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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/105

10:00 a.m., July 13, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	T. Ramtoolah, Temporary
	S. Kolb, Temporary
B. de Maulde	X. Blandin
	M. Teijeiro
	D. C. Templeman, Temporary
M. Finaish	
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	G. W. K. Pickering, Temporary
	C. Robalino
G. Laske	
G. Lovato	N. Coumbis
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	
	A. J. Tregilgas, Temporary
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindå
	T. A. Clark
	Chen J., Temporary

J. W. Lang, Jr., Acting Secretary
C. Fairbairn, Assistant

Also Present

Asian Department: N. N. Choudhry, R. G. Di Calogero, I.-S. Kim, M. R. P. Salgado, D. A. Scott. Central Banking Department: M. R. Vaez-Zadeh. European Department: L. G. Manison. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; E. H. Brau, B. de Schaetzen, E. R. J. Kalter, P. M. Keller, E. B. Maciejewski, C. M. Watson. External Relations Department: I. S. McDonald. Fiscal Affairs Department: V. P. Gandhi, M. Katz, C. A. Sisson. Legal Department: A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; A. Lanyi, D. J. Mathieson, M. Williamson. Treasurer's Department: D. S. Cutler. Bureau of Statistics: W. Dannemann, Director; C. Briançon, J. B. McLenaghan, J. C. O'Connor, C. A. Patel. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, S. El-Khouri, K. A. Hansen, L. Ionescu, W. Moerke, I. R. Panday, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, C. Flamant, V. Govindarajan, N. U. Haque, H. Kobayashi, M. Rasyid, J. Reddy, D. J. Robinson, C. A. Salinas, A. A. Scholten, Shao Z., S. Sornyanyontr, A. Yasseri.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that, during his recent trip to Europe, he had addressed the Economic and Social Council of the United Nations in Geneva on July 5 and had later met with a number of ambassadors and discussed international monetary and debt problems. On July 6 and 7, he had participated in a meeting of the Tidewater Group and discussed development matters. Chaired by the Chairman of the DAC Committee of the OECD, the Tidewater Group was made up of heads of aid agencies such as the UNDP, the World Bank, and UNICEF, and ministers associated with development and planning matters. The Group had focused on possible ways of convincing the developed countries of the desirability of more generous aid programs. Although he had not contributed greatly to the discussions, he had been exposed to a number of ideas. A shorter discussion had followed on the longer-term aspects of adjustment programs and the means by which the World Bank and other development agencies could act in support of Fund adjustment programs.

On July 9, 1984, he had participated in a monthly meeting of central bankers in Basle, including the Chairman of the Saudi Arabian Monetary Agency, the Managing Director continued. A useful discussion had been held on the Fund's liquidity position and on various international financial problems. On July 10 and 11, he had met with Mr. Delors and French Treasury officials. Overall, he had encountered a favorable response to the Fund's work, although some concern had been expressed about the difficulties of adjustment and the level of interest rates.

2. MALAYSIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Malaysia (SM/84/137, 6/18/84). They also had before them a report on recent economic developments in Malaysia (SM/84/140, 6/22/84).

Mr. Jaafar made the following statement:

> On behalf of my authorities, I thank the staff for the excellent review. My authorites consider the appraisal fair and well balanced. My comments would merely serve either to emphasize or to add to the points raised in the papers. I will not elaborate on developments in 1983, except where they touch on some aspect of policy measures and initiatives taken by my authorities.
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> The Economy in Perspective
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> The current difficult phase in the Malaysian economy (1981-83) came after more than two decades of extraordinary performances and sound management of the economy. In the 1960s, the thrust of policy was to diversify from the narrow base of natural rubber

production and tin mining into other commodities, such as oil palm, timber, and also into import-substituting industries, besides the continued promotion of external trade as the primary engine for growth and development. This objective was achieved smoothly in the context of price stability, with the rate of GDP growth averaging 5.2 percent during 1961-70. The second phase was the dynamic 1970s, when growth performance sharply increased to average 8 percent per annum, with the annual inflation rate contained at about 6 percent. The balance of payments was in persistent surplus, brought about by the coming on stream of oil production, strong commodity prices, and buoyant exports in manufacturing.

The constraint on financial resources that emerged with the severe and prolonged global recession by the first half of the Fourth Malaysia Plan, 1981-85, was a new experience to the authorities in Malaysia. The policy to sustain growth during 1981-82 had proven inappropriate. The downturn had been more pronounced and longer than expected, and by mid-1983 it became clear that financing the public sector deficit had substantially increased foreign borrowings, and repayments had threatened to become burdensome. Structural weaknesses in the economy, which had not been dealt with in the 1970s, resurfaced as a major source of concern in the authorities' efforts to come to grips with the external and domestic imbalances.

Three of the major areas have been identified and given urgent attention. They include the declining trend in output growth in traditional agriculture; the relatively narrow manufacturing base centered on electronics and textiles; and the growing intensity of imports in domestic consumption. In the immediate term, the main issue remains the structural deficit in the broad public sector and the current account deficit in the balance of payments.

Let me first take up the policies to address the financial resource constraint relating to the "twin deficits" before taking up the other supply side measures.

Policies on Public Finance

The picture that emerged from the IMF and the IBRD missions, as well as the Mid-Term Review of the Fourth Malaysia Plan on the rising savings-investment resource gap, is indeed of deep concern to the authorities. They would like, however, to stress that the situation is well within control. The economy possesses the necessary resilience and strength in terms of its resource base to overcome the present difficulties. They consider the economic prospect as manageable. The external debt burden, though threatening to be moderately large, is not exceptional. The key, they emphasized, is in taking timely adjustment measures to redress the situation. In this respect, the first major step was in mid-1983 through a substantial retrenchment of the federal budgetary expenditures. The outcome was a decline in budget deficit in 1983 to M$6.6 billion or 10 percent of GNP compared with 15.8 percent and 17.2 percent respectively in 1981 and 1982.

However, a source of disappointment to the authorities when the outturn of the 1983 austerity program was reviewed was the less than expected improvement in the external current account. 1/ There was growing awareness by late 1983 that an important element of the public sector had not been addressed by the program. These were the 13 to 15 major public sector enterprises and corporations, either owned or controlled by the Federal and State Governments. These agencies (the "off-budget agencies" or OBAs) which had until recently been funded partly through the Federal Treasury, had in recent years expanded their recourse to domestic and external borrowings to increase the size of their development expenditure. The growing impact of these agencies, particularly on the current account of the balance of payments, is of serious concern to my Malaysian authorities.

At the time of the staff consultation in April, my authorities were setting up a review committee to address the problems relating to the OBAs. I have been informed that the committee is now in place and is finalizing the mechanism for evaluating, approving, and monitoring the investment program of the public sector, including the OBAs. Four subcommittees are focusing on the following areas of work:

a. Definition of OBAs for inclusion in the public sector (the recommendations conveyed in a report prepared by the Fund's Bureau of Statistics in 1983 shall form the basis for its consideration);

b. Formulation of administrative machinery to monitor and control public sector expenditure, including those of OBAs;

c. Formulation of criteria to evaluate and approve public sector projects; and

d. Determination of resource constraints of the public sector.

With respect to these efforts, the authorities have received two World Bank missions in May and June 1984 to review development expenditure by the public sector and to evaluate and enhance the mechanism for external debt monitoring and coordination.

1/ The extent of adjustment and a projection of the likely outcome were conveyed by my authorities to the Executive Board on October 7, 1983.

These additional steps, when fully implemented, would represent a major effort by the authorites in reinforcing and sustaining the initial austerity measures taken in 1983.

Other Measures

Some of the fundamental structural issues have already been addressed. The National Agriculture Policy, announced in January 1984, was formulated with a long-term perspective to inject vitality into agricultural production by promoting research and modern farm management techniques. A primary area is the promotion of agricultural food production.

In the manufacturing sector, two Industrial Master Plan Studies are already under way to evaluate, identify, and formulate industrial strategy and programs for the country in the medium term, based on the manpower, energy, and natural resources available.

The efforts to correct the imbalances in the services account of the balance of payments have been partly the responsibility of the ongoing work of the Council on Malaysian Invisible Trade which had been responsible for the recent actions taken to redress the unfavorable situation on shipping, insurance, and tourism.

Prospect and Outlook on the External Sector

Although the trend in the balance of payments position has improved since last year and a better outlook is in prospect for 1984, my authorities concur with the staff's views that the improvement in the current account over the medium term is not yet assured. Much would depend on the outcome of the efforts to contain public sector expenditure, in particular by the OBAs. Further, the phasing of the government investment policies will be essential, in their view, if the current accout deficit is to be narrowed to more prudent amounts during 1986-88, particularly in view of the external debt and debt service obligations.

At this stage, it is still premature to form an opinion on the oil picture over the next few years. Oil output in excess of the 440,000 barrels per day, mentioned in the staff report is within the capacity of existing oil wells. This outlook, I believe, would alter somewhat the federal revenue prospects and the net oil export picture over the next three to four years. The result could be that a further rise in the domestic oil consumption need not be met by higher imports.

On the expected outturn for the current account of the balance of payments, there are encouraging signs now of a stronger pickup in exports--25 percent in the first quarter in 1984--on account of the substantial surge in exports of palm oil and the moderation in import growth, which slowed to 4 percent. The overall outturn, however, should be discounted with the weaker than expected export performance of natural rubber. Accordingly, the balance of payments current account deficit could be lowered by US$128-214 million in 1984. This would imply a lower current account to GDP ratio for 1984 of about 6.5-7 percent, compared with the present estimate of 8.2 percent.

Direct Investment

The policy to encourage foreign direct investment had already been in place in Malaysia for a long time. The aim remains to attract foreign industries and acquire foreign expertise and know-how. Recently, this policy has been vigorously promoted to help ease the emerging resource constraints. As of May 1984, the authorities revised the investment incentives to encourage greater inflow of foreign capital. To attract capital-intensive and resource-based, export-oriented industries, it is now possible for foreign partners to retain majority equity of up to 70 percent, as opposed to the previous minority share of ownership. Executive Directors may wish to refer to Part II, Section 2 on pages 3-4 of the staff report for a brief review of developments in foreign direct investment in 1983.

Monetary Policy

On the conduct of monetary policy, my authorities concur with the staff on the policy stance for 1984. They agreed that a more restrictive stance of credit policy and a rise in interest rates would be appropriate to contain any rapid rise in the private sector liquidity that could contribute to the pressure on the balance of payments. The authorites wish to stress that they remain committed to restraining monetary and credit growth to ensure against renewed inflation and external disequilibrium.

With respect to the deposit interest rates, the latest report on developments over the last two months showed an increase of between 0.25 and 0.5 percentage point on deposits of various maturities. This increase represents the authorities' most recent initiative to encourage savings.

In the interest of encouraging the development of the financial sector, an interest rate study will be conducted toward the end of 1984, under the technical assistance program of the Fund. Two similar technical missions have been agreed to with the World Bank to conduct a study of the Malaysian financial sector. The first team will cover the Malaysian money and capital market, the second the long-term financing needs of industries. These studies are scheduled to start in November 1984.

In summary, my authorities broadly endorse the staff appraisal. Their findings were generally in line with the authorities' view. They intend to continue with the current austerity program to its rightful conclusion.

Mr. Hirao remarked that, in mid-1982, the Malaysian authorities had begun to reduce domestic and external imbalances that had emerged during the period of global recession since 1980. With a strong commitment by the authorities, some important progress had been made, particularly in the fiscal area, although the external position remained relatively weak and vulnerable and would require continued adjustment in coming years.

He was pleased to note that the position of the Federal Government's budget had significantly improved in 1983, Mr. Hirao said. The authorities had made a comprehensive review of fiscal policy in the latter half of that year and acted strenuously to restrain both current and development expenditure; as a result, total expenditure had declined by about 8 percent from 1982, and the rapidly increasing trend in the ratio of budget expenditure to GNP had been reversed. Progress had also been made on the revenue side. The overall deficit had thus been sharply reduced by about 7 percent of GNP, although further efforts would be necessary, as the budget deficit still exceeded 10 percent of GNP. Because revenues had been as high as 25-29 percent of GNP for the past several years, the recent large fiscal deficit had to be attributed mainly to the sharp increase in expenditure. Hence, the forces of fiscal adjustment should be on the expenditure side, although the scope for restraint was limited by the steadily increasing interest payments on public debt and the rising demands for social services, reflecting demographic factors. In the circumstances, the authorities should perhaps direct their efforts to constraining nonstatutory current expenditures, such as wages and salaries, and development expenditure. In that regard, the continued limitations on public investment programs funded by the government budget were welcome.

The heavy dependence of the tax system on the petroleum sector needed to be addressed, Mr. Hirao continued, particularly in the light of the limited capacity for oil production and the uncertain export prospects. Furthermore, the national oil company, Petronas, could no longer be expected to contribute appreciably to deficit financing. An effort should therefore be made to broaden the tax base from domestic transactions, income, and profits. Although, as indicated by the authorities, it might not be feasible to increase substantially the overall tax burden, which was already higher than in neighboring countries, it might be possible to alter the composition of tax revenue.

That the improvement in the Federal Government's budget was likely to be offset by a rapid increase in investment spending by nonfinancial public enterprises was worrying, Mr. Hirao said. Investment expenditure by 13 off-budget agencies (OBAs) was tentatively estimated to rise by almost 75 percent in 1984, a conspicuously high figure, given the generally restrictive policy stance. He fully endorsed the staff's view that a comprehensive periodic review of the investment priorities of OBAs was necessary. In that regard, he was pleased to note from Mr. Jaafar's statement that the authorities had set up a review committee, which had nearly completed the task of establishing mechanisms for evaluating, approving, and monitoring the investment programs of the public sector, including the off-budget agencies. Perhaps the authorities should also ask the review committee to explore ways of substantially reducing expenditures of the OBAs.

On monetary policy, Mr. Hirao observed that the rapid credit expansion to the private sector in 1983 and the first half of 1984 had contributed to the unexpectedly weak external position. He understood that monetary policy had a role to play in reconciling the need to support domestic activities with the need to strengthen the external position; however, he endorsed the view of the staff and the authorities that credit policies should be somewhat tightened, and that greater emphasis should be placed on external considerations than in previous years.

It was encouraging to note that a strong revival of exports would result in a smaller than estimated current account deficit in 1984, Mr. Hirao commented, although the improvement in the current account over the medium-term was not yet assured. The medium-term balance of payments outlook indicated that external debt, in relation to GNP, would steadily increase in the coming years to reach almost 60 percent toward the end of the decade. Moreover, although the debt service burden did not appear excessively high at present, it would also rise over the medium term. It was thus crucial to reduce overall public investment, particularly by off-budget agencies, and to pursue somewhat tighter credit policies. Finally, he hoped that the implementation of exchange rate policy would be flexible enough to sustain export competitiveness.

Mr. Templeman noted that Malaysia's record of growth, price stability, and a strong balance of payments was a good one, but that the economy faced some serious problems, due primarily to a public investment boom that had created serious imbalances in both the fiscal accounts and in the balance of payments.

The Malaysian authorities appeared determined to address the serious fiscal problems, but were finding them more intractable than expected, Mr. Templeman continued. In fact, the statistics indicated a remarkable increase in the ratio of fiscal expenditures to GDP, from 20 percent in 1979 to more than 45 percent in 1982. Moreover, those figures covered only the Federal Government and not the broader concept of the public sector. Although the ratio of revenues to GDP had risen substantially between 1979 and 1980, it had since remained constant, which seemed appropriate given its already high level. On the expenditure side, the authorities had achieved some cutbacks in 1983, particularly in development expenditures, but the ratios of both the federal government deficit and the consolidated public sector deficit to GNP remained high by international standards, even when the major off-budget agencies were excluded. Despite some reduction in 1983, those ratios had still been

10.3 percent and 13.7 percent, respectively. Furthermore, a large share of the deficits had been financed externally, and the authorities were planning to continue large-scale foreign borrowing to finance fiscal deficits again in 1984.

On fiscal problems, Mr. Templeman agreed with the staff that room for action on the revenue side was limited, although some improvement in elasticity and some broadening of the tax base might be possible as a way of reducing dependence on taxation of petroleum. In that respect, the elimination of remaining subsidies on the domestic sales of petroleum in 1983 had been encouraging. The major effort in his view must be on the expenditure side, although there were some inherent limits because of demographic pressures on social services, the growth of interest payments, and other rigidities. For example, the staff had noted that interest payments on federal debt had already amounted to 22 percent of current expenditures in 1983, suggesting that some of the focus must continue to be on cuts in development expenditures. Since the ratio of fixed investment to GNP was high, such cuts would probably not hurt Malaysia's future growth prospects. He fully endorsed the efforts already made or planned by the authorities to reassess fiscal policies, including existing contractual obligations on development spending, and to review the investment priorities and efficiency of the off-budget agencies in 1984. In fact, the absence of full data on the activities of the entire public sector had made the management of fiscal policy in particular, and of macroeconomic policy in general, quite difficult; however, the information in Mr. Jaafar's statement concerning the latest steps toward more effective control of the activities of off-budget agencies was reassuring.

On the monetary side, the authorities had already substantially reduced the rate of increase of broad money and of net domestic credit expansion between 1980 and 1983, Mr. Templeman said. However, given developments in 1984, credit policy should be more restrictive for the remainder of the year. He also supported the staff's view that some diversification away from lending for import-intensive property development, an encouragement of the growth of term deposits, and a strengthening of the capital base of financial institutions were desirable. The tying of most bank lending rates to the cost of bank funds in 1983--in order to make lending rates more responsive to changes in market conditions--had been a positive development. The achievement and maintenance of more positive real interest rates would help to contain credit expansion and allocate funds more efficiently, both domestically and internationally.

The sharp deterioration in the current account from a surplus of 4.7 percent of GNP in 1979 to deficits of 12.4 percent of GNP in 1982 and 10.5 percent in 1984 was striking, Mr. Templeman remarked. Even the revised 1984 forecast for a deficit of 6.5-7 percent of GNP was quite high. Although the volume of exports, particularly manufactured exports, had recovered substantially in 1984, the likely stagnation in net petroleum exports, the rise in interest payments and in payments for construction services, and the potentially large import bill for capital goods for public investment programs all created doubts about the sustainability of the current account deficit, although recent measures to improve incentives for foreign investment in the non-oil sectors of the economy, as an alternative source of financing and economic growth, were welcome.

Given the continuing large current account deficit and the expansionary effects of the large fiscal deficit, he was not convinced that the exchange rate policy was appropriate, Mr. Templeman said. A real effective depreciation of the ringgit in the past three years had reduced the exchange rate to the level registered in 1975-77, when the balance of payments had seemed to be in equilibrium. However, important economic changes had occurred since then. In fact, the three structural weaknesses cited in the staff report and in Mr. Jaafar's statement--declining agricultural output, a narrow manufacturing base, and high import intensity--suggested that export incentives were inadequate. Although manufactured exports were indeed growing, it was essential that all exports should expand rapidly if the current account deficit were to be reduced further and the growing foreign debt serviced on schedule.

The debt situation in Malaysia was not yet a matter of great concern, Mr. Templeman noted. However, the growth of foreign debt had been rapid, increasing from less than 20 percent of GNP in 1979 to over 48 percent of GNP at the end of 1983, even excluding short-term debt. At the same time, the debt service ratio had grown considerably, and both ratios were expected to continue to grow until the late 1980s and perhaps beyond. Unless the budget and balance of payments problems were dealt with promptly and forcefully, Malaysia risked losing its creditworthiness. Of course, that outcome could be avoided with effective economic management of the sort that had been employed in the past.

Mr. Polak observed that Malaysia had registered an enviable growth rate of 6-7 percent of GNP in recent years. Unfortunately, that growth had been achieved at considerable risk, as reflected in the current account deficit of about 10 percent of GNP and a rapidly rising external debt, which had grown from 19 percent of GNP in 1980 to 55 percent in 1984, the prospect being for a continued rise into the late 1980s. Clearly, Malaysia was following an unsustainable growth path that could lead to a severe debt crisis within the next five or ten years. The authorities, aware of the problem for some time, had taken major fiscal action to correct it in the form of a sharp cutback in government expenditure--particularly development expenditure--of 8 percent of GNP.

The rapid growth of nonfinancial public enterprises, particularly the off-budget enterprises, appeared to be a major problem for the Malaysian economy, Mr. Polak continued. Investment policy was highly aggressive, but was unfortunately focused on capital-intensive projects whose output would make a relatively small contribution to domestic value added. Such policy had an adverse impact on both the budget and the balance of payments. At present, the off-budget enterprises, financed partially from the budget and partially through government guarantees of their debt, were excluded from the public sector. That the authorities were in the process of redesigning the public sector to include the off-budget enterprises was encouraging; the adjustment, which so far was only statistical, appeared however to have occurred too late, since the enterprises were continuing to operate outside the control of the central authorities, as evidenced by the tentative estimate of an increase in investment expenditures by OBAs of 75 percent in 1984.

The staff had noted that the so-called Economic Planning Unit had been instructed to initiate before mid-1984 a comprehensive review of all new major projects by the OBAs, Mr. Polak continued. Such a review was long overdue, given that the major problem posed by the OBAs had been recognized for some time. He supported the staff view that, although the authorities were correct to aim for a diminution in the size and role of the public sector, the absence of explicit consideration of the investment programs of the OBAs was a weakness that should be quickly corrected. He also agreed with the staff that Malaysia should move in orderly fashion to reduce and reorient public investment expenditure, especially in the off-budget agencies, giving greater priority to activities with a relatively short gestation period and high economic return. Although such changes were ambitious, he wondered why they had not been attempted before, since the need for them was so clear. The staff report gave little reason for the Malaysian authorities' hesitation in dealing with the OBAs and provided little information on the activities of those enterprises. In his view, it was a necessary and nearly sufficient condition for the satisfactory future development of the Malaysian economy that policies toward off-budget agencies be corrected. Malaysia was an open economy, with a low inflation rate of 4-5 percent; exchange rate and monetary policy were well conceived, and there were ample resources available in many areas. In the circumstances, if the problem posed by the OBAs were attacked in a determined way, the basic strengths of the Malaysian economy would allow for a continuation of the positive developments registered over the past two decades.

Mr. Orleans-Lindsay noted from the staff paper and from Mr. Jaafar's statement that the Malaysian economy had regained the economic momentum that had been interrupted between 1980 and 1982, when the prolonged international recession had substantially reduced demand for Malaysian exports. The Malaysian authorities had maintained a flexible and sound approach to managing their economy in response to the adverse developments, and they were to be commended for their success in reducing inflation from almost 10 percent in 1981 to 5.8 percent in 1982 and 3.7 percent in 1983. That achievement, though relatively modest, was noteworthy because it had been combined with a revival of growth in real output of about 6 percent and a reduction in the current account deficit from 12.4 percent of GNP in 1982 to 10.5 percent of GNP in 1983. Since then, the strong adjustment effort of the authorities had been bolstered by the recovery in the international economy, which had strengthened demand for primary commodities. As noted by Mr. Jaafar, the country's enormous resource base had provided the necessary resilience and strength needed by the economy to withstand the difficulties that it had been facing.

The Malaysian authorities had taken determined corrective action in the fiscal area, Mr. Orleans-Lindsay said. A review of expenditure policies had led to a sharp reduction in development outlays, effected by canceling or rephasing various projects. Those actions had greatly contributed to the realization of the 1983 budgetary objective of curbing growth in total federal expenditure. As a result, the overall budget deficit had been reduced to M$6.6 billion, or 10 percent of GNP. However, since the fiscal adjustment had not covered the entire public sector--off-budget agencies being excluded--it was encouraging that the authorities had recently established a review committee to finalize the evaluation, approval, and monitoring of the investment programs of public sector enterprises. That action by the authorities was certainly a step toward further consolidating and strengthening the Government's financial position and, in turn, improving the balance of payments. He was also pleased to note that the remaining subsidies on domestic sales of petroleum products had been eliminated, an action that should lead to substantial savings in operating expenditures, estimated at M$400 million. The authorities should maintain their commitment to a strong fiscal adjustment; in particular, the feasibility of introducing additional revenue measures, including broadening the tax base, should be examined; at the same time, the impact of expenditure cuts on the Government's program for alleviating poverty should be evaluated.

On monetary policy, Mr. Orleans-Lindsay noted, although a more restrictive credit stance would certainly have discouraged private investment and eroded business confidence in Malaysia, the need to maintain stable conditions in the overall financial environment implied that a more restrictive credit policy would be appropriate to support the adjustment efforts in the external sector in 1984, especially given the continued rapid expansion of private sector credit. He therefore welcomed the authorities' intention to adopt a policy stance that would stem the rapid rise in private sector credit and further ease pressures on domestic prices and the external payments position. The authorities should persevere in applying appropriate monetary instruments to balance the credit needs of the private sector against the need to achieve external adjustment. The idea that the authorities, with Fund technical assistance, should conduct a study on the interest rate structure in the context of the overall development of the financial sector was welcome, as was the proposal for two other studies, to be conducted with assistance from the World Bank, on the Malaysian money market and the needs of industry for long-term finance.

The staff analysis of prospects in the external sector for 1984 gave him cause for concern, Mr. Orleans-Lindsay commented, especially since the outcome of the external adjustment in 1983, while encouraging, did not provide a strong enough foundation for a sustainable improvement in the current account deficit over the medium term. The pessimistic outlook was in part a reflection of the strong growth in private sector demand originating from the high investment expenditures of the off-budget agencies, which had planned additional large investment projects with a high import content for 1984. Like the staff, he urged the authorities to give high priority to the comprehensive review of those investment plans as part of the effort to reduce the current account deficit in the medium term to a level consistent with Malaysia's evolving external debt obligations. Judging by the resolve with which the authorities had so far tackled their economic and financial problems, he had no doubt that they would achieve the impressive performance that had characterized their open, diversified, well-managed economy two decades previously.

Mr. Finaish noted that Malaysia's economic performance during the 1970s had been impressive in terms of growth, price stability, a strong balance of payments position, and a comfortable cushion of international reserves. However, like many other developing countries, especially those with more open economies, Malaysia had been vulnerable to the recent international recession. As a result, real GDP growth had declined, and the current account deficit had widened, developments that had led, at least initially, to the adoption of countercyclical policies. More recent policies had been redirected toward greater restraint in demand management, particularly in the fiscal field. The result of the policy adjustment had been an encouraging improvement in economic performance in 1983 within a stronger external environment.

The staff had taken note of the authorities' substantial effort to tackle the growing fiscal deficits, which had been an area of concern in the previous Article IV consultation discussion, Mr. Finaish continued. A comprehensive review of expenditures focusing on ways to restrain operating expenditures and on reassessing development expenditure priorities had helped to reduce expenditure by 8 percent during 1983. Measures taken on the revenue side, including a doubling of sales tax rates, had increased total revenues by 9 percent; the net effect of the two sets of measures had been to reduce the overall deficit to 10 percent of GNP in 1983 from 17 percent in 1982. However, given the high government debt and the fact that expenditure was currently running at 40 percent of GNP, the authorities should work more vigorously to increase revenues--for example, through broadening the tax base--and reduce government expenditure in order to reach a sustainable fiscal position.

In view of the adverse impact on the overall fiscal adjustment of the recent increases in the expenditure of the nonfinancial public enterprises, particularly the off-budget agencies, the authorities should review the expenditure and investment policies of those agencies more carefully, Mr. Finaish considered. Toward that end, improvements in public finance statistics would help to ensure a clearer delineation and better control of public expenditures. It was thus encouraging to note from Mr. Jaafar's statement that further measures had recently been taken to reduce public sector expenditure and strengthen control over the OBAs.

Although the stance of montary policy was expected to remain restrained, Mr. Finaish continued, monetary expansion in 1984/85 was estimated to be higher than in 1983/84, with the expectation that the surge in private sector credit for property and real estate development would continue. A greater effort toward monetary restraint, which would improve the allocation of credit and its diversification, might therefore prove an important policy instrument for the future.

On the external side, Mr. Finaish remarked, although the current account deficit was expected to decline in 1984, future deficits were expected to be large and to be accompanied by a sharp rise in the debt service ratio. The authorities should therefore continue to pursue firm adjustment policies to enable the economy to return to the satisfactory growth rates of the 1970s. Such policies should include structural reform to correct the rigidities that had contributed to domestic and external imbalances.

Mr. Laske, commending the authorities for their management of the economy, noted that although Malaysia's current account position had improved since 1982, both in absolute size and in terms of the ratio of the current account deficit to GNP, the improvement had fallen short of the authorities' original objectives. Furthermore, although the budget deficit of the Federal Government had been reduced in absolute and relative terms in 1983, it remained uncomfortably large. Monetary growth was also accelerating rapidly, following a slowdown in 1983. Although Malaysia was unlikely to face an unsustainable balance of payments situation, its position could continue to deteriorate if no significant policy measures were taken to reduce the current account deficit. Malaysia had enjoyed an excellent credit rating and thus had been able to finance its external deficits through commercial borrowing. Its medium-term and long-term external debt, at just under 50 percent of GDP, was moderately high although not excessive. Unless the current account deficit were continually reduced, however, the external debt would increase rapidly, as indicated by the projections in Table 5 of the staff report; simultaneously, the debt service ratio would grow strongly, with damaging consequences for the economy.

The strain on Malaysia's balance of payments was largely attributable to the ambitious development and investment policies pursued since 1980, Mr. Laske remarked. The gap between domestic savings and investment had widened considerably in recent years, while Malaysia's exports had been adversely affected by the global recession. The authorities' valiant efforts to contain public expenditure, particularly investment, had had mixed results, mainly because a large part of public sector investment had been excluded from the budget but had nonetheless been financed from public resources, including foreign borrowing. Although the budget deficit had been reduced in the recent past, the broader public sector had continued, and was continuing, to expand, as evidenced by the 75 percent increase in investment expenditure by off-budget agencies estimated for 1984. He therefore strongly supported the staff's view that the public sector should be more comprehensively defined and that the OBAs should be brought under budgetary control.

The authorities appeared to have adopted a relatively loose monetary policy in recent years, despite unsatisfactory progress in correcting both the internal and external financial imbalances, Mr. Laske continued.

In fact, private sector credit expansion for unproductive purposes had been substantial, suggesting that, although interest rates on both borrowing and lending were positive in real terms, further increases might be justified to contain credit expansion and provide more incentives for saving. The nonbank financial institutions should also be brought under more stringent monetary control, since they were clearly contributing to credit and monetary expansion.

On the external side, Mr. Laske commended the authorities for having maintained a liberal exchange and trade system, and for having prudently managed the exchange rate. They had also preserved the competitiveness of export industries through a successful anti-inflationary policy; however, if wages were to rise too rapidly and inflationary pressures were to increase, exchange rate policy might have to be implemented more flexibly than in the past. Finally, he could support the provision of Fund technical assistance in improving Malaysia's statistics, which appeared inadequate in several areas.

Mr. Suraisry, noting that he was in full agreement with the staff's analysis and conclusions, considered that the Malaysian authorities had taken commendable measures in 1983 to correct the economic imbalances that had intensified between 1980 and 1982. The results of their efforts had been remarkable: economic growth had accelerated, inflation had slowed, the overall budget deficit had declined, and the current account of the balance of payments had improved. The authorities were to be congratulated for those achievements, which had laid the foundation for orderly adjustment. On the other hand, large imbalances remained, and a number of weaknesses had not yet been eliminated. The authorities were therefore determined to continue along the chosen adjustment path, which, although difficult, was better than any alternative course of action.

On fiscal policy, Mr. Suraisry observed, the authorities had been successful in the adjustment measures taken within the federal budget. However, the overall performance of the public sector had been adversely affected by the increase in imports of the off-budget agencies. The authorities were aware of the need for correction and intended to review the new projects of the off-budget agencies planned for 1984, a process that should continue in the future. It was reassuring to note from Mr. Jaafar's statement that a review committee had been established to address the problems of off-budget agencies. The fiscal deficit, projected at 12.8 percent of GNP for 1984, was still too high and would need to be further reduced if Malaysia were to achieve a viable external position. Perhaps what was needed was a lowering of expenditure on less essential projects, since neither revenue measures nor a depletion of reserves could ensure a reduction in the deficit.

On monetary matters, Mr. Suraisry agreed that a reduction in the growth of credit to the private sector by all financial institutions was necessary given the current economic imbalances, although credit to agriculture and manufacturing should not be affected. Credit restraint should be exercised primarily in the real estate sector, which currently absorbed more than one third of the credit provided by financial institutions; the emergence of excess supply in commercial property suggested that the real estate sector had too much access to credit.

The balance of payments outlook for 1984 and the medium term was not favorable, Mr. Suraisry remarked. The current account deficit was projected, under favorable assumptions concerning oil production and public sector investment, to reach about 5 percent of GNP in 1987, and an even higher figure if those assumptions proved invalid. Efforts to achieve adjustment in the external sector should therefore be strengthened.

Although the external debt was still manageable, it had increased sharply in the last three years, Mr. Suraisry observed, and it would thus be prudent to pursue more cautious policies. He endorsed the staff's view that the Malaysian economy was still strong enough, and the debt burden still small enough, to give the authorities an opportunity to modify public investment spending in order to facilitate external adjustment. In sum, although the imbalances in the Malaysian economy were still large, the authorities were making a serious effort to reduce them.

Mr. Clark considered that the Malaysian economy had performed well in a number of areas over the past few years. Since 1979, real growth had averaged 7 percent and inflation only 6 percent, an enviable performance by most standards. However, in 1981 and 1982, that good performance had owed much to an expansionary fiscal policy, which had resulted in large fiscal and current account deficits financed by substantial recourse to foreign borrowing. The authorities had more recently made an encouraging start in tackling those imbalances; particularly notable was their achievement in reducing federal expenditure in relation to GDP by 7 percentage points in 1983, although the fiscal deficit remained high and was projected to rise slightly as a proportion of GDP in 1984. Given that the deficit did not comprehend a number of financial public enterprises, including substantial expenditures by off-budget agencies, he could endorse the staff's recommendation that central control over the whole of the public sector should be improved to ensure that its activities were consistent with the objectives of fiscal and development policy in general and that a lasting reduction in the current account deficit was to be achieved. The further steps toward that end outlined in Mr. Jaafar's statement were welcome.

On the revenue side, Mr. Clark said, he shared the staff's concern about the overdependence of the tax system on receipts from the petroleum sector, and he encouraged the authorities to consider broadening the tax base. Although the tax burden was heavy relative to that of neighboring countries, it should be seen against Malaysia's level of spending. Besides, the revenue positions of some of Malaysia's neighbors were also in need of strengthening.

The expansion of commercial bank lending to the property sector was worrying, Mr. Clark continued, and the staff's suggestion that undrawn commitments should be included in the capital-to-risk asset ratio would thus be a useful complement to moral suasion. He would appreciate elaboration by the staff on the reasons for the apparent fall of 25 percent in the velocity of broad money between 1979 and 1984.

The removal of the petroleum subsidies in January 1984 was welcome and should serve not only to bolster the fiscal position but also to encourage domestic conservation of petroleum, thereby improving the current account, Mr. Clark concluded. On another matter, the buildup of external debt over the past year had been substantial, and the increase in debt service payments had had a notable impact on both government expenditure and the current account. The further increase in the debt and debt service ratios projected for the remainder of the decade was a source of concern and underlined the need to reduce the domestic imbalances leading to the accumulation of external debt. Finally, as noted by Mr. Laske, there appeared to be no data on short-term debt incurred by the nonbank sector. Experience in other countries suggested that the ability to gather data on short-term debt was important, and he therefore encouraged the authorities to focus on the problem when setting priorities for statistical improvement.

Mr. Tregilgas observed that there had been several encouraging features in Malaysia's economic performance following substantial expenditure cutbacks by the Federal Government in 1983. Among the most notable of those features were the growth in real GNP of 6 percent, compared with only 3 percent growth in 1982, and the decline in the domestic inflation rate from 6 percent in 1982 to 4 percent in 1983, as measured by movements in the consumer price index.

There were, however, some worrying aspects to Malaysia's economic performance, Mr. Tregilgas continued. In particular, the overall budget deficit had remained high at 10 percent of GNP in 1983 and was expected to increase in 1984, although it would remain lower than the 17 percent registered in 1982. The current account deficit also remained high, at just over 10 percent of GNP in 1983, although it too had narrowed slightly from its 1982 level. Since neither of the deficits was sustainable, the authorities must intensify their adjustment efforts. In particular, they should remedy the problems posed by the rapid increase in investment planned by nonfinancial public enterprises, particularly the off-budget agencies. They should also give the highest priority to reviewing the investment projects of public entities currently outside the federal government budget and to implementing projects with a relatively short gestation period and high economic return.

Current levels of external debt and debt servicing were of less immediate concern, Mr. Tregilgas observed, but were nonetheless indicative of the urgent need to strengthen domestic and external adjustment policies. Even if measures to reduce the broad public sector deficit were implemented, it was possible, according to the medium-term projections, that, by 1987, outstanding medium-term and long-term external debt could rise to 60 percent of GNP, compared with 48 percent in 1983, and that debt service could increase to 17 percent of exports, compared with 9 percent in 1983.

The projections were clearly a cause for concern, although it was reassuring that the Malaysian authorities recognized the problem and were strongly committed to effective fiscal and external adjustment. The authorities were to be commended for their declaration that the primary objective of economic policy in 1984 and 1985 was the reduction of those domestic and external imbalances.

The strong fiscal adjustments proposed for 1984 and 1985 would require the implementation of highly stringent measures, Mr. Tregilgas continued, since they aimed to reduce the overall budget deficit to about 6 percent of GNP in 1985, primarily through expenditure reduction. In effect, the Malaysian authorities would be taking austerity measures resembling those under a stand-by arrangement, without the benefit of such an arrangement with the Fund. He would be interested in hearing from Mr. Jaafar whether the authorities were contemplating requesting such an arrangement to support their adjustment efforts.

Mr. Malhotra observed that the Malaysian authorities had been successful in substantially reducing the fiscal deficit, from 17 percent to about 10 percent of GNP in 1983, by cutting expenditure by 8 percent and ensuring revenue growth of 9 percent. At the same time, a new tax package had been introduced, and several subsidies had been reduced. The shrinking fiscal deficit had been accompanied moreover by a steady decline in the rate of inflation, from 9.6 percent in 1981 to 5.8 percent in 1982 and to as low as 3.7 percent in 1983, a remarkable achievement for which the authorities should be commended.

Despite improvements, the overall budget deficit was still high, indicating that adjustment measures should be continued, Mr. Malhotra said. The persistence of large imbalances between investment and gross domestic savings demanded external commercial borrowing, which put considerable strain on Malaysia's debt servicing capacity, although the debt service ratio was not yet high. Moreover, the Malaysian economy was strong, and, as observed by Mr. Jaafar, possessed the necessary resilience and rich resource base to overcome its present and prospective difficulties.

Any consideration of necessary adjustment measures should take place against the background of Malaysia's economic strength and its fine record of growth with price stability, Mr. Malhotra commented. The monitoring and evaluation of investment programs should be extended to the off-budget agencies as a crucial step toward bringing the level of investment in line with available resources. It was encouraging that the authorities had already set up a committee to address that issue.

With limited scope for greater mobilization of revenue, the restoration of financial balance depended crucially on expenditure reduction, Mr. Malhotra continued. The 75 percent increase in the expenditures of the off-budget agencies estimated for 1984 was, in that respect, a cause for concern. Still, the authorities should proceed with caution to avoid a panic reaction that could damage the economy's medium-term prospects. Ideally, there should be a hold on new projects and a slowdown in those recently undertaken; but projects involving large pre-existing commitments should be implemented, since retrenchment could cause disruptions and inflate future costs.

Monetary expansion in Malaysia had slowed, Mr. Malhotra remarked. However, it was expected to accelerate somewhat in the future, and the authorities were rightly committed to a restrained approach to monetary policy. Credit had been too much concentrated in the real estate sector, which was highly import intensive. While that situation needed correction, he disagreed with the staff that an increase in interest rates would be appropriate; inflation at present was at only 4 percent, deposit rates were at about 8-9 percent, and lending rates were also positive. Even assuming that an increase was called for, it was not clear whether the authorities could actually raise the rates, since the banks appeared to operate autonomously. In his view, the technical study commissioned by the authorities would have to make a very strong case for increasing interest rates further before any action toward that end was taken.

The staff had estimated a current account deficit of 8 percent of GNP in 1984, while Mr. Jaafar expected a somewhat smaller deficit equivalent to 6.5-7 percent of GNP, Mr. Malhotra observed. The exchange rate appeared to be appropriate, and the authorities were committed to pursuing the exchange rate flexibility necessary for an open economy. The major external account problem related to the debt. Although the debt service ratio appeared manageable at 17 percent of export receipts, the rapid rate of debt accumulation was clearly unsustainable. Malaysia should refrain from acquiring new debt to avoid any loss of creditworthiness in international financial markets. Other large deficits included those on the invisibles account, which were not solely due to the debt servicing, and also on the shipping, insurance, and payments to contractors accounts.

On structural problems, Mr. Malhotra noted, Malaysia's industrial base was small and manufactured exports were highly import intensive. The real estate and construction industries were also import intensive. Clearly, investment priorities needed to be restructured to augment the use of domestic resources, manpower, and entrepreneurship.

Mr. Salehkhou considered that Malaysia's economic performance in 1983 had been satisfactory, mainly because of intensified adjustment policies and a significant improvement in the terms of trade, in marked contrast to the deteriorating trend that had paralleled the prolonged international recession since 1980.

Real economic growth had shown particularly good progress, increasing to 5.8 percent in 1983 despite substantial cutbacks in development expenditures implemented by the Federal Government, Mr. Salehkhou continued. Malaysia had also succeeded in reducing domestic inflation to below 4 percent and in significantly curtailing deficits both in the public sector and in the external current account. However, domestic and external imbalances persisted, mainly as a result of a strong expansion of the public sector between 1979 and 1982, which had enabled Malaysia to withstand the adverse impact of the world economic recession and to achieve relatively high rates of real growth. There had also been a rapid accumulation of external debt, which had reduced the authorities' room for maneuver in the medium term.

In broad agreement with the staff analysis of Malaysia's policies and prospects for 1984 and the medium term, Mr. Salehkhou observed that oil production from existing oil fields had been raised to the maximum sustainable level, and domestic consumption of oil products was rising. Furthermore, oil exploration efforts had recently fallen off; he thus welcomed the authorities' decision to review incentives so as to encourage more exploration. Perhaps the review should be extended to cover oil conservation and the reduction of production costs as well.

On the fiscal side, Mr. Salehkhou remarked, there was a need for further reductions in the public sector deficit and for a strengthening of public sector non-oil revenues. Because the authorities' adjustment efforts had excluded investment by off-budget agencies, the overall deficit had remained high in 1983. Their decision to eliminate all subsidies on domestic sales of petroleum products and to review all public sector investment expenditures was appropriate and should help to curtail the fiscal deficit in 1984; however, the burden of fiscal adjustment should be more adequately distributed between expenditure cutbacks and revenue-raising measures. The authorities themselves recognized that there was scope for broadening the tax base in Malaysia; although the tax rate was already higher than in neighboring countries, a strengthening of the base would permit lower cutbacks in development expenditures and would allow the maintenance of an appropriate level of real growth.

The authorities appeared well aware of the need to maintain a restrictive credit policy to keep inflation down, Mr. Salehkhou concluded. Their efforts to reduce the fiscal deficit further should moderate the growth of domestic demand while partially accommodating the private sector's credit needs. At the same time, the authorities should show more concern for the rapid accumulation of external debt than for the high external current account deficit. Indeed, although the trade account was projected to improve steadily over the medium term and to register a surplus equivalent to 8 percent of GNP by 1988, that improvement would not be reflected in the current account, primarily because of the sharp rise in interest payments. Although the ratio of debt service to exports would remain manageable, the staff's medium-term projections indicated the need for caution with respect to external borrowing and balance of payments policies, especially since the projections were based on the assumption that fiscal and external adjustment would be strengthened throughout the period to 1988. The authorities' intention to continue with the current adjustment program was therefore encouraging.

Mr. Chen, noting his broad agreement with the staff appraisal, commented that, in the period 1980-82, the Malaysian authorities had sought to offset the effects of the international recession by boosting domestic demand regardless of weaknesses in the international markets.

As evident from Table 1 on page 20 of the staff report, the rate of increase of domestic demand had continued to outstrip the rate of real GDP growth, and the value of merchandise imports in 1982 had surpassed the value of merchandise exports for the first time in years. Consequently, the government deficit had increased substantially,and the current account had moved from persistent surplus to large deficit. Clearly, the situation had been unsustainable, and in mid-1982 the authorities had initiated adjustment.

The results of the adjustment in 1983 had been largely satisfactory, resulting in a rate of increase of domestic demand consistent with the increase in real GDP growth, Mr. Chen continued. Particularly striking had been the sharp reduction in the government deficit, from 17 percent to 10 percent of GDP, together with a significant curtailment in both broad money and domestic credit expansion. The value of merchandise exports once again had exceeded that of imports, and the trade surplus was expected to grow further in 1984. The reduction in the current account deficit had been less than projected, primarily owing to increases in debt service, but domestic inflation, in terms of consumer prices, had declined to less than 4 percent. The achievements were noteworthy, particularly since they had been accompanied by growth in real GNP, demonstrating the determination and effectiveness of the authorities in pursuing their adjustment program.

The area of immediate concern appeared to be the heavy investment spending of the off-budget agencies, Mr. Chen remarked. As shown by Chart 3 on page 2(c) of the staff report, the sole contributor to the growth in broad money in 1983 had been credit to the private sector--particularly to the off-budget agencies--which had more than offset the decline in other credit demands. Such spending was planned to rise still further in 1984 and could undermine the authorities' intention to reduce the twin deficits of the broad public sector and the current account. Given the large resource gap between investment and domestic savings and the prospect of a rising debt burden, early action against the planned increase in expenditure was important, although restructuring should be implemented carefully so as not to cause abrupt dislocation. He was glad to note from Mr. Jaafar's statement that the Malaysian authorities were taking effective measures to address the problem. Finally, on interest rate policy, he endorsed Mr. Malhotra's point that there appeared to be no reason for increasing interest rates further in Malaysia.

Mr. Pickering took note of the authorities' deep concern at the increase in the savings/investment resource gap and welcomed the recent measures to ameliorate the problem. The reduction in the fiscal deficit in 1983 was noteworthy, although much of the progress made had unfortunately been offset by the continued high expenditure of the off-budget agencies. The share of interest costs in government expenditure was particularly worrying, since it had more than doubled since 1980. Despite heightened awareness of the fiscal problem, the overall government deficit was expected to increase slightly as a percentage of GNP in 1984. The authorities should therefore implement further expenditure reducing measures as soon as possible and, in view of the current difficulties in increasing revenues as a share of GNP, they should broaden the tax base and reduce its heavy dependence on the petroleum sector.

The expenditures of the off-budget agencies should be reappraised and substantially reduced, Mr. Pickering continued. The authorities' plan to set up a review committee to address the problems of the OBAs was welcome, although further steps to improve statistical information on OBA activities, to gain more direct federal government control over their expenditures, and to make OBA reform the centerpiece of the next five-year plan were warranted. Emphasis might also be given to shortening the average "gestation" period of OBA investments and to reducing their capital intensity.

The wage costs of the Government were expected to increase by 14 percent in 1984, Mr. Pickering noted, reflecting in part an increase in the number of employees. He would appreciate hearing from the staff or Mr. Jaafar whether wage increases per employee were expected to be large.

Both the authorities and the staff seemed to agree that monetary policy should be strengthened in 1984, given the rapid expansion in credit to the private sector in 1983 and 1984, Mr. Pickering commented. However, the authorities had not clearly specified the means by which a tighter monetary policy was to be implemented. Unlike Mr. Malhotra, he believed that interest rates should be increased in order to improve savings rates; furthermore, the credit expansion of finance companies and merchant banks should be limited. Finally, although the burden of Malaysia's external debt was not yet onerous, the authorities should take the opportunity to reduce and reorient the public sector in an orderly manner.

The staff representative from the Asian Department recalled that several Directors had noted a broad convergence of views among government officials, the authorities, and the staff concerning the analysis of the current situation in Malaysia and the areas in which policy adjustment could contribute to more durable growth and external stability. Except perhaps at the highest political levels, there was agreement that, if Malaysia were to act in a persistent, strong, decisive manner over the next one to three years, the most costly and painful aspects of external adjustment could be avoided.

Recent action by the Malaysian authorities to extend and improve statistics covering activities of the public sector should facilitate the Government's decision making on policy issues, the staff representative continued. However, the necessity for such steps highlighted one of the major reasons for the current problems. A great deal of public sector investment since 1980 had been initiated in a manner not always consistent with a comprehensive economic strategy, and the result had been a wide range of investment expenditures of doubtful productivity. The staff, believing that the lack of effective and cohesive machinery for assessing project priorities had contributed to that pattern of public expenditure, was recommending that the authorities move toward projects with a higher rate of return and a lower gestation period. That matter had not been given extensive coverage in the report, since it was difficult to describe comprehensively many of the projects and their likely economic returns. However, one development in the electric power industry had been striking, in that, by the end of 1984, installed capacity would be about double the required capacity owing to the excessive investment expenditure over the past three years; Malaysia would thus possess surplus generating capacity until the end of the decade. Other similar examples existed, but neither the staff nor the Malaysian authorities were in a position to elaborate on them. He hoped that Malaysia's Fifth Five-Year Plan would contain a more comprehensive analysis of the economic efficiency of public sector investment, which was at the root of Malaysia's problems.

Construction activity in Malaysia had a surprisingly high import content of over 50 percent, a fact that underlay the desire to accelerate activity, the staff representative noted. The construction industry depended heavily upon foreign expertise, skills, and contractors, and it used the most advanced and expensive technology, imported from other parts of Asia.

The staff supported the establishment of a review commmittee to address the problems relating to the off-budget agencies, as described in Mr. Jaafar's statement, the staff representative said. That action was a necessary but not sufficient condition for reducing the domestic and external imbalances; still, the end result should be improved decision making and economic efficiency in the public sector.

He found it difficult to give an adequate answer to Mr. Polak's query about why it had taken so long to address the problems, given the apparent ease in reaching a consensus, the staff representative remarked. Consensus at high political levels could not always be achieved as rapidly as at a lower, more technical, level; still, he was optimistic that progress would be made in the coming year in addressing the problems. Several deficiencies in Malaysia's macroeconomic statistics had been identified, including all aspects of the measurement of expenditure and performance in the public sector. Statistics on labor costs and wage rates were also deficient, thereby complicating the assessment of trends in competitiveness and the appropriateness of the exchange rate policy. The staff's concerns about those deficiencies were shared by the Malaysian authorities, so that those problems would surely be rectified in the future. The discussions with the Malaysian authorities regarding a more comprehensive examination of interest rates--their levels and the policies and mechanisms influencing them--should be undertaken later in the year as part of the effort to update work done ten years previously by a staff team.

Commenting on a question by Mr. Pickering, the staff representative said that, as he understood it, there was no plan for a general wage increase, although the normal progression in the structure of public service salaries, merit increases and promotions would result in an increase in the wage bill per employee of some 7 percent. That increase was only slightly above the rate of inflation and was below the rate of wage increase in the private sector. The remainder of the increase in the wage and salary bill reflected the broadening of services, the staffing of health and education facilities, and the transfer to the Federal Government of some functions currently executed by the states and localities.

The decline in the velocity of broad money over the past four years was principally attributable to the long record of price stability in Malaysia vis-à-vis the rest of the world, the staff representative noted. Thus, since inflation had fallen after 1979, interest rates had remained appropriately high to attract savings into the banking system, and income growth had been quite rapid.

Malaysia was an open economy, with a minimum of controls on trade and payments and an almost totally open financial market with Singapore, the staff representative from the Asian Department oberved. Given the important financial flows between the markets of Southeast Asia, interest rates in neighboring and international markets, as well as the domestic inflation rate, should be taken as guidelines in Malaysia for the determination of interest rate policies. In order to restrain the rate of credit expansion in the private sector and to reflect interest rate developments in international markets, Malaysia should be guided by broader considerations than merely whether or not domestic interest rates were positive in real terms. Concern had been expressed in the Annual Report of the Bank Negara Malaysia that property investment was "soft investment" of relatively low priority and economic efficiency and had contributed greatly to the burden on the balance of payments. Therefore, there was no reason to believe that the present real rates of interest had acted as a deterrent to financially attractive investment. Moreover, Malaysia followed certain political priorities in the pursuit of an open economy and was dependent upon prices to determine the allocation of resources; interest rates, which should be regarded as among those prices, could not be set independently from other financial markets.

Mr. Templeman asked the staff to comment on the exchange rate, which he found difficult to believe was in equilibrium, given the size of the current account deficit. The staff had used a period in the mid-1970s to justify its argument that the exchange rate was appropriate, an argument that he did not find persuasive.

The staff representative from the Asian Department observed that the mid-1970s had been used as a base period, in which the external accounts and domestic resource supply and use appeared to have been broadly in balance, in order to construct an effective exchange rate index. The staff believed that the current disequilibrium in the Malaysian economy stemmed not from the exchange rate level but from the public expenditure policy, which was relatively insensitive to prices, including the price of foreign exchange. To rectify the economic imbalances, the Malaysian authorities must therefore deal with the large imbalance in the public sector, including the investment demand in the OBAs. Altering the exchange rate alone would not solve the external problem.

An effective exchange rate index that considered only consumer prices might not properly reflect developments in competitiveness, the staff representative continued. Wage increases in the private sector appeared, on very imperfect data, to be higher than the rise in the cost of living. For that reason, the staff had stressed to the authorities that the lack of information on wage developments was an important limitation in the assessment of developments in competitiveness. Thus, the staff had seen the small strengthening of the price-adjusted effective exchange rate index as reflecting a movement of the exchange rate in the wrong direction. However, that did not imply that either the cause or solution of Malaysia's external imbalances could be found in the area of exchange rate policy.

Mr. Malhotra remarked that there had been no mention in the staff report of competitive interest rates in the Singapore market, nor any indication of a substantial flow of savings from Malaysia into Singapore owing to differentials in deposit rates. As a result, he was unsure of the magnitudes and interest differentials involved that would justify the recommendation for higher interest rates. Current real lending rates in Malaysia were as high as 6-7 percent, a level that would normally cause complaint. In the absence of complaints, he wondered whether there were major leakages in the form of savings from the Malaysian economy to the Singapore economy.

The staff representative from the Asian Department said that the large negative "errors and omissions" item in the balance of payments indicated that there were some unidentifiable leakages. However, on a more fundamental level, it was difficult to assess real interest rates in isolation from events in the rest of the economy. In Malaysia, resource absorption greatly exceeded output; the cause of that problem was not primarily interest rates, but rather low economic efficiency and high public sector investment. It appeared that, even in the private sector, investment might be financially attractive but not necessarily economically efficient, a view endorsed by the Malaysian authorities in the Annual Report of Bank Negara. Interest rates should be judged in the context of identifiable resource imbalances; the sizable negative "errors and omissions" item was attributed by the authorities to unidentified transactions with Singapore. That theme was also reflected in the Bank Negara's Annual Report, which referred to the slowing of growth in bank deposits and the reduction in the national savings ratio. Those broad considerations supported the view that an early and gradual increase in interest rates was preferable to inaction, which could lead to an exacerbation of imbalances and therefore to more costly adjustment in the future.

Mr. Jaafar considered that Malaysia had emerged from the deepest world recession since its independence in 1957 facing problems which were not unmanageable. He was optimistic that, if the international recovery were sustained, Malaysia would resolve those problems with little difficulty, since the economy had an adequate resource base and a competitive and open market. Of course, necessary corrective action should be continued along the lines of that taken in 1983, when expenditure had been cut to reduce the budget deficit to M$6.6 billion, or 10 percent of GNP, a clear improvement from the deficit of 1982. Of course, such substantial rephasing of public investment created practical problems, including, in particular, sacrifices in economic development. The austerity measures instituted by the Government would be continued in the remaining year of the Fourth National Plan up to 1985, but the authorities were committed to implementing in full the priority programs aimed at attacking poverty, particularly those designed to assist small landholders, paddy farmers, fishermen, essential workers, and the urban poor. Moreover, projects in advanced stages of implementation, where contractual obligations had already been made, income-generating projects, and projects contributing to the balance of payments would also be continued; projects with long gestation periods and a high import content would be rescheduled or postponed, as would ongoing lower-priority projects.

The key to success in the external sector was finding a solution to the problem of broad public sector expenditure, Mr. Jaafar commented. Leakages from the federal budget into off-budget agencies' activities had already been addressed; he was confident, given the authorities' record of sound economic management, that the necessary measures would be enforced once the various control mechanisms had been instituted. The vitality of the external sector should not be underestimated. Although a more diversified production base was desirable, past policies aimed at diversification had been successful, particularly in the agricultural sector, which still contributed to 23 percent of GDP and 35 percent of export earnings, while absorbing 40 percent of manpower. Many export commodities remained competitive; some, like natural rubber and tin, had not been badly depressed, although the former had not recovered as projected. Palm oil, on the other hand, had recovered markedly during 1983/84, and he expected a greater reduction in the current account deficit than had been estimated in the staff report. In general, the authorities were expecting a turnaround as the economies of the United States and of other countries in the OECD began a stronger recovery. Problems in exports did not lie so much with Malaysia as with the world economy in general. In particular, the manufacturing sector would be able to recover rapidly if it were not for growing protectionism. Another area of concern was high interest rates, which, if maintained, could threaten global recovery and worsen Malaysia's debt obligations.

Malaysia's tax-to-GDP ratio of 28 percent from 1980 to 1984 was considered high by comparison with ratios in neighboring countries, Mr. Jaafar said. Still, there remained scope for increasing revenues. Tax increases of more than 10 percent in 1983 had been reflected in both higher income tax receipts, by about 21 percent, and larger indirect taxes, which had increased by 22 percent. Similar increases were expected for 1984. The petroleum sector had made a substantial contribution to revenue. He had taken note of the remarks by those Executive Directors who felt that Malaysia was overdependent on the oil sector. Still, the revenue was there, and the authorities should take advantage of it, particularly since latest estimates indicated that a higher output of petroleum could be achieved in 1984; an extra 2,000 barrels per day were expected. Furthermore, the prospects over the next two or three years could be significantly better than suggested by the staff and could lead to a need for changes in revenue and current account projections. However, such developments did not preclude the need to cut expenditure, a point accepted by the authorities.

A reduction of the current account deficit to 5 percent of GNP in the medium term was within reach, Mr. Jaafar considered, although it was obviously subject to uncertainty. Once the grace period expired, debt servicing would increase over the medium term, although much would depend on actions taken by other countries to bring down their interest rates. Furthermore, if the global recovery proved durable, the export performance of commodities other than petroleum--including manufactured goods--should improve. As for the price of oil, the Malaysian authorities were more optimistic than the staff; a high price for oil would act as an additional bonus for the Malaysian economy. In view of the budget and current account deficits, it was important to note that the ratio of private savings to GNP between 1976 and 1980 had been about 22 percent, although the savings had derived in part from captive sources, with an average overall growth in national savings of 29-30 percent over the period, compared with 24 percent in 1983.

With regard to the interest rate, Mr. Jaafar noted, the 12-month deposit rate was 7.5-9.5 percent. The average lending rate in 1983 had been 11.6 percent, while the inflation rate had been only 3.7 percent. He took note of the comments on the interest rate by the staff representative from the Asian Department, and hoped that the planned study would provide more comprehensive answers to the questions raised. He also noted the concern expressed over the contribution of the interest rate to excess demand in the construction sector, especially in housing. Finally, the Malaysian authorities had no intention at present of requesting a stand-by arrangement with the Fund, since all steps necessary for economic recovery had been taken. However, such a request might be considered if the international environment were to worsen.

The Chairman made the following summing up:

> Executive Directors generally agreed with the thrust of the staff's views in the report for the 1984 Article IV consultation with Malaysia. Directors welcomed the reductions in domestic and external imbalances during 1983, which had followed a marked widening in previous years, and commended the Malaysian authorities for the substantial strengthening of their adjustment efforts, which had contributed significantly to the improved economic performance in 1983. Directors commented favorably on the further fall in domestic inflation and the rebound in real economic growth from the recession-induced slowdown in the previous two years.

Directors noted the significant curtailment in federal expenditures during 1983, which had helped to reduce the fiscal deficit and to moderate strains on the balance of payments. In view of the still relatively large overall deficit, which had been rising rapidly in recent years--from 3.4 percent of GNP in 1979 to 10 percent in 1983--Directors urged persistent and strong efforts over coming years to restrain government expenditures and to broaden the tax base and increase tax revenues. With regard to developments in the broader public sector, Directors noted the limited success in restraining expenditures by nonfinancial public enterprises during 1983, contributing to the smaller than expected external adjustment. Directors expressed concern about the sharp further increase in investment spending by those agencies planned for 1984, pointing to the tentative but disquieting estimates of a rise of 75 percent in investment by 13 off-budget agencies in 1984. They considered it crucial that the authorities rein in the expansionary plans of public sector enterprises. Directors were in agreement with the staff's view that investment priorities for major off-budget agencies should be assessed periodically, taking into account domestic and external resource constraints. In this connection, they stressed the importance of implementing a comprehensive review and reassessment of project priorities in view of the weak external outlook and large borrowing requirements. Directors welcomed the steps taken recently to formulate a consistent and comprehensive classification of public sector entities and to adjust economic and financial statistics accordingly.

Directors observed that monetary growth slowed further during 1983, reflecting the decline in net foreign assets and credit to the government sector. However, they expressed caution about the relatively rapid expansion in credit to the private sector. While recognizing the need in early 1983 to support recovery in the private sector, Directors were in general agreement with the staff's view that credit policy should now assume a more active role in restraining domestic absorption. Several Directors also supported the staff's view encouraging a more flexible approach to interest rate policy, noting the declining trend in the national saving rate, the slowdown in the growth of bank deposits, and the recent rise in interest rates in international markets, which is of relevance for an open economy like Malaysia's.

Directors expressed concern about the balance of payments prospects in 1984 and over the medium term, given the rapid increases in external debt, which had risen from 19.5 percent to 48.4 percent of GNP from 1979 to 1983, and the debt service burden. They noted that the projected outlook included further rephasing of the public sector investment program and nearly maximum use of available oil resources over coming years. They felt that an intensification of adjustment efforts beyond those envisaged in the medium-term outlook would be important to restore a sustainable external payments position and allow some room for maneuver in case of unforeseen adverse developments. In this context, Directors urged further efforts to reduce and reorient public sector investment expenditure, giving greater priority to investments with a relatively shorter gestation period and lower capital intensity. Also, they encouraged a more active and flexible use of exchange rate policy to maintain export competitiveness and support external adjustment.

In sum, Executive Directors urged the authorities to take advantage of the currently manageable debt service burden to implement significant and persistent measures to reduce fiscal and external imbalances, so as to reduce the excess of domestic resource use in relation to output and to avoid serious external financing problems in the future. If such action were not taken, the continuation of the present policy stance was likely to contribute to severe external adjustment problems toward the end of the decade. Executive Directors thus urged the authorities to act early and vigorously to reduce the present imbalances.

It is expected that the next Article IV consultation with Malaysia will be held on the standard 12-month cycle.

2. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1984

The Executive Directors considered a staff paper on the assessment of and prospects for international capital markets (SM/84/134, 6/13/84). They also had before them a paper on recent developments in international capital markets (SM/84/144, 6/25/84).

Mr. Ramtoolah noted the staff's emphasis on economic adjustment as a prerequisite for banks to increase capital flows to a country. He agreed that external borrowing alone could not correct external economic imbalances, and that adjustment had to occur sooner rather than later. Non-oil developing countries in general, and African countries in particular, were undertaking adjustment programs on an unprecedented scale. As a result, the aggregate current account deficit of the non-oil developing countries was expected to decline from a peak of $109 billion in 1981 to $50 billion in 1984, the lowest figure since 1978, mainly through a massive reduction in imports. Similarly, the deficit of African countries (excluding South Africa) was expected to decline from $14 billion in 1981 to $9.5 billion in 1984, also the lowest figure since 1978.

Unfortunately, despite the adjustment effort, African countries were continuing to experience a decline in their access to bank loans, Mr. Ramtoolah remarked. It appeared that the adjustment/financing process was being superseded by the so-called "contagion effect." In addition, it was a source of concern for developing countries generally that the United States had changed from being a net supplier of funds of $34 billion in 1982 to being a net absorber in 1983 of $8 billion, a figure likely to increase substantially in the next two years.

Positive developments in the international capital markets included a lengthening of maturities for both restructuring and for new lending, and an extension of the grace period, Mr. Ramtoolah noted. In addition, a new pattern of relationships between debtors and creditors appeared to be evolving, with the banks maintaining almost permanent contact with the debtor countries in order to monitor their policies more closely. A forward-looking approach to debt restructuring could contribute significantly to more favorable conditions in the financial markets.

He agreed with the staff's recommendation that developing countries should seek ways of increasing longer-term capital flows, Mr. Ramtoolah said, although the source of such funds was not clear at a time when the most concessionary arm of the World Bank, the International Development Association, had been forced to scale down its activities, owing to the policies of some of its major contributors. Furthermore, the World Economic Outlook had forecast that net foreign direct investment to non-oil developing countries would rise only slowly in the next few years, remaining below previous levels. Developing countries therefore had only limited room for maneuver.

Remarking on prospects for the international capital markets, Mr. Ramtoolah took note of the staff statement on page 9 of SM/84/134 which said that high interest rates had deterred banks from resuming and sustaining their lending to certain developing countries. Clearly, the single greatest threat to the system was the unbearably high level of real interest rates. Further increases would not only crowd out non-oil developing countries from the market--where their presence was already shrinking--but also increase the vulnerability of their economies and jeopardize existing gains at high social cost. He therefore strongly endorsed the staff's recommendation on page 4 of SM/84/134 that "policy actions in member countries should contribute to restraining the rise in real interest rates and, over time, reducing them closer to historic levels."

Overall, his authorities were not optimistic about the evolution of, and prospects for, international capital markets, Mr. Ramtoolah remarked. Although the re-examination of recent rescheduling of external debt--including the length of the consolidation period by private banks through the Institute of International Finance--was a positive development, the effects of high and increasing interest rates and of unjustified movements in foreign currencies on already vulnerable economies like those in his constituency were cause for increasing concern.

Mr. Lovato observed that the staff papers on international capital markets offered the usual, detailed description of current trends in world capital markets, and he therefore saw no reason to deviate from the established policy of publishing the survey as an occasional paper. Movements in the world capital markets in 1983 reflected the incipient economic recovery in the industrial world, the high interest rates and the uncertainty surrounding them, and the decreasing confidence of the financial community in the solvency of several heavily indebted countries. As expected, flows of funds and credit conditions had been dampened by the restrictive global stance of monetary policy in major countries, while different classes of borrowers were offered different access to those funds. Overall flows of bank lending had diminished in 1983, although flows to industrial countries had increased during the second half of the year, owing to the recovery of the U.S. economy and increased activity by U.S. banks. High interest rates and buoyancy in the bond market had contributed to a curtailment in the flow of new deposits to international banks and in the flow of direct investment to developing countries. The proportion of resources passing through the international banking system had diminished in favor of the bond market, where the trend toward financial indexation reflected the high degree of uncertainty concerning interest rates.

Two positive features were evident in recent developments, Mr. Lovato considered: the tendency toward a strengthening of the balance sheet structure of international banks, revealed by recent trends in both liquidity and capital ratios; and the dramatic process of readjustment and improvement in financial discipline in many developing countries. Both points had been correctly emphasized in the staff report. In addition, banks were tending to engage in project-related financing rather than in loans to cover balance of payments deficits, a development that should increase the ability of banks generally to assess creditworthiness, thereby contributing to the overall stability of the system. The recently enhanced role of the Fund in assessing the adequacy of financial programs should continue to be a key element in assuring the success of balance of payments financing.

On the adjustment efforts of developing countries, Mr. Lovato remarked, two related aspects should be considered. First, each indebted country faced its own specific imbalances, requiring a case-by-case approach to debt restructuring; second, conditionality was crucial to ensure maximum efficiency in addressing each country's situation. There was a growing awareness of the multilateral aspects of the debt problem and, in particular, of the repercussions of the economic policies of the industrial world on the economic environment which debtor countries were attempting to adjust. The recent escalation of interest rates in the United States had created new difficulties, acting as a reminder that the debt problem could not be considered on a purely bilateral basis. He endorsed the Managing Director's recent public affirmation of the connection between the industrial countries' policies and the debt problem.

The medium-term outlook for the capital markets, and its compatibility with the World Economic Outlook, were less than satisfactory, Mr. Lovato continued. In recent discussions of the World Economic Outlook, it had been assumed that the exposure of international banks vis-à-vis non-oil developing countries would increase at a rate of 6-7 percent annually until the end of the decade. However, some Directors had questioned whether that new flow of bank credit would actually materialize. He had expected the staff to justify its assumptions by giving projections of banks' assets and liabilities, of financing flows through the bond market and of direct investment for the period covered by the World Economic Outlook projections. Unfortunately, the staff had made no attempt to explore the medium-term prospects for such flows, and the questions recently raised in the Board remained unanswered.

A particularly crucial issue, Mr. Lovato considered, was whether the projected development in bank lending to developing countries was compatible with the growth of the resources intermediated by the banking system. Since banks' exposure in developing countries was likely to decrease relative to the stock of international loans through 1990, and the share of international loans relative to total assets was projected to decline, the implied growth in bank deposits should be substantially greater than the figure of 6-7 percent mentioned in the World Economic Outlook papers. It would be interesting to explore the relationship between bank deposits and interest rates from historical perspectives as a guide to the outcomes that might reasonably be expected in the future.

Another crucial issue was whether the projected growth of direct foreign investment was compatible with future developments in the capital markets, Mr. Lovato said. A forthcoming staff paper on direct investment flows indicated, under conservative assumptions, an annual real increase of 5 percent until 1990; however, that forecast did not appear consistent with prospective capital market developments. For example, direct investment flows were sensitive to the effect of real interest rates on international financial assets, although the response was lagged. It would be interesting to examine the compatibility of the forecasts for direct investment with the projected stance of financial policies in the major industrial countries and the consequent flow of funds toward the banking system.

Finally, if the staff wanted its report on international capital markets to be a more effective complement to the World Economic Outlook, it should expand the report to examine those factors treated as exogenous in the World Economic Outlook, Mr. Lovato observed. Such a broadening of perspective would enhance the Fund's policymaking abilities and the quality of the signals that it transmitted to the international financial community.

Mr. Polak noted that the staff report on international capital markets had properly focused on the credit flows to the non-oil developing countries. While he would have welcomed somewhat more detailed considerations of capital flows to the smaller OECD countries, he recognized that capital flows between developed countries was too broad a subject for the paper under discussion.

He agreed with the staff that the rise in interest rates could undermine the recent improvement in international financial confidence, Mr. Polak remarked. Not only did high international interest rates deter the banks from lending to developing countries, they also reduced the willingness of those countries to borrow. Perhaps the staff should explore the interest elasticity of demand for credit under a floating interest rate system and under a fixed interest rate system; as he saw it, the elasticity of demand for credit was normally small, except perhaps with respect to the demand for new loans under a fixed interest rate system, while, under a floating interest rate system, the elasticity of demand for credit was much larger, since, in theory at least, all past loans came up for reconsideration. It was possible that, at certain interest rates, the demand for loans actually became negative, suggesting that the tendency toward current account surplus in some developing countries reflected a tendency toward an equilibrium consistent with the current high real interest rates, compensating for excess borrowing in the past. If the current situation did indeed represent equilibrium, it would partially explain the apparent lack of interest by debtor countries in the possible imposition of a cap on interest rates. That idea appeared to be based on the assumption, in his view an unrealistic one, that countries would be willing to sustain or increase their indebtedness, regardless of interest rates.

A second issue for discussion concerned actions by banks and their regulators, Mr. Polak said. He was interested in staff comments made on the strengthening of the international banking system, the improvements made in capital ratios, the spreading of the consolidated approach to risk, the enhanced awareness by banks of the risk, and the conclusion that a resumption of lending to the non-oil developing countries would be slow.

On the third discussion topic, he agreed with the staff that the banks should take a longer-term and more forward-looking approach to debt rescheduling, Mr. Polak continued. It was encouraging that the banks were becoming aware of the "hump problem," as reflected in their negotiations toward a multiyear rescheduling arrangement with Mexico. Such a change in attitude was in the interest of all parties concerned because it was a precondition for the return of normal spontaneous access by debtors to the capital markets; in that regard, continued Fund support on a contingency basis was essential. The final sentence in paragraph 3 on page 6 of SM/84/134 read: "To encourage the negotiation of such restructurings, and countries' eventual return to market access, it is important that the Fund should continue to be in a position to support countries' adjustment efforts with arrangements allowing them to draw, where necessary, on Fund resources." Was that statement a comment on the availability of Fund resources, on Fund borrowing, on access policy, or even on net access policy? He could accept an interpretation whereby, if access policy were scaled down over time, the reduction should not be so drastic as to exclude many members from any access simply because they failed to qualify under some new criteria of need and/or satisfactory policies. The sentence should not be understood to suggest that members could have continuous stand-by arrangements with the Fund during the whole period of rescheduled bank credit, which might run as long as 12-15 years. A clarification of the staff's intention would be welcome.

As to the fourth item for discussion, Mr. Polak considered that the staff's treatment of possible innovations in financing techniques had been excessively disparaging. Unrealistic general solutions should of course be rejected, but the staff should not reject all such solutions a priori. The concept of multiyear rescheduling was meant to be a general innovation, although it was not applicable to all countries at present. Other ideas, such as a "cap" on interest rates, or the systematic provision of additional access in case of external developments, had not been mentioned in the staff report; while those measures were not, in his view, particularly useful, the staff should at least explore them. That was not to say that there should be any deviation from the principle that methods of financing or refinancing should in general reflect the policies of the debtor countries; indeed, multiyear rescheduling had to be based on adequate adjustment programs, which could be assessed only on a case-by-case basis. An excessively accommodating stance toward countries with inadequate adjustment programs would lead to a continuation of what the staff had called the "split market." Attention should also be drawn to the relative ease with which small OECD countries were able to raise financing for balance of payments deficits, whether or not they were engaged in adequate adjustment programs. On a related matter, what implications could be drawn from the cases of those countries that had not been meeting their financial obligations, even though they had been granted repeated deferments? There appeared to be no suggestion in the staff report that those countries had suffered under that approach, although the staff had concluded the treatment of countries should indeed depend on the degree of their adjustment.

On the fifth discussion item, Mr. Polak agreed with the staff that future commercial bank lending would probably depend heavily on cofinancing and export credit guarantees. The extent to which such activity should be monitored by the Fund was an important question, to which the staff should give full attention. He agreed with the staff that private direct investment could also be important for the future, although he did not accept the staff's qualification of that point for countries that did not welcome such investment. Countries rejecting direct foreign investment should not expect the resulting shortage of capital to be compensated by flows in other forms. That issue raised the more general point of the extent to which developing countries were responsible for their own supplies of capital. He agreed with the conclusion of the Bureau of International Statistics that it was asking too much of multilateral institutions, governments, banks, and corporations to expect those agencies to perform functions that the relevant countries' own nationals refused to assume. The relationship between capital flight and the need to find additional bank financing was clearly important in that connection. Finally, while endorsing publication of SM/84/134, he suggested that the discussion in the Annex on the Institute of International Finance (IIF), should be deleted from the published version, since its inclusion might give the impression that the IIF was a protegé of the Fund.

Mr. Joyce, noting that the views expressed in the staff papers were largely shared by his authorities, considered that an important development over the past year had been the manner in which the balance of payments financing process had continued to function, despite severe shocks to the international payments system. The more "alarmist" predictions of the past few years had not materialized, and his authorities could support the judgment of the staff that present methods of financing, refinancing, and restructuring had produced good results and should not be altered without good reason; where modifications or corrections were needed, they should be made on a case-by-case basis. New generalized solutions to the problems of debt financing and restructuring were not required, nor should the adjustment efforts linked to financing packages be weakened. With continued strenuous efforts by member countries--both debtors and creditors--and with resourcefulness by the international banking community and international organizations, the current problems could be resolved.

Despite the good results mentioned above, many areas of vulnerability remained, and there was no scope for complacency, Mr. Joyce said. He agreed with the staff that the durability of the recovery was still at risk, particularly given the prospect of further increases in interest rates, a development that also threatened the ability of debtor countries to service their debts. The emphasis in the World Economic Outlook papers regarding the need for policy action to restrain the rise in real interest rates and to reduce them over time to more reasonable levels was therefore wholly appropriate. Sound fiscal restraint, rather than self-defeating monetary expansion, should be the chosen policy instrument for most governments in pursuit of interest rate reduction.

The strains imposed by the debt servicing difficulties of the past two years had had significant structural effects on the international capital markets, Mr. Joyce continued. For example, balance of payments financing had declined in favor of more project-related and trade-related financing, a trend that could be expected to continue. Nonprice rationing to borrowers with low credit standing, price discrimination between borrowers, and wide shifts in market sentiment were indications that the market was not working as smoothly as it should. The restoration of normalcy in the international capital markets was an important priority, and one that would take time to achieve, given the recent strains on those markets.

He welcomed the recent strengthening of banks' financial positions in the face of a deterioration in their loan portfolios; also notable were the increases in the capital/asset ratios of the commercial banks and the augmented provision for loan losses, Mr. Joyce commented. In that regard, the Inspector General of Banks in Canada had recently issued tougher guidelines for classification of loans with overdue interest payments, a move that should further strengthen confidence in deposit-taking institutions. However, the banks' ability to assess risks and price their loans accordingly needed to be further improved, as indicated by the market's occasional inability to discriminate among borrowers in the same geographical region and the tendency of banking institutions to set prices wrongly in individual cases.

Another encouraging development was the improvement in market confidence, as recently reflected in support for a lengthening of maturities and a possible softening of terms for borrowers successfully implementing economic adjustment programs, Mr. Joyce said. Flexible rescheduling terms based on a medium-term approach were necessary to restore more normal borrowing and lending conditions and would become increasingly urgent as a number of major debtors faced a bunching of debt servicing obligations over the next few years. In that connection, he particularly welcomed some of the Managing Director's suggestions that had received support at recent meetings in both New York and Philadelphia. A medium-term approach should be taken by the private financial institutions as well as by international organizations.

For most developing country borrowers, Mr. Joyce continued, access to bank financing, particularly short-term bank credit to finance balance of payments deficits, would remain tightly constrained in the near future. Debtor countries had few choices other than to lay a strong foundation for their economies by following sound policies in order to attract project-related, longer-term financing and private direct investment. The staff had made sensible suggestions for a larger role for official export credit agencies, commercial bank cofinancing with the World Bank, and the inclusion of trade-related lending and other private sector transactions within the financial packages.

Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/104 (7/9/84) and EBM/84/105 (7/13/84).

4. TUNISIA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for concluding the 1984 Article IV consultation with Tunisia to not later than August 10, 1984. (EBD/84/188, 7/10/84)

Decision No. 7752-(84/105), adopted
July 12, 1984

5. NEPAL - TECHNICAL ASSISTANCE

In response to a request from the Nepalese authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/84/186 (7/6/84).

Adopted July 12, 1984

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/15 and 84/16 are approved. (EBD/84/183, 7/5/84)

Adopted July 11, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/105, Supplement 1 (7/10/84), EBAP/84/145 (7/9/84), and by Advisors to Executive Directors as set forth in EBAP/84/145 (7/9/84) and EBAP/84/149 (7/11/84) is approved.

APPROVED: March 6, 1985

LEO VAN HOUTVEN
Secretary