PERFORMANCE OF THE STOCK MARKET (KLSE) WITH THE FLUCTUATION OF KUALA LUMPUR INTER BANK OFFER RATES (KLIBOR)

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Dedicated To,

Both my mother and father, whom I know have me in their prayers, always. My love to you both.

My brothers and sister, Ady, Kakak and Amirin.

My Love......

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ABSTRACT

This research is mainly on the effect of Kuala Lumpur Inter Bank Offer Rate(KLIBOR) and volume traded in the stock market as a market indicator to the performance of the stock market.

The stock market consists of many factors in influencing its movement. The economic conditions of a country is a major factor besides other factors such as political stability, future expectation of investors and government policies.

Interest rates are always associated with many business activities such as banking industry and classical theories has derived many theories on interest rates. Here the interest rate represented by KLIBOR has an indirect impact on the stock market.

ABBREVIATION

CI	- Composite Index
FI	- Finance Index
KLIBOR	- Kuala Lumpur Inter Bank Offer Rates
KLSE	- Kuala Lumpur Stock Exchange
CPI	- Consumer Price Index
GDP	- Gross Domestic Product

CHAPTER I

INTRODUCTION

The Stock Exchange is an organized capital market that plays an important role in the functioning of Malaysia's open market. It is the main capital market in Malaysia. It makes easier for large firms and the government to raise long term capital, providing a market place for borrowers and investors to come and do business together.

The Stock Market has enforce certain rules of conduct for its listed firms and for operators in the market, so that investors have the assurance that companies whose shares are traded on the Exchange and traders who operate there are reputable. Confidence in the Stock Market will make investors more willing to put their money in to stocks and shares. The index of share prices on the stock market acts as an indicator of the state of the country's economy. KLSE does not forbid speculation nor does it forbids excessive speculation. Speculation is an inevitable feature of any organized market, and it is doubtful whether the activities of speculators seriously distort or impair the function of the market.

Stock market is constructed to measure the performance of the overall stock market or a sector of a market. KLSE itself has constructed the widely followed Composite Index. Besides the Composite Index there are several indexes used to measure the performance of each sector such as Industrial index, Finance index, Property index, Tin index, Plantation index, Second board and etc.

In measuring our economic performance the Composite index itself is a leading indicator. Other indicator used are Gross National Product, Gross Domestic Product, Consumer Price index and market interest rate. In late 1993 the stock market has seen the all high composite index, 1275 points. That year alone has out performed the stock market in term of volume and index for the past ten years.

The stock market moves every day, in fact it moves every second. Such movement is better to compare with other variables such as industrial product, changes in money supply, and corporate profits. Rates of return on the stock index itself can be a valuable benchmark for judging the performance of actual portfolios of shares. Modern portfolio theory requires knowledge of the relationship of prices of individual stocks to movement in the market in order to allocate funds rationally among stocks.

The stock market indices also have proved to be considerably useful to analysts in forecasting the price movement in the future. It is regarded as a fairly good barometer of business conditions as the stock market is especially sensitive to changes in business activity and expectations[1].

There is a strong relationship between the monetary growth cycle and stock market performance. Important determinant of monetary growth is the level of interest rates. Rising interest rates results in the tighter credit and higher cost of funds, leading to a slowdown in monetary growth.

In term of market capitalization, KLSE has undergone tremendous changed during its stewardship. Its growth has been phenomenal, from just 282 companies with the total market capitalization of RM58.3 billion in 1985, there are now 508 companies(as at Aug 1995) listed with 358 in the main board and 150 in the second board with market capitalization of RM623.74 billion.

It is important to analyze the course of national economy because economic activity affects corporate profits, investors' attitudes and security prices. An outlook of sagging economic growth can lead to lower corporate profits, a prospect that can endanger investor pessimism and lower security prices[2].

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[1] Pelanduk Publication , 1995, Kok Kim Lian, Goh Kim Leng.
[2] Security Analyst and Portfolio Management

1.1 Objective of the Study

It is intention of the study to identify :

a) Relationship between composite index of our stock market with the economic indicator and market interest rates.

b) Contribution of the economic indicator and market interest rates to the performance of composite index.

c) Relationship between finance index of our stock market with economic indicator and market interest rates.

d) Contribution of the economic indicator and market interest rates to the performance of finance index.

1.2 Scope of the Study

It is the intention of the study in this project paper to analyze the performance of the stock market from 1988 to 1995 in relation with the market interest rate based on monthly basis. The economic indicator is a statistical series that has been found to represent a fairly accurate change in business conditions. There are three major groups of economic indicator the demonstrate a consistent relationship to the timing of the general business fluctuation:

i. Leading Indicator :Time series of data that historically reached their high points (peaks) or their low points (troughs) in advance to total economic activity.

ii. Coincident Indicators : Reached their high points (peaks) or low points (through) at approximately the same time as the economy.

iii. Lagging Indicators : Reach their turning points after the economy has already reached its owned.

In this study, volume transacted in each index will be taken as an economic indicator to the performance of the stock market and three months forward interbank rates or KLIBOR as the market interest rate. Generally KLIBOR is used by banks within the financial institutions.

In conducting the study, the Composite index and Finance index will represent the stock market mean while KLIBOR and volume represent the market interest rate and economic indicator respectively.

Other economic indicator such as Gross Domestic Product, Gross National Product, and Unemployment rate will not be considered in this study. This is because this study is to analyze the significant of KLIBOR in determining the performance of the stock market.

1.3 Limitation

In this study, data are based on the monthly basis in which it is taken at the end of the month. Any large movement will not be detected prior to the time taken. This is to determine the accuracy of the data taken and further as it is a monthly basis, the difficulties to obtain and to average it with the time given to complete this paper, it is not possible to do so. Furthermore there are no studies regarding the effect of KLIBOR to the stock market.

CHAPTER II

LITERATURE REVIEW

Fisher effect express the nominal rate of interest as the sum of the real rate of inflation expected over the life of an instrument . The nominal rate of interest embodies in it an inflation premium sufficient to compensate lenders for the expected loss of purchasing power associated with the receipt of future dollars.

Mundell - Torbin effect (Mundell 1963 ; Tobin 1965) says that inflation reduces real money balances. The resulting decline in wealth increases real saving and real investment, thus causing a negative relationship between inflation and real interest rate.

Carmichael and Stebbing (1983) argue that provided there is some regulation of interest rate (a minimum degree of regulation being the nonpayment of interest on money balances) and provided there is a relatively high degree of substitutability between money and financial assets, the Fisher hypothesis as applied to financial assets, may be completely inverted. That is in after tax terms, we suggest that the nominal rate of interest on these assets may be approximately constant over the longer term, with the real rate of interest moving inversely one-for-one with the rate if inflation.

The pure expectation theory of the term structure expressed by Fisher(1930) and Lutz(1940) predicts that the term premium is zero. In other words, forward rates are unbiased estimates of expected future interest rate. However, the liquidity preference theory (Hicks 1946) asserts that the presence of risk-averse investors ensures that forward rates are positively biased estimates of expected future rates. This is because investors have to compensate them for the risk of lending long.

Keynes (1936) argue that if interest rates are high compare with what is considering normal, there is a possibility that interest rate will fall. Hence the demand for longer term securities will increase because risk-averse investors will not fear a fall in the price of securities and will be looking for investment that promise certainty of income. Borrowers however would prefer to borrow when interest rates are low, predicting an inverse relationship between the level of interest rates and the term premium.

Kessel (1971) on the other hand argue that the relationship is positive. When interest rates are high, the cost of holding money in term of foregone interest income is also high. People therefor exchange their money balances for securities. If we assume that people prefer short term to long term securities, the long term yield would rise relative to short term yields, increase the term premium.

Syed M. Ali and M. Aynul Hasan (1993) says in the absence of a precise theory which explained the interlink among the fiscal policy variable, stock returns and other relevant variables, the decision as to which variables are to be included is somewhat arbitrary.

Further there is no theory in financial literature would argue that the relation between financial markets and the macroeconomy is entirely undirectional. Movements in stock market prices are usually considered to be responding to some external and exogenous factors.

Base on impulse response functions found favor of the efficient market hypothesis for the Canadian stock market with respect to both fiscal and monetary policy.

Choong Khuat Hock (1992) in his seminar says that a high interest rates leads to a tighter liquidity conditions in the market. Higher interest rates act upon the market in a number of ways. First they dampen the demand for goods and services provided by companies leading to a slower earnings growth.

Second they reduce the attractiveness of stock market investment by providing higher return on risk-free securities. Thirdly they increase cost of borrowing for both companies and individuals.

Companies faced with slower demand and higher borrowing costs are likely to cut down on investment expenditure while individuals faced with a higher interest burden may be less incline to dabble in the stock market.

A rising interest rates trend is negative on the stock market. The level of interest rate in Malaysia is dependent on Bank Negara's policy which in turn is dependent on its perception of the current state of the Malaysian economy. Due to Malaysia's relatively open door policy the burden of an overheating economy seems have been shifted to the external account.

In the case of Bank of England it acts as administrator or agent for carrying out the government monetary policies. It attempts to control the level of short term interest rates, so as to control the growth of the money supply . The process by which the bank can control or influence short-term interest rates is known as open market operations. These are the operations by which the Bank provides the banking system with cash when the system is short of cash or removes excess cash from the banking system when there is a surplus.

The rate of discount on the bills bought or sold reflect a rate of interest , and this rate of interest provides the basis for determining interest rates throughout the money markets as well as the banks' base rate and overdraft rates.

CHAPTER III

Overview of Malaysian Economy

Malaysian has been enjoying a high rate of economic growth. Growth in GDP at a constant price(real GDP) had steadily accelerated from an annual average of 4.1% in the second half of 1950's to 8.1% in 1970's. However, the rate of economic growth slowed down considerably in the early 1980's as a result in the prolonged world recession and structural problems in domestic economy. But, the Malaysian economy has been on a strong recovery path with real GDP growth averaging 8.3% during 1987 to 1992. In 1993, the GDP rose by 8.5 %. It represented the sixth consecutive year of sustained, rapid growth of over 8% and strengthened further in 1994 with an increase of 0.2% at 8.7%, making it the seventh consecutive year of rapid growth of over 8%[1].

The Malaysian economy grew steadily in 1980 underpinned by strong growth in the manufacturing, construction and services sector. The inflation rate exceeds the budget forecast as a result of development in domestic economic and international economic. Real GDP is estimated to have growth of 8% exceeding the 1980 budget estimate of a growth of 6.5% but lower than growth of 8.9% in 1979. Unemployment rate has decreased significantly from 5.6% in 1979 to 2.9% in 1994. In 1981, as a result of adverse effects arising from the recession in the major industrial country has slowed down the trend of Malaysian economy. The economic decline has lead to lower demand for Malaysian major commodities and affected business activity as well as investment decision.

In 1992, demand by private sector, provided the main thrust to economic growth. The real GDP grew 7.8% in 1992 to RM93,072 million compared to a growth of 8.7% to RM109,661 million in 1994. The CPI decreased from 5% in the fourth quarter of 1992 to 3.8% in the fourth quarter of 1994.

In the mid 80's with the global recession and problems of the 'twin-deficit' has seen the up-turn of the Malaysian economy. The most and the clearest testimony was the fine performance of the KLSE, it reached unprecedented

[1] Bank Negara Annual Report, 1994

heights in 1993, surpassing the cumulative total volume and value of shares traded over the past 20 years. With a trading volume of 107.8 billion units valued at RM387.3 billion, the KLSE actually outperformed trading in some of the major international brouses in 1993[2]. At the end of the year, market capitalization (RM620 billion) was four times the GNP.

Nor Mohamed Yakcob, managing director of RHB Research Institute Sdn. Bhd. says, "High and rising market capitalization of the KLSE is in fact, a healthy sign of a growing economy". The local stock market has evolved by leaps and bounds. The KLSE composite index for example surged 98% in 1993 and market capitalization has grown more than three folds since the end of 1991 rising from RM161 billion to about RM575 billion as at September 1994. So in terms of market capitalization, KLSE ranks the first among ASEAN countries and the fifth in Asia. As a consequence of this, market capitalization to GDP ratio escalated to 2.94 in 1994 as compared to 0.75 in 1985. And this ration happens to be the highest in the world.

The overall market sentiment in 1995 is still bearish with a continuity of 1994 bearish market. The increasing domestic interest rates and inflation rate with speculation of ringgit devaluation have led to the non support from institutional and retail players dampening the market sentiment. As a result of this , the daily average turnover declines to 148 million units valued at

[2] Bank Negara Annual Report 1994

RM764 million from 167 million units valued at RM960 million in the preceding quarter of 1994. Most major sectors too recorded a very poor performance. The all-share EMAS index fell to close lower at 282.19points, whereas the CI close higher at 984.07 points at the end of the first quarter.

3.1 FINANCIAL INDUSTRY OVERVIEW

3.1.1 *COMMERCIAL BANKS*

With the process of economic recovery having been set in motion since 1987 , the role of Bank Negara was to further develop and strengthen Malaysia's financial system and to increase the effectiveness of monetary policy institution as a to support private investment initiatives.

In the early stage of recovery, to preserve price stability, monetary policy was used in order to nurture the strength of private investment. To assist the growth and development of productive investment at a reasonable cost, a number of innovative measures were introduced by Bank Negara to effect a smooth transition to a regime of lower lending rates by basically reducing the bank cost of fund. These measures included the dismantling of pegged interest rate arrangement, the averaging of liquidity requirements by banking institution guideline on the maximum margin between the actual lending rate and the base lending rate of banks and a moratorium on wage increases in the banking industry.

In 1988, commercial banks continued to recuperate from the after-effects of the recession of 1985 and 1986. As a result of a higher growth rate of the economy with low inflation, rising foreign investment and low interest rates, the banking industry consolidated its operations further during the year with improvements in productivity and profitability. The early signs of economic recovery were reflected in a substantial improvement in commercial bank lending. The recovery of loans growth was helped by an adjustment downwards in the mode base lending rate of 0.5 percentage point to 7 percent per annum with effect from July 1, 1988.

As the bank also competed to lend based on rates linked to KLIBOR, the average lending rate of commercial banks fell throughout the year, declining by 0.78 percentage point to 8.95 percent per annum in 1988. In 1989 in line with the rapid economic growth and higher investors' confidence, commercial bank industry accelerated further. Profit before tax increase to RM299 million or 47 percent to RM935 million[3]. Overall increase is due to income interest although lower loans given, showing a substantial demand in loans. Total expenses increase only 10.1 percent as deposit cost and

[3] Bank Negara Annual Report 1989

higher deposit growth overcome the interest expense of 27.3 percent. On October 1, 1989, Banking and Financial Institution Act 1989 (BAFIA) was enforce to replace the Banking Act 1973. With the abolishment of the Banking Act 1973, under the section 128, BAFIA all regulations, controls made by Bank Negara in the Banking Act[4] are still valid and must be followed by all. Bank Negara has widen the investment field of commercial banks. As at September 1, 1989, commercial banks are allowed to invest in share such as Malaysia Airline System, Malaysia Incorporated Shipping Corporation and highly valued shares that are permitted by Bank Negara.

The commercial banks has increased the rates for the fixed deposits to mobilized savings to finance the demand for increasing loans. As a result, the mode rate of fixed deposits on one and three months increase to 1.5 point percentage, from 3 percent and 3.5 percent in 1988 to 4.5 percent and 5 percent respectively in 1989. The six and nine months increase to one point percentage to 4.75 percent and 5 percent respectively, and the 12 months increase 1.25 point percentage to 5.5 percent per annum. Savings rate is still the same with 3.5 percent per annum.

In 1990, profit before tax shows a significant increase to RM1,358 million or 51.6 percent from RM896 million. The good performance was due to the

[4] Bank Negara Annual Report 1989

sharp reduction in net interest suspense and provision of bad debt. of RM259 and RM633 respectively. 1990, also saw a rapid outflow of fund from commercial bank to other financial institution. Commercial banks have only 45.7 percent of new deposits in their banking operation. Due to these commercial banks have increases their rate of deposits to finance the demand of loans. At the end of the year the mode of fixed deposits of less than 12 months were increased to 0.75 to 1.0 point percentage to 6.5 percent, 7.0 percent for one and three months, and 7.25 percent per annum for six, nine and twelve months respectively.

In 1991 the industry showed a significant improvement in earnings and profitability as the quality of loan portfolios improved and loan-loss provisions were reduced sharply, coupled with an expansion in the industry activities. The profit before tax rose by RM348.7 million or 24.5 percent to RM1.8 billion . Total income exceeded the previous year by RM1.9 billion or 20.6 percent, the bulk of which was derived from interest income following a strong demand for loans in 1991 and a sharp decline in net interest-in-suspense.

With effect on February 1, 1991, Bank Negara has allowed banking institutions to fix their base lending rate. This is to give the banking institutions sufficient flexibility and yet maintain sufficient discipline to ensure that actual lending rates reflect the true credit standing of the borrower and the borrowers are not charged exorbitant interest rates. It is to create a new market oriented interest rate regime whereby both lending rates and deposit rates are determined purely on the basis of free market forces and competition.

Profitability in 1992 has improved further as income from fund-based activities continued to increase in tandem with the expansion in the lending activities. Profit before tax rose by RM308.7 million or 18.5 percent to RM2 billion. Total income rose by RM2.7 billion or 22.9 percent to RM14.4 billion, accounted for largely by the increase in interest income of RM2.3 billion[5].

In 1993 pointed another significant increase in profitability, as income from fund-based activities continued to increase in tandem with the expansion in their lending activities, whilst interest expense increased at a slower rate amid increasingly cheaper funding costs. Furthermore in line with the easier liquidity condition, the base lending rate was reduced from 9.29 percent to 8.23 percent. The rate fell down further in 1994 to 6.83 percent as ample liquidity remained throughout the year. In 1994 the banking institution were allowed to invest in non-trustee shares/interest in non-trustee shares of any corporation listed on the main board of the KLSE subject to a limit of 5

[5] Bank Negara Annual Report 1992