plans after plans and spends big money to ensure the country is at the right track and pace. Often, the private sectors are encouraged by the government and they spend billions in investments likewise, the public are also summoned to be adequate and equip with financial knowledge. Now the question which arises here is that, whether these actions are wise and necessary for Malaysia's economy? If so why?

2.0 FINANCING OF BUSINESS IS IMPORTANT TO AN ECONOMY

Financial market is extremely important to the economy of a country and its absence can bring forth the county's economy to run stagnant or very slow-moving. Financial market offers our country with many benefits. Financial markets provide our country specialized, inter-dependent economy with many financial services, including time preference, distribution and diversification of risk, transactions economy, transmutation of contractual arrangements, and financial management.

Financial market consists of agents, brokers, institutions, and intermediaries transacting purchases and sales of securities. The persons and institutions operating in the financial markets are linked by contracts, communications networks which form an externally visible financial structure, and laws. The financial market is divided between two elements; they are investors and financial institutions.

2.1 Time preference

Time preference refers to the value of money spent now relative to money available for spending in the future. Hence the financial principle number 2, which is the "The Time Value of Money". Businesses are frequently making decisions among short-term and long-term uses of funds, and business executives must be able to calculate the risks and determine between the amount which provide a return in the near term and those which pay off many years from now. They must decide upon commitments requiring funds now and those requiring funds later, by allocating not only funds that they expect to receive currently, but also those that they expect to receive in the future. Besides that they will also have to diversify the investments that they are going to invest in based on the risk-return trade off which is the 1st principle, and balancing the weight of the investment on risky ones with higher return and the low risky ones which only provides lower-safe return.

Malaysian government ensures that the money and capital markets price funds so that businesses and government can make rational economic allocations of capital. The price of capital is set in a competitive marketplace and it is through the supply and demand forces and the market price of capital is always compared by businesses to the expected returns in future money expenditures. Businesses allocate their resources to real investments whose return is at above the cost of capital. Long-term investments are judge against to short-term investments using the financial-market-determined cost of capital. Consequently, the allocation of capital between short-and long-term investments depends on the free play of supply and demand in an open market.

Financial markets allow us to implement time adjustments in the payments for goods. Without them, there would be no opportunity to earn interest on savings, and expenditures would be limited to current receipts and cash. Savings allows many consumers to postpone consumption and to receive returns from investments.

2.2 Risk Distribution

The financial markets distribute economic risks. Employment and investment risks are separated by the creation and distribution of financial securities. On a larger scale, the money and capital markets transfer the massive risks from people actually performing the work (employment risks) to savers who accept the risk of an uncertain return. For instance, the chance of failure for a RM100 million worth mobile phones manufacturer may be divided among thousands of investors living and working all over the world. If the mobile phones business fails, each investor loses only part of his or her wealth and may continue to receive income from other investments and employment.

2.3 Diversification of risk

Diversification means combining or dividing the securities with different attributes into a portfolio. The financial markets allow individuals to diversify among their investments. Normally, a diversified portfolio of financial claims is less risky than a portfolio consisting of one or at most a handful of similar securities. For example if an organization plans to invest in a few projects, they will diversify the investment plans by investing in not only risky and heavy project but also in some other low risky projects. The balancing of the investments is vital and the investment plans are carried out rationally only after the risks are calculated

Total risk is reduced because losses in some investments are offset by gains in others. Hence the principle number 1 whereby the investors will not take additional risk unless the return is more and principle number 9, because not all risks can be diversified away and some cannot be. The benefits of diversification are possible due to the existence of large, diversified financial markets where investors may buy and sell securities with minimum transactions cost, regulatory interference, and so forth.

2.4 Functions of financial Mediators

Financial markets assist the movement of funds from those who save money to those who invest money in capital assets. Savings are circulated among investments and expenditures through securities traded in the financial markets. This is to ensure that the economy has a good flow of the Fiscal Policy. Financial Mediators share a common characteristics their own financial claims, called indirect securities, to economic units with access savings. The proceeds from selling their indirect securities are then used to purchase the financial claims of other economics units. These latter claims can be called indirect securities. Financial institutions such as banks and insurance company facilitate and improve the distribution of funds, money, and capital in several aspects, such as payment mechanism, Security trading, Transmutation, Risk diversification and Portfolio management.

Financial institutions also act as portfolio managers and advisers over most of the primary securities owned by investors. The private financial sector manages most of the home mortgages, consumer loans, and business loans. In addition, almost half or less of outstanding common stocks are managed by investment companies, and a large portion of the remaining shares of stock are invested with the advice of trust institutions.

A developed financial market system provides for a greater level of wealth in the economy. In the absence of financial markets, savings are not transferred to the economics units most in need of those funds.

3.0 ABSENCE OF FINANCIAL MARKET IN AN ECONOMY

With the absence of financial market in the economy, the wealth of the economy would be lessened. Without financial market, saving could not be transferred to economic units that operate in the private, as opposed to governmental and the economy would remain stagnant. It would be a disaster to the economy perhaps. The economy of the country with less developed or no financial market would definitely grow slow.

During the 1997 till 2001 time period, Malaysia's economy has remained fairly open to trade and foreign investment. . Imports and exports of goods and services were the same to 106% and 117% of GDP on average during the period 1997-2000. Statistics shows that during the period of recession under review (1997-2001), Malaysia's economy has remained relatively open to trade and foreign investment. This is especially real of the goods sector; by contrast, the services sector is more closed, although judging from the then launched Eighth Malaysia Plan, the Government does envision opening up the sector gradually.

Based on the case study ('Malaysia 1997 Crisis'), both capital and total factor productivity growth had dropped markedly (from an annual average rate of 2.4% in 1990-1995 to 0.9% in 1995-2000), reflecting over-investment. The outcome was that after having grown on average by more than 8% annually since the recession of 1985, real GDP fell by 7.4% in 1998 owing to a large drop in private domestic demand caused by a sharp decline in investment. Also to a lesser extent in which lower consumption. As a result, the unemployment rate rose to 3.3% in 1998, up from 2.5% in the previous year.

Inflation doubled, from 2.6% in 1997 to 5.3% in 1998, partly due to higher import prices resulting from the depreciation of the ringgit, which fell from about RM 2.8/US$ in the third quarter of 1997 to RM 3.8/US$ a year later.

Based on the Malaysia’s economy, Malaysia went through a process of financial liberalization with much greater freedom for foreign funds to invest in the stock market, for conversion between foreign and local currencies, and for exit of funds to abroad. The Central Bank however retained a key control that private companies wanting to borrow foreign-currency loans exceeding RM5 million must obtain the Bank's approval. This is generally given only for investments that would generate sufficient foreign exchange receipts to service the debts. Companies are also not allowed to raise external borrowing to finance the purchase of properties in the country.

Thus there was a policy of "limiting private sector external loans to corporations and individuals with foreign exchange earnings" which according to Bank Negara "has enabled Malaysia to meet its external obligations from export earnings." According to a private sector leader, this ruling saved Malaysia from the kind of excessive short term private sector borrowing that led the other countries into a debt crisis.As a result of these controls, Malaysia's external debt has been kept to manageable levels.

The large inflows of foreign funds, either as loans to the banking system companies directly, or as equity investment in the stock markets, contributed to an asset price boom in The International Monetary Fund was called in but it made the crisis worse. In exchange for 'rescue packages', comprising huge loans, it insisted that the countries keep their financial system open and indeed further liberalize and thus allow even more freedom for the inflow and outflow of funds.

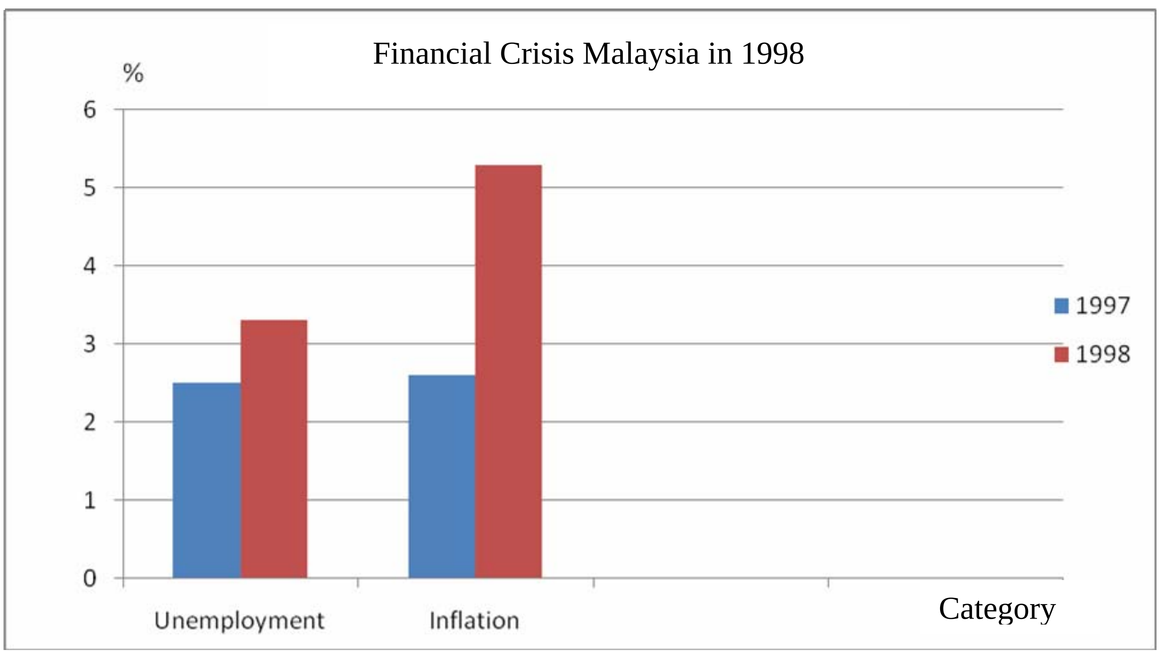
That meant that the exchange rate would continue to be subjected to speculation and further depreciation, since the countries were in a condition of financial panic, with the herd instinct prevailing and every creditor or investor wanted to take their money out. In order to counter this stampede for the exit door, the countries were asked by the IMF (International Monetary Funds) to instill foreign investor confidence by jacking up interest rates, imposing a credit squeeze, closing some ailing banks, and cutting government spending. But these measures induced a much sharper recession than would otherwise have taken place. The deterioration of the real economy eroded confidence further and led to more depreciation.

With the depreciation of currencies and expectations of a debt crisis, economic slowdown or further depreciation, substantial foreign funds left suddenly as withdrawal of loans and selling off of shares. Share prices fell. Thus the falls in currency and share values fed each other. With weakened demand and increasing over-supply of buildings and housing, the prices of real estate also fell significantly.

For the countries afflicted with a less developed financial markets, the problems involved:

- Heavier debt servicing burden on local banks, companies and governments that had taken loans in foreign currencies.

- The fall in the value of shares seems as collateral for loans by companies and individuals, and the fall in the values of land, buildings and other real estate property. This has led to financial difficulties for the borrowers.
- The higher interest rates caused by liquidity squeeze and tight monetary policies have caused added financial burdens on all firms as well as on consumers that borrowed.
- As companies and individuals face difficulties in servicing their loans, this has increased the extent of non-performing loans and weakened the financial position of banks.
- Higher inflation caused by rising import prices resulting from currency depreciation.



In Malaysia, which has fortunately not had to seek an IMF loan package, interest rates were lower than the three IMF client countries. Nevertheless they also went up during the first year of the Asian crisis. The interest rate hike and the reluctance of many banks to provide new loans caused serious difficulties for many firms and consumers. However, after the imposition of capital controls in September 1998, interest rates have gone down significantly. This has eased the financial position of debtors and banks.

The capital controls were thus able to lay the condition for enabling interest rates to go down without this affecting the exchange rate. Without making use of capital controls, countries subjected to currency speculation face a serious dilemma. They have been told by the IMF that lowering the interest rate might cause the "market" to lose confidence and savers to lose incentive, and thus the country risks capital flight and currency depreciation.

However, to maintain high interest rates or increase them further will cause companies to go bankrupt, increase the non-performing loans of banks, weaken the banking system, and dampen consumer demand. These, together with the reduction in government spending, will plunge the economy into deeper and deeper recession. And that in turn will anyway cause erosion of confidence in the currency and thus increase the risk of capital flight and depreciation.

Because of improper financial market in most countries, money is allowed to flow in and out the countries. Perhaps when they adhere to the principle of allowing almost total freedom of capital mobility to the market, these countries expose themselves to extreme volatility of funds entering and exiting, and thus to high economic instability.

Without a proper financial market in an economy, domestic and foreign investors could be contributed to the dramatic deterioration such as:

- the prolonged maintenance on exchange rates, which complicated the monetary policies, encouraging external borrowing and leading to excessive exposure to foreign exchange risk in both the financial and corporate sectors;
- a buildup of overheating pressures, evident in large external deficits and inflated property and stock market values;
- problems of governance and political uncertainties, which worsened the crisis of confidence, fueled the reluctance of foreign creditors to roll over short-term loans, and led to downward pressures on currencies and stock markets;
- international investors, mainly commercial and investment bank may have contributed along with domestic investors and residents seeking to hedge their foreign currency exposures, to the downward pressure on currencies.

4.0 CONCLUSION

The financial market in a country determines the economic development in the country for it is an important part of the economy. Without financial market the wealth of the economy will be less, because the rate of capital formation will be low. Without financial market many people will be without businesses, and many people will be without jobs. And with all this the economy of the country will be very low. A well developed financial market system has to be established and implemented in order for a country to flourish. Thus, it is necessary for a country to have financial market in an economy which could enable a fast growth, low inflation stability, strong fiscal positions, high saving rates, open economies, and thriving export sectors. After all, well-functioning financial markets are the integral part of modern economies.

BIBLIOGRAPHY

Financial Management, James C. Van Horne and John M. Wachowicz, JR., 12th edition.

Financial Market definition from Online Wikipedia, last updated: 16 September 2008. Retrieved on 19 September 2008, from http://en.wikipedia.org/wiki/Financial_market

Financial Markets And Institutions: Important Functions, RePEc (Research Papers in Economics) articles. Retrieved on 19 September 2008, from http:// 129.3.20.41/econ-wp/fin/papers/0512/0512025.doc

Capital Controls during Financial Crises: The Case of Malaysia and Thailand, Hali J. Edison and Carmen M. Reinhart, International Finance Discussion Papers, March 2000.

Malaysia's sustained recovery helped by export growth but many challenges looming, WTO Secretariat report, Trade Policy Reviews: First Press Release, Secretariat and Government Summaries, Press Release, 5 December 2001.

Revisiting How Malaysia Overcame the Financial Crisis, Global Trends by Martin Khor, Sunday 18 January 2004.

Foundations of Finance, Arthur J. Keown, David F. Scott Jr., John D. Martin, John W. Petty, Prentice Hall, 2008, 5th Edition.

Ø