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June 14, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Malaysia - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Malaysia, which will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Scott, ext. 72818.

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INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with Malaysia

Approved by P.R. Narvekar and Donald K. Palmer

June 14, 1983

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I. Introduction

The 1983 Article IV consultation discussions were held in Kuala Lumpur during April 2-14, 1983. Discussions were held with the Minister of Finance and the Deputy Finance Minister, the Governor and the Deputy Governor of Bank Negara Malaysia, the Secretary-General and the Deputy Secretary-General of the Treasury, the Director General and Deputy Directors-General of the Economic Planning Unit, and other senior officials. The staff team consisted of Messrs. Douglas Scott (Head), Choudhry, Kashiwagi, Mansur, and Miss Lee (all ASD).

Malaysia has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Background

Malaysia is the world's largest producer and exporter of tin, rubber, and palm oil; it is a major exporter of tropical hardwoods and also exports oil and, since January 1983, has become an exporter of liquified natural gas. With a richly endowed resource base, a population of 14.1 million, and per capita income at US\$1,763, it is one of the most prosperous countries in Southeast Asia. Nevertheless, important segments of the population continue to live at or below the government-determined poverty level. Elimination of poverty thus remains an important objective of economic policy. Malaysia is an open economy; external trade (average of exports and imports of goods and services) accounted for 59 per cent of GNP in 1982. The maintenance of an exchange system free of restrictions on current payments is a basic element of financial policies aimed at promoting growth with stability.

Malaysia embarked upon development planning in 1966. The First Malaysia Five-Year Plan (1966-70) concentrated on laying the infrastructure and institutional framework for more rapid economic growth. Nevertheless, the persistence of social and economic imbalances led to civil disturbances in May 1969. In the aftermath, the authorities enunciated the New Economic Policy (NEP) in 1971, which embodied the twin objectives of eradicating poverty and restructuring the society through a redirection of the economic growth and employment in favor of the Bumiputeras (Malay and other indigenous groups). The restructuring was to be achieved through increasing the share of Malaysian ownership of assets to at least 30 per cent by 1990 within the context of an expanding economy.

The economic policies pursued in the Second and Third Malaysia Five-Year Plans (1971-80) emphasized growth consistent with the attainment of the broader NEP goals. These policies led to a substantial increase in employment for all Malaysians. Employment gains were greatest in manufacturing, construction, and government services; the share of the manufacturing sector in the labor force increased from 11 per cent to over 15 per cent. While the labor force grew by 4 per

cent a year, unemployment declined from an average of 7 per cent in the Second Plan period to 5 per cent at the end of the Third Plan. The incidence of poverty, which is measured as the proportion of households at or below the poverty income level, declined to 29 per cent from 49 per cent at the beginning of this period, and basic amenities became accessible to an increasing segment of the rural and urban population. However, efforts to restructure the ownership of the corporate sector fell short of the target by the end of the Third Plan (16 per cent), reflecting the low base of Bumiputera ownership in 1970 (2 per cent), saving habits, and the long start-up period for the implementation of the necessary programs to attain such ownership.

The growth and diversification of aggregate output were impressive over the decade 1971-80. Real output increased at an average annual rate of 8 per cent, inflation was held below 6 per cent, the balance of payments was consistently strong, and reserves were comfortable. External debt and its servicing remained low. The size of the vigorously promoted manufacturing sector expanded, growing from 13 per cent of GNP to about 20 per cent, and became increasingly export-oriented. Petroleum emerged as a major export, rising from about 8 per cent of total exports in 1971 to about 24 per cent in 1980.

Rapid economic growth was sustained by a high rate of investment, which rose from 21 per cent of GNP in 1971 to about 30 per cent in 1980. Investment in the exploration and development of petroleum resources increased rapidly, accounting for about 10 per cent of total investment during 1976-80. The sharp increase in the overall rate of investment was achieved without an undue strain on domestic resources. The excess of domestic savings over investment was equivalent to 2.7 per cent of GDP during 1976-80, compared with a shortfall of savings in relation to investment of a somewhat larger magnitude during 1971-75.

Developments during the 1970s reflected the pursuit of economic policies that made effective use of the available resources. The latter contributed to strong export growth, which was enhanced by the boom in the prices of most of Malaysia's primary commodities during 1977-80. The tax system shifted an appreciable part of the gains from the commodity boom to meet the rising level of public expenditure. Thus, despite the substantial expansion in government expenditure over the decade, financial policies held the overall federal budget deficit to about 6 to 7 per cent of GNP. This was consistent with available sources of financing from nonbank sources; after 1975, outstanding net bank credit to the Government declined steadily until 1980. Monetary expansion was associated with a substantial rise in net foreign assets and monetary policies were oriented toward sustaining stable growth. These policies and developments helped to establish for Malaysia an excellent credit rating in international financial markets.

However, the acceleration of growth had already set in motion the rising trend in imports during 1976-80, reflecting partly the increasing import intensity of investment. This was further accentuated by the fiscal stance in 1980, adopted at the time of the mid-term review of the Third Plan in March 1979, which sharply increased the level of Federal Government expenditure, including import-intensive development outlays, to 35 per cent of GNP. However, while imports gained momentum, the demand for Malaysia's exports slackened with the slowdown in economic activity in the industrial countries that began in the second half of 1980. Consequently, the external balance on current account moved from a surplus into a deficit in 1980, a shift of some 6 per cent of GNP, even as Malaysia's export prices reached their peak.

Malaysia's economic performance in 1981, the first year of the Fourth Malaysia Plan (1981-85), was affected by the fall in demand for its exports as a consequence of the deepening international recession. Fiscal policy, with the momentum of expenditure already in place, countered the domestic consequences of weakened external demand. The overall budget deficit increased to about 16 per cent of GNP as government expenditure increased to over 44 per cent of GNP. The growth of government revenue slowed as receipts from nonpetroleum export taxes fell sharply. However, this was largely compensated by higher revenues from petroleum taxes and by a sizable transfer of profits from Petronas, the national oil company. Nevertheless, the Government, which had moved from the position of net creditor to the banking system to net debtor in 1980, obtained further accommodation from domestic banks and external sources to finance the large budget deficit. Monetary expansion slowed but inflation increased, reflecting primarily higher import prices. The external position deteriorated markedly, as export earnings declined while imports continued to rise strongly. The current account deficit rose to 10 per cent of GNP; government and other official foreign borrowing accounted for one half the long-term capital inflows. Total outstanding external debt (excluding short-term) rose to 28 per cent of GNP; however, the debt service ratio remained low because loans on commercial terms were a small part of debt in 1981 and all such new borrowings had substantial grace periods. External reserves declined to the equivalent of four months of imports.

III. Developments in 1982

Economic growth slowed to below 5 per cent in 1982 with the further deterioration in Malaysia's terms of trade contributing to weaker private demand (Chart 1 and Appendix Table I). The prices of most of Malaysia's export commodities declined. Adjusted for the terms of trade, real gross national income increased by about 3 per cent, compared with about 5 per cent in 1981. The increase in export volumes, primarily of palm oil and petroleum, provided the major support to growth. Growth of domestic demand slowed sharply, as both private and public demand weakened; the latter reflected the impact of the change in fiscal stance that took place in mid-July. Total investment in

nominal terms, which had increased twice as fast as GNP in the immediately preceding years, increased to about 36 per cent of GNP in 1982. Private savings fell short of private investment for the second consecutive year. Gross domestic savings, which peaked in 1979, declined to 23 per cent of GNP in 1982.

Agricultural output increased, primarily reflecting the sharply increased production of palm oil which was due to productivity gains resulting from the introduction of a new technique of pollination. Rubber production remained at about 1.5 million tons, approximately the same level as in the preceding three years. The growth of manufacturing, construction, and services slowed substantially.

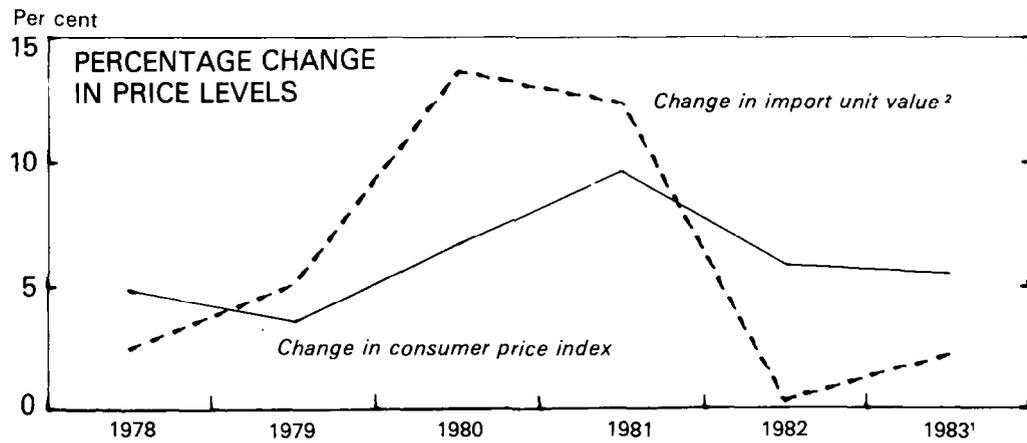
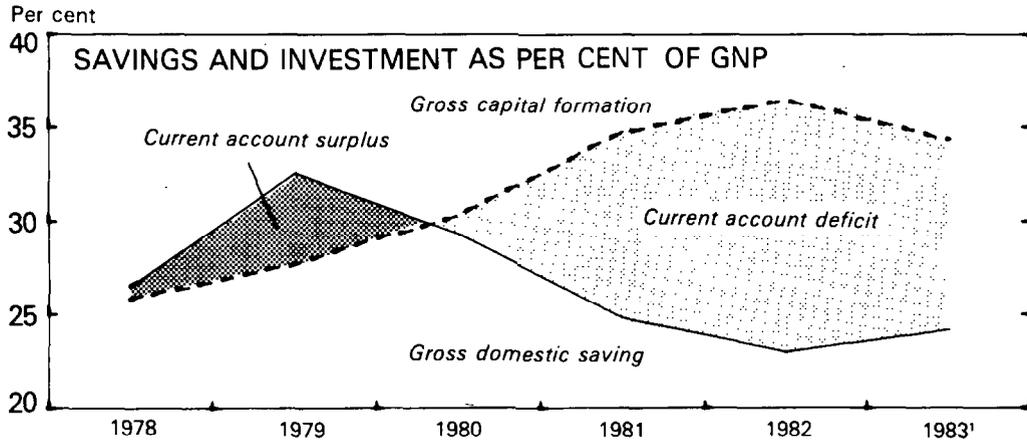
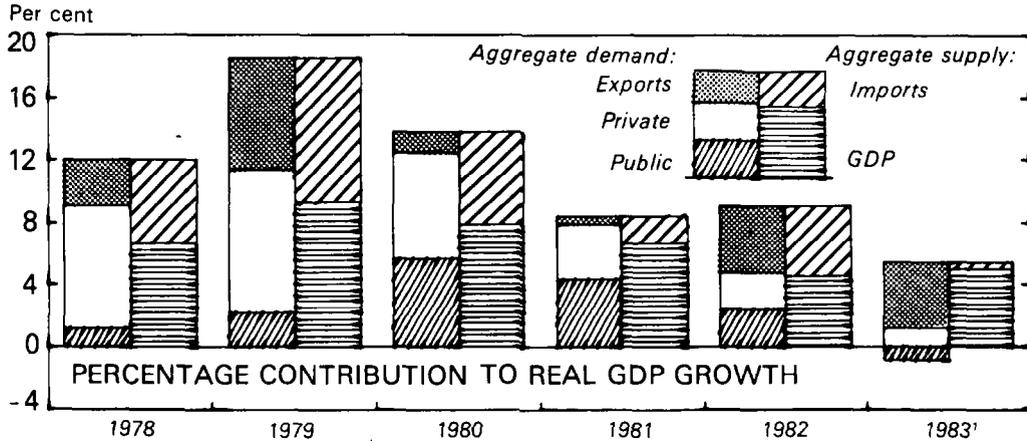
Domestic inflation, in terms of consumer prices, peaked at about 11 per cent in the second quarter of 1981, and thereafter declined through the third quarter of 1982 to less than 6 per cent. The easing of inflation was due to weaker domestic demand; moderation in import price increases, due in part to the appreciation of the ringgit; and the diversion of nontraditional tradables to the domestic market because of sluggish external demand.

Fiscal operations had to be modified during the year because of the unanticipated duration and severity of the international recession. The growth of government revenue, particularly receipts from taxes on petroleum exports and on domestic transactions, was adversely affected while those from non-oil exports declined sharply. Despite a sizable transfer of profits from Petronas for the second consecutive year, government revenue increased by less than 5 per cent, compared with the average annual rate of increase of about 23 per cent in 1980 and 1981 (Chart 2 and Appendix Table II). In mid-1982, the stance of fiscal policy was shifted by giving less emphasis to the countercyclical posture of the budget. This was achieved through cutbacks in less essential operating and development expenditures. Also, transfer payments were reduced substantially in 1982, reflecting primarily the elimination of funds for the acquisition of assets in Malaysia for Bumiputeras. These and other cutbacks slowed the growth of expenditure to 8 per cent. Nevertheless, government expenditure and the budget deficit reached 45 per cent and 17 per cent, respectively, in relation to GNP.

To finance the fiscal deficit in 1982, the Government markedly increased its recourse to foreign market borrowings and domestic borrowing from the Employees Provident Fund (EPF). For the second consecutive year, the Government borrowed heavily from Petronas.^{1/} The increasing role of the banking system in financing the budget deficit caused the

^{1/} The transfer of resources from the petroleum sector to the Federal Government through taxation, dividends, and borrowing in 1981 and 1982 was equivalent to 75 per cent and 80 per cent, respectively, of the gross value of Malaysia's oil production. An additional 5 per cent of oil production was transferred to State governments as royalty payments.

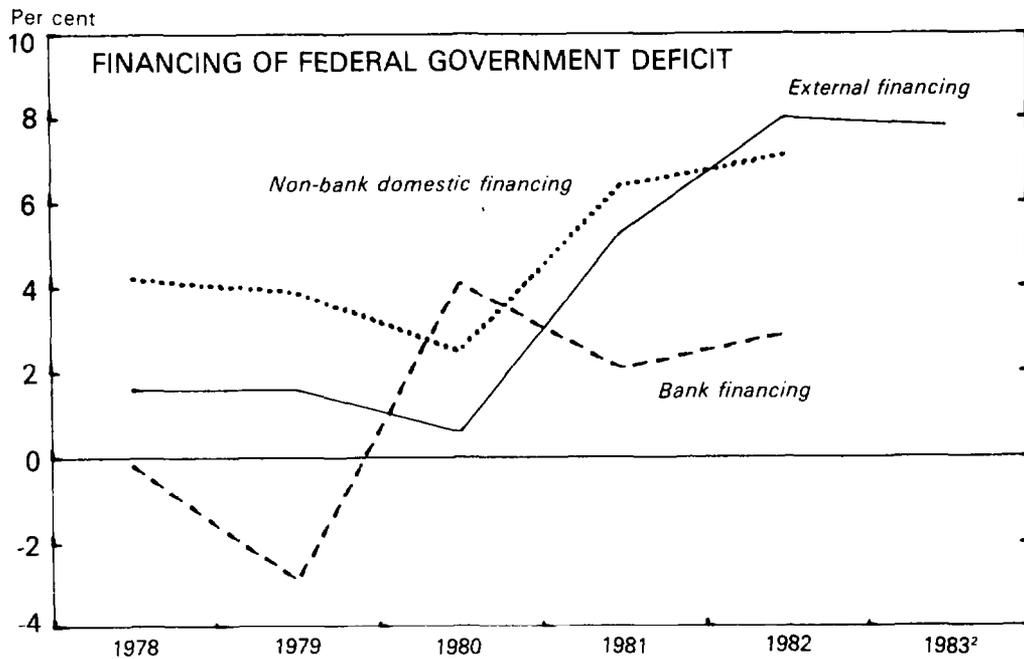
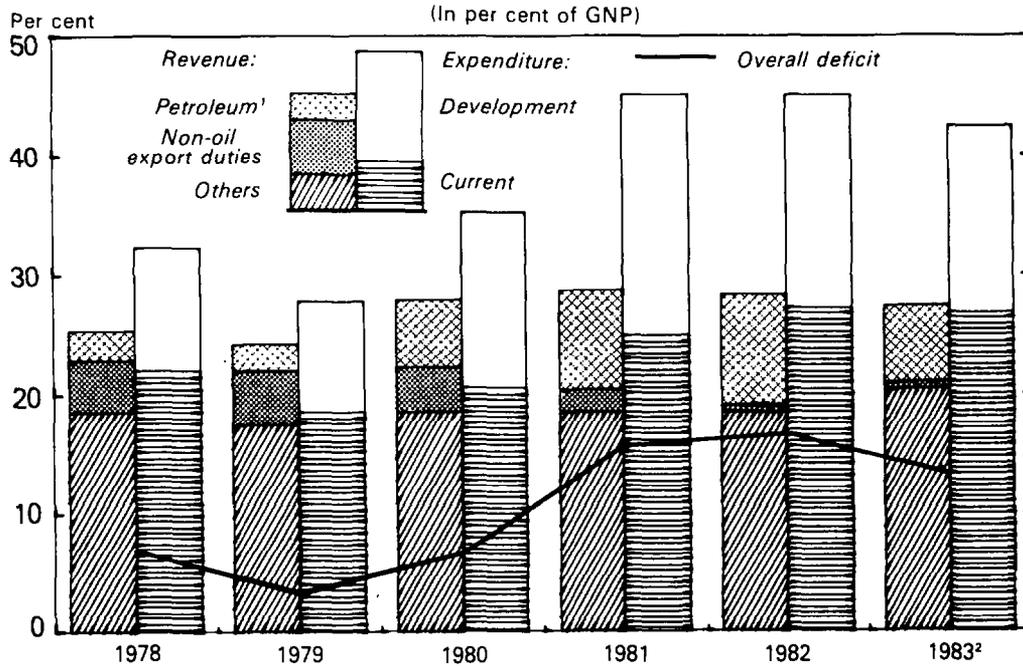
CHART 1 MALAYSIA SELECTED INDICATORS OF MACROECONOMIC DEVELOPMENTS, 1978-83



Source: Data provided by the Malaysian authorities.
¹ Forecast.
² Based on 1980 trade weights.



CHART 2
MALAYSIA
FEDERAL GOVERNMENT OPERATIONS, 1978-83



Source: Data provided by the Malaysian authorities.

¹Includes petroleum company tax, export duties, royalties and dividend paid by the national oil company.

²Estimates.



share of net credit to the Government to rise to 14 per cent of total domestic credit. Domestic and external Federal Government debt rose to 70 per cent of GNP in 1982; interest payments in the Federal budget reached 5 per cent of GNP.

Monetary developments in 1982 followed similar trends as in the previous year. Total liquidity increased at a slightly higher rate, reflecting a somewhat smaller decline in net foreign assets (Chart 3 and Appendix Table III). The growth of domestic credit slowed to 23 per cent because of the lower rate of credit expansion to the private sector. The liquidity position of banks eased during the year. Nevertheless, the Central Bank remained ready to inject liquidity as needed; however, this was primarily through foreign exchange swaps with commercial banks, which ensured that such accommodation would only be on a temporary basis. The volume of these transactions was lower than in 1981 when swap transactions were an important means of easing the tight liquidity situation of banks.

The balance of payments further weakened in 1982, as the current account deficit widened to 13 per cent of GNP (Chart 4 and Appendix Table IV). This reflected the continued rise in imports, especially investment goods; weakness in key export prices; and a larger deficit on invisibles. The volume of exports rose by 9 per cent, notwithstanding withholding of exports of rubber and tin; the latter reflecting export limitations under the International Tin Agreement. The value of manufacturing exports, which has been a major element in export expansion, resumed rapid growth after a pronounced slowdown in 1981. Exports of petroleum also rose, reflecting higher production and effective exploitation of markets within the region. The rising payments on invisibles reflected primarily the rapid increase in interest payments on external debt.

The larger current account deficit was financed chiefly by an expansion of nonmonetary capital inflows. These were largely in the form of increased official borrowing. Short-term capital inflows also rose sharply, including repatriation of foreign assets of Petronas, which was partly offset by a rise in the foreign assets of commercial banks. Overall, net official reserves declined by M\$0.6 billion; gross reserves fell by M\$0.45 billion and reserve-related liabilities, reflecting transactions with the Fund under the Buffer Stock Financing Facility, rose. At the end of 1982, gross external reserves, including gold holdings amounting to 2.33 million fine troy ounces,^{1/} stood at M\$9.4 billion (US\$3.9 billion) and represented almost four months of imports. Outstanding external debt increased to M\$23.9 billion in 1982, equivalent to 41 per cent of GNP. Debt service during the year rose to the equivalent of 9 per cent of exports of goods and services.

^{1/} Official gold holdings are valued at SDR 35 per fine troy ounce.

The ringgit, which had appreciated by about 12 per cent vis-a-vis the U.S. dollar, the intervention currency, from the average level during 1975-77 through the end of 1980, depreciated by 9 per cent subsequently through the end of 1982. In real effective terms, the ringgit appreciated against the composite currencies of Malaysia's major competitors by 9 per cent from the end of 1980 through the end of 1982 (Chart 5 and Appendix Table V). Nevertheless, from the average level during the base period 1975-77, the ringgit depreciated in real effective terms against the same currencies by 7 per cent through 1982.

IV. Prospects and Policies for 1983

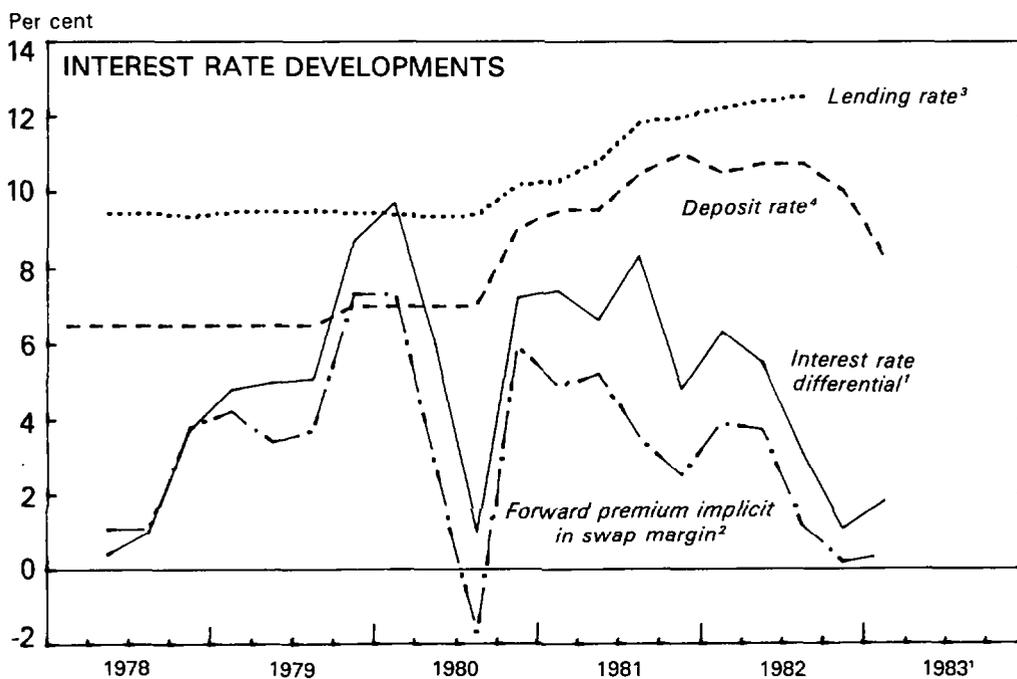
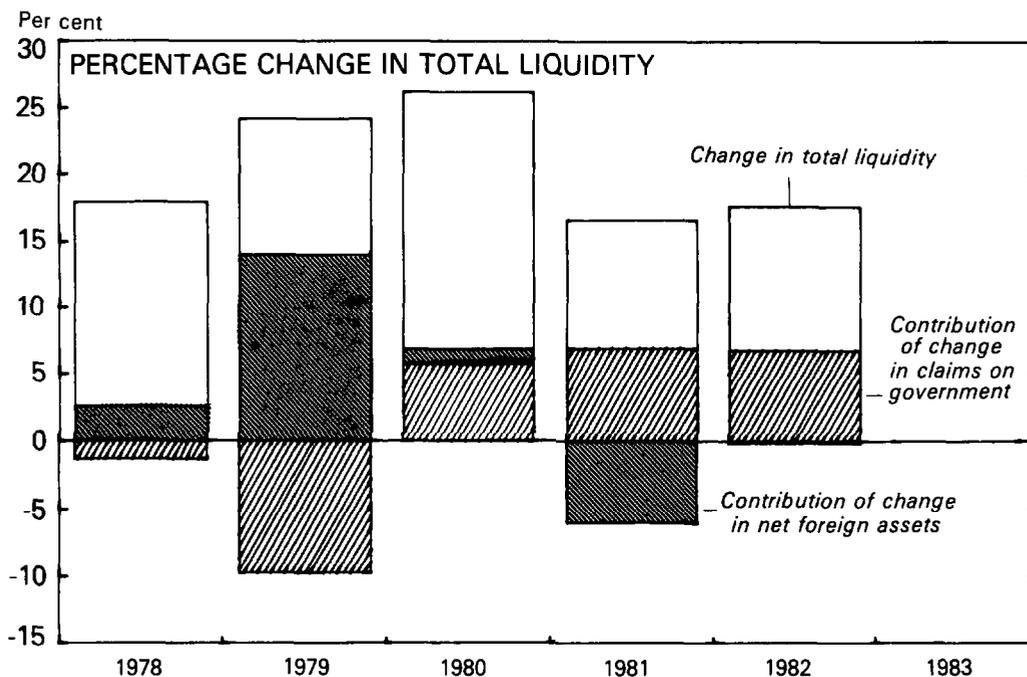
The authorities are of the view that a recovery in the international economy is under way, although there is uncertainty regarding its strength and durability. Consequently, somewhat higher real growth is expected because of the anticipated firming of external demand. The expansion in private consumption expenditure resulting from higher export earnings is likely to be offset by the decline in private investment and public sector outlays. Higher growth is forecast in most nonagricultural sectors except government services. The leveling-off of productivity gains in oil palm and the drought conditions affecting padi are expected to lower agricultural growth.

1. Fiscal policy

The previous year's shift in fiscal stance was carried forward in 1983 in order to strengthen the Government's financial position, and to moderate pressure on the balance of payments. Accordingly, the 1983 budget was aimed at restraining the growth of expenditure while making a substantial tax effort. The original budget envisaged expenditures of M\$27.0 billion and revenues of M\$18.5 billion, including M\$1.2 billion from new tax measures; the overall budget deficit was forecast to be equivalent to 13 per cent of GNP.

In formulating the budget, the available options to restrain the growth of expenditure were limited. The automatic growth of statutory expenditures, including interest payments, imposed a severe limitation; the rise in interest payments alone accounted for 90 per cent of the projected increase in operating expenditure. Further efforts to restrain total spending, therefore, involved a freeze or reduction in other operating expenditure or reduced development spending. The authorities opted for the latter, primarily by reducing transfer payments. The restraint in expenditure growth in the 1983 budget was thus achieved by a reduction of about 5 per cent in development expenditure and a containment of the increase in operating expenditure to about 8 per cent. At the same time, a major package of tax measures, estimated to raise M\$1.2 billion in 1983, was introduced. The principal increases in taxes relate to sales and service taxes (M\$858 million), import duties (M\$209 million) and automobile registration and road use taxes (M\$189 million); relief from export taxes on rubber and tin was estimated at M\$162 million.

CHART 3
MALAYSIA
MONETARY DEVELOPMENTS, 1978-83



Sources: Data provided by the Malaysian authorities and staff estimates.

¹Three-month LIBOR on U.S. dollar minus three-month inter-bank rate, period average.

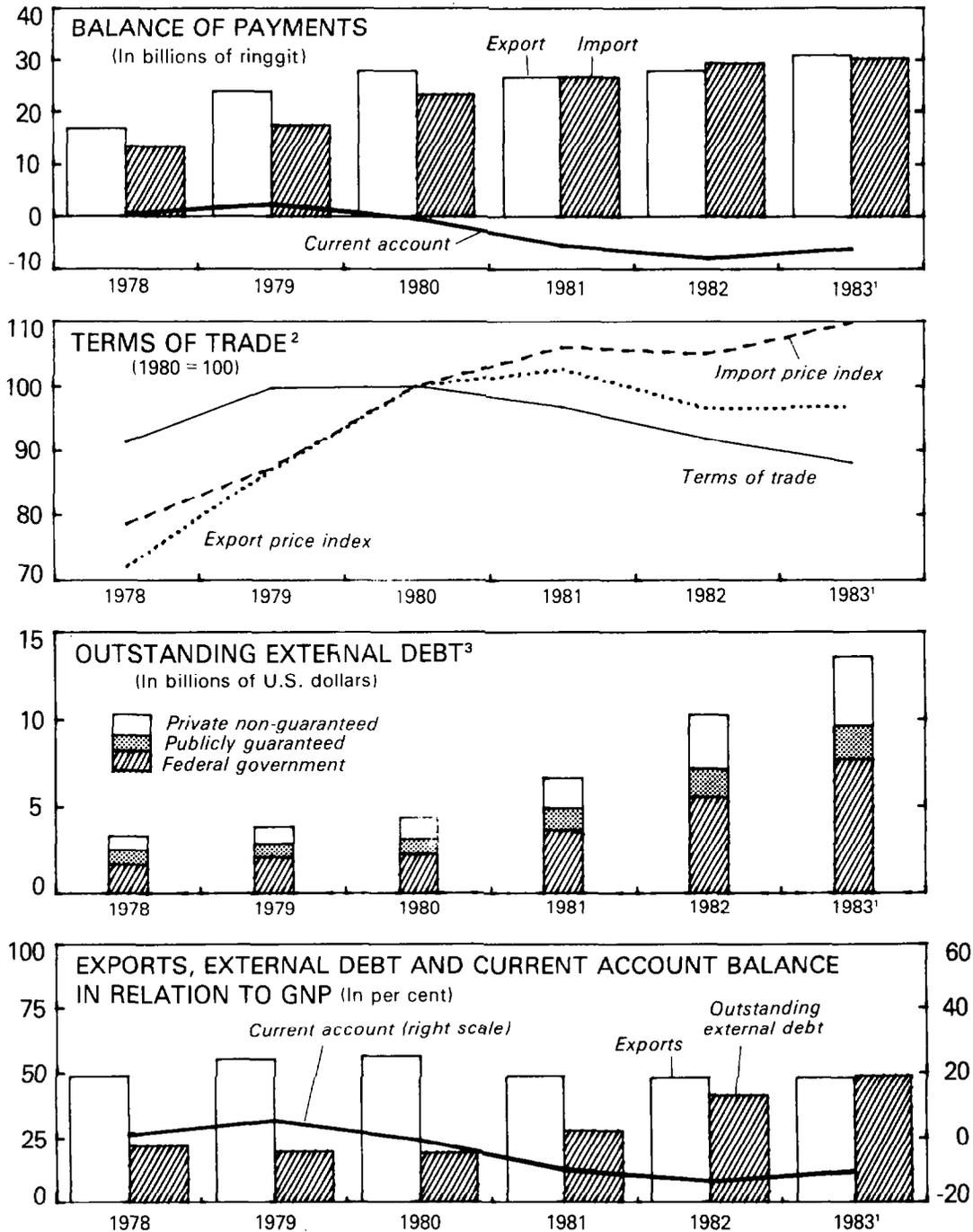
²Representative three-month swap effected through foreign exchange brokers, average of the end of month data.

³Weighted average lending rate of all commercial banks.

⁴Interest rate on one year time deposit of commercial banks, at end of period.



CHART 4
MALAYSIA
EXTERNAL INDICATORS, 1978-83



Sources: Data provided by the Malaysian authorities and staff estimates.

¹Forecast.

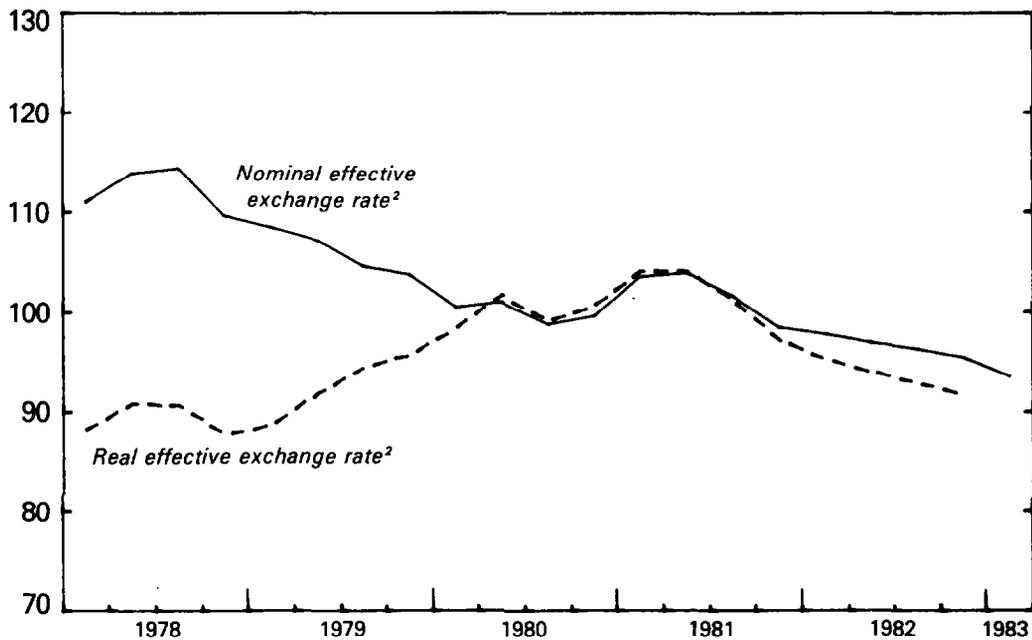
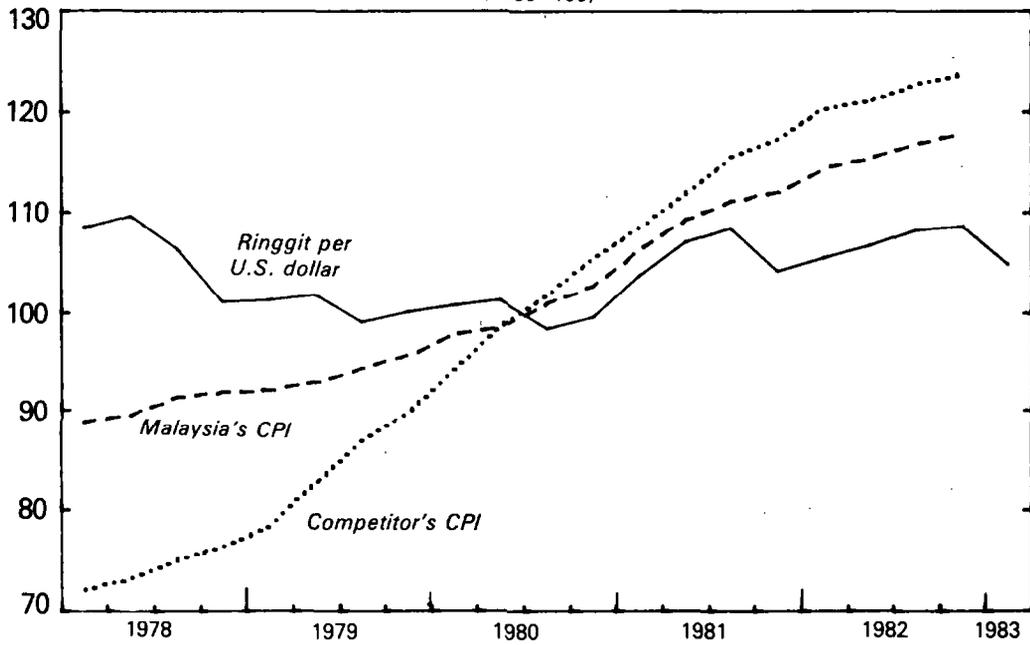
²Based on 1980 weights; indices are in terms of U.S. dollar.

³Outstanding external debt of original maturity of one year and over.



CHART 5
MALAYSIA
DEVELOPMENTS IN RELATIVE PRICES AND
EXCHANGE RATE INDICES¹, 1978-MARCH, 1983

(1980 = 100)



Sources: Data provided by the Malaysian authorities; IMF, *International Financial Statistics*; and staff estimates.

¹Indices calculated using period average quarterly data.

²Vis-a-vis competitors; reduction indicates appreciation.



Developments during the first four months have altered assumptions underlying the 1983 budget. The recent oil price reduction indicated that revenues were likely to fall short of earlier expectations by some M\$0.6 billion. Part of this shortfall was offset by not passing on the oil price reduction to consumers of diesel and kerosene; thus, expenditures on consumer subsidies were reduced by some M\$400 million on an annual basis. The present fiscal outlook for the year, after adjusting for the effects of reduced oil prices and a somewhat less optimistic assessment of revenues from income taxes, is for expenditure of M\$26.8 billion, revenue of M\$17.4 billion, and an overall fiscal deficit of M\$9.4 billion, equivalent to almost 15 per cent of GNP. The Malaysian representatives stated that the present fiscal outlook was a source of concern and that the Government is currently reviewing its expenditure programs with a view to making further adjustments, where appropriate. This would be a continuation of the fiscal measures introduced in mid1982 and in the 1983 budget.

During the discussions, the staff representatives noted that it had become increasingly difficult to finance increases in expenditure through the growth of revenue. This reflected the fact that expenditures had increased very rapidly while the tax system depended heavily on the taxation of petroleum and on nonpetroleum export taxes. The resource transfer from the petroleum sector, based on the present price and production outlook, appeared to have exceeded sustainable levels. Also, the growth of receipts from other export taxes would be limited by policy considerations aimed at reducing the burden of taxation on primary producers (predominantly Bumiputeras) and by the degree of expected recovery in world market prices. At the same time, the provision of liberal exemptions and incentives has adversely affected the elasticity of domestic-based taxes, including import duties; during the period 1979-82, revenues from these taxes averaged about 16 per cent of GNP and would have declined in 1983 without the substantial new tax measures. Thus, without substantial further expenditure restraint, revenue growth is unlikely to prove adequate to bring about significant fiscal adjustment.

The authorities recognize that financing of the continuing large fiscal deficit could result in an undue preemption of domestic savings and the possible crowding out of private expenditure. At the same time, Petronas can no longer contribute appreciably to financing of the deficit as most of its accumulated savings has been shifted to holdings of government debt. However, substantially increased use of bank credit could cause excessive monetary expansion or the possible limiting of access of the private sector to credit from the financial system. In these circumstances, the Government plans to reduce domestic borrowing in the current year and rely somewhat more on borrowing from foreign markets to cover the fiscal gap. Such borrowing is projected to increase Federal Government external debt to 27 per cent of GNP at the end of 1983.

2. Monetary policy

The major objectives of monetary policy have been to promote a sustainable rate of growth with relative price stability and to use monetary instruments to counter the effects of disturbances from the external sector and to protect the balance of payments. In 1983, the authorities intend to limit the growth of narrow money to the range of 11 to 13 per cent and of broad money to the range of 17 to 18 per cent. Domestic credit expansion is anticipated to be the main source of growth of overall liquidity as the external sector is projected to exert a moderate contractionary effect. The rate of expansion of credit to the private sector is likely to be about 17 per cent, the same as in 1982. The authorities remain committed to the provision of credit to priority sectors at reasonable cost. To this effect, guidelines introduced in 1982 require commercial banks to extend at least 18 per cent of their total loans outstanding at the end of 1981 to the Bumiputera community. By end-1982, this target was exceeded by commercial banks as a group although some individual banks had not yet reached the target ratio.

The authorities are using monetary and credit policy instruments to increase capital inflows and strengthen the liquidity base of banks. The banks are being discouraged from financing investment-related imports from domestic resources; instead, increased use of suppliers' or buyers' credit is being encouraged. Also, to give enhanced incentives to the mobilization of foreign resources, banks have been exempted from the withholding tax of 15 per cent on interest paid to all non-residents, and the liquidity and statutory reserve requirements on such foreign currency deposits have been set at zero. The monetary authorities have also implemented measures to broaden the capital base of banks and otherwise strengthen the banking system. These include the introduction in 1982 of new capital adequacy requirements for the commercial banks and the setting of new quantitative guidelines to discourage speculative activities.

Interest rates have increased in response to market forces since they were freed in late 1978. Despite this trend, a substantial differential in favor of domestic borrowing continued to exist between domestic and international rates until late 1982. The impact of this differential on commercial banks was largely offset through the provision of foreign exchange swap facilities in which the ringgit was quoted at a premium. The interest rate differential narrowed sharply as international rates fell after mid-1982, so that at end-year there was near comparability and the forward premium on the ringgit had declined sharply. In the authorities' view, the lending rates during 1983 have not responded efficiently to market forces in light of the decline in domestic inflation and interest rates abroad. However, deposit rates have declined in recent months, with the one-year rate now at 8.25 per cent. In real terms, deposit rates have been maintained at 1 to 3 per cent. The authorities consider the present level of interest rates appropriate to further the objective of stable and noninflationary growth.

3. Balance of payments outlook and policies

The authorities expect the external imbalance to ease in 1983, with the current account deficit declining to about 10 per cent of GNP, reflecting primarily an appreciable improvement in prices of rubber and timber and strong growth in the volumes of manufactured exports. This improvement will be partially offset by the impact of the recent reduction in the price of oil, despite the increased production and export of petroleum, including liquified natural gas (LNG), which came on stream in January. The growth of imports is expected to be modest in light of measures to restrain the growth of domestic absorption. The expected widening of the deficit on invisibles is primarily due to higher interest payments on foreign debt.

For 1983, the authorities plan to continue large-scale foreign borrowing and expect foreign direct investment to continue at about the same level as in 1982. Nonmonetary capital inflow is projected to decline to M\$7.4 billion, with net official foreign borrowing amounting to M\$4.5 billion. Net official reserves are expected to decline, although to a lesser extent than in the preceding two years. The authorities' policy on external reserves is based on the maintenance of an adequate level in view of the open and liberal exchange system and the fact that Malaysia's export earnings vary substantially with fluctuations in the prices of primary commodities. The level of reserves, however, has steadily declined in recent years. In 1983, gross official reserves, including gold holdings at national valuation, are projected to decline to the equivalent of 3.6 months of merchandise imports. The authorities regard the present level of reserves in terms of months of imports as adequate under the prevailing circumstances.

Exchange rate policy remains one of not resisting basic market forces and intervening only to smooth out temporary fluctuations. The ringgit is linked to an undisclosed basket of currencies of Malaysia's major trading partners. The real appreciation of the ringgit vis-a-vis the index of the currencies of its principal competitors since mid-1981 is not considered by the authorities as being inconsistent with their exchange rate policy; much of the external deterioration is viewed as due to cyclical factors. The strong growth of Malaysia's manufactured exports in 1982 and the continued favorable outlook in 1983 are indicative of the continuing competitiveness of those industries that have been the basis of much of the export growth and diversification since the early 1970s.

V. Medium-Term Outlook

The external outlook for the medium term was discussed within the framework of very tentative estimates of the balance of payments outlook

through 1985 (Table 1).^{1/} In this outlook, the deficit on current account is expected to remain at about US\$2.7 billion, and medium- and long-term external debt to rise to US\$19 billion. Debt servicing, excluding interest payments on short-term debt and liabilities of commercial banks, will remain relatively modest through 1985, not exceeding 15 per cent. However, to an important extent this reflects grace periods, typically up to five years, on the large market-related borrowings of the Government since 1981. With the expiration of these grace periods, the burden of debt servicing could rise substantially.

VI. Staff Appraisal

Malaysia's economic policies over the decade 1971-80 were remarkably successful. A strong and relatively stable growth was maintained and a substantial diversification in production and exports was achieved. Investment and domestic savings rates increased sharply and the external payments and reserve position strengthened. A very high international credit rating was attained.

The economy was adversely affected in 1981 and 1982 by the pronounced international recession that began in mid-1980. The external current account deteriorated sharply and real growth slowed, averaging below 6 per cent. Prospects for economic growth are somewhat better in the current year amid indications that the international recovery process is under way.

Expansionary fiscal policies during 1981, and initially in 1982, countered the domestic consequences of weakened external demand. The most important element of these policies was a rapid expansion in budgetary expenditure, initiated following the mid-term review of the Third Plan in early 1979. In mid-1982, the authorities shifted fiscal policy through expenditure restraint. This was largely in response to their recognition of the persistence and severity of the global recession and to the rapid weakening of government finances and the balance of payments. Notwithstanding these adjustments, Federal Government expenditure rose further in 1982 to 45 per cent of GNP. The authorities' current expenditure plans reflect a more somber assessment of the domestic and external payments outlook. Because of the limitation imposed by the automatic growth in statutory expenditures, including sharply rising interest payments, the restraint in expenditure in 1983 is to be achieved mainly by reducing development outlays. However, even after allowing for additional yields from the substantial tax effort, the budget deficit in 1983 is likely to be about 15 per cent of GNP.

^{1/} These consultation discussions took place prior to Executive Board consideration of SM/83/45, "Fund Policies and External Debt Servicing Problems." It is expected that a longer-term period covering five years will be reflected in subsequent consultations.

Table 1. Malaysia: External Debt Projection, 1981-85

(In millions of U.S. dollars) 1/

	1981	1982	1983 <u>2/</u>	1984 <u>2/</u>	1985 <u>2/</u>
Outstanding debt	6,658	10,214	13,593	16,517	18,920
Central Government	3,630	5,493	7,651	9,448	11,166
State enterprises <u>3/</u>	1,281	1,646	1,998	2,255	2,506
Private sector <u>4/</u>	1,747	3,075	3,944	4,814	5,248
Gross disbursement	2,790	4,150	4,206	3,860	3,355
Central Government	1,573	2,058	2,419	2,115	2,123
State enterprises	427	468	522	435	435
Private sector	790	1,624	1,265	1,310	797
Amortization	426	594	827	937	952
Central Government	87	195	261	318	405
State enterprises	92	103	170	178	184
Private sector	247	296	396	441	363
Interest payments	448	718	1,211	1,649	1,959
Central Government	262	399	622	852	1,030
State enterprises	79	87	172	195	200
Private sector	107	232	417	600	709
<u>Memorandum items:</u>					
Current account					
Receipts <u>5/</u>	13,908	14,328	16,042	17,675	20,210
Balance	-2,377	-3,351	-2,802	-2,672	-2,677
Ratio to current account earnings					
			<u>(In per cent)</u>		
Debt service	6.3	9.2	12.7	14.6	14.4
Central Government	2.5	4.1	5.5	6.6	7.1
State enterprises	1.2	1.3	2.1	2.1	2.0
Private sector	2.5	3.6	5.1	5.9	5.3
Ratio to GNP					
Total debt	27.9	41.0	49.1	53.3	54.3
Central Government	15.2	22.0	27.6	30.5	32.0
State enterprises	5.4	6.6	7.2	7.3	7.2
Private sector	7.3	12.3	14.3	15.5	15.1

Source: Data provided by the Malaysian authorities.

1/ Outstanding external debt of original maturity of one year and over; end of period.

2/ Estimates.

3/ Publicly guaranteed debt of state enterprises.

4/ Includes the borrowings of some state enterprises without government guarantee.

5/ Excluding transfers.

The recent and prospective fiscal trends highlight the fact that imbalances of such magnitude cannot be readily corrected on the revenue side. The heavy dependence of the tax system on the petroleum sector, including dividends from Petronas, has become worrisome in view of recent developments in the oil market and excess production capacity in many oil-exporting countries. Moreover, liberal exemptions and fiscal incentives have affected the yield from domestic-based taxes at a time when tax policy is shifting away from export duties on primary commodities other than oil. The financing of fiscal deficits in recent years has had a cumulative effect on servicing government debt. In the domestic market, the Government has shifted from being a net creditor of the banking system in 1979 to being a net debtor, while recourse to large-scale foreign borrowing has led to sharp increases in external public debt. In 1981-82, the Government utilized much of the resources saved by Petronas in earlier periods, as well as diverted a substantial portion of private savings through increases in the Provident Fund contribution rates and subsequent investment in government securities. In the staff's view, the fundamental fiscal imbalance derives from the excessively rapid growth in budgetary expenditure since 1979. Consequently, the fiscal imbalance should not be viewed as either temporary or cyclical. In these circumstances, the staff would urge a comprehensive review of project and other nonstatutory expenditure priorities, with a view to achieving a substantial reduction in such expenditures and the fiscal deficit over the medium term. In this context, the staff welcomes the review of expenditures currently under way and urges that this lead to early adoption of a program of fiscal adjustment.

During 1981 and 1982, monetary policy sought to promote a sustainable rate of economic growth with domestic and external stability. While the supply of credit to the private sector slowed, monetary and credit policies accommodated the enhanced requirements of the public sector. The stance of monetary policy in 1983 is aimed at an increase of 17 to 18 per cent in total liquidity and an expansion of 16 to 17 per cent in credit to the private sector. Together with the requirements of the public sector, these are consistent with the expected balance of payments outlook. The differential between domestic and external interest rates has narrowed as the latter declined from the very high levels at mid-1982. The staff believes that, because of the extent of Malaysia's external financing requirements, the level of key external interest rates should be accorded considerable importance in determining domestic rates.

The large and sustained deterioration of the external current account in recent years was influenced by the flattening of exports and also by the strong upward trend in imports--a development that has emerged since 1979. The financing of these external deficits resulted in the substantial depletion of the oil sector's savings and in a rapid growth of external debt. With prospective increases in foreign borrowing in 1983, medium- and long-term external debt is likely to

increase to 49 per cent of GNP. In the medium-term outlook, the current account deficit is expected to remain at about the 1983 level, and external debt is forecast to rise somewhat further in relation to GNP through 1985.

The trends outlined above appear difficult to sustain in the medium term. In the staff's view, a timely and comprehensive reassessment of expenditures, aimed at achieving a substantial reduction in nonstatutory expenditures over the medium term, would make an enduring contribution to sustaining external stability and achieving longer-term developmental objectives. The strength of Malaysia's economy and excellent credit rating provide sufficient time for the adjustment to be effected within the framework of a well-conceived fiscal and development strategy.

The staff welcomes the importance accorded by the authorities to maintenance of a liberal exchange and trade system. Exchange rate policy has been implemented consistent with the need to sustain the competitiveness of the export sector. However, the weakness in the balance of payments, including the medium-term outlook, indicates that exchange rate policy should be managed to avoid continuation of the trend of appreciation in the real effective exchange rate index that has been evident since mid-1981. Sufficient and timely adjustments in fiscal policy would help to maintain exchange rate stability within the present framework of policies governing external trade and payments.

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

Table I. Malaysia: Output, Prices, and Foreign Trade, 1979-83

(Per cent change from previous year)

	1976-80 Average	1979	1980	1981	1982	1983 <u>1/</u>
Real GDP	<u>8.6</u>	<u>9.3</u>	<u>7.8</u>	<u>6.7</u>	<u>4.6</u>	<u>5.0</u>
Agriculture	5.4	8.2	3.1	3.5	6.2	2.6
Mining	8.1	13.6	-2.2	-3.2	5.9	9.9
Manufacturing	11.3	9.5	9.0	5.7	3.4	7.0
Construction	14.6	11.8	17.7	13.0	8.0	11.0
Consumer prices	<u>4.5</u>	<u>3.6</u>	<u>6.7</u>	<u>9.6</u>	<u>5.8</u>	<u>5.5</u>
Merchandise exports <u>2/</u>	<u>28.0</u>	<u>49.9</u>	<u>17.6</u>	<u>-9.2</u>	<u>2.6</u>	<u>10.1</u>
Volume	15.0	24.0	2.6	-11.6	9.2	9.7
Prices	11.3	20.9	14.7	2.7	-5.9	0.3
Merchandise imports <u>2/</u>	<u>25.0</u>	<u>38.1</u>	<u>34.6</u>	<u>9.5</u>	<u>7.8</u>	<u>4.6</u>
Volume	19.0	24.1	17.8	3.2	8.9	0.1
Prices	5.0	11.2	14.3	6.1	-1.0	4.5
Terms of trade	6.0	8.7	0.4	-3.2	-5.0	-4.0

Sources: Data provided by the Malaysian authorities; and staff estimates.

1/ Estimates.

2/ In U.S. dollars.

Table II. Malaysia: Summary of Federal Government Operations, 1978-83

	1976-79 (Average)	1978	1979	1980	1981	1982 <u>1/</u>	1983 <u>1/</u>
<u>(In billions of ringgit)</u>							
Total revenue and grants	8.3	8.8	10.5	13.9	15.8	16.5	17.4
Total expenditure and net lending	10.3	11.2	11.9	17.2	24.4	26.3	26.8
Overall deficit	-2.0	-2.4	-1.4	-3.3	-8.6	-9.7	-9.4
Financing (net)							
External	0.5	0.5	0.7	0.3	3.4	4.8	5.0
Domestic <u>3/</u>	1.5	1.9	0.7	3.0	5.2	4.9	4.4
Of which:							
Banking system	(-0.5)	(-0.1)	(-1.2)	(2.0)	(1.2)	(1.7)	(...)
<u>(As per cent of GNP)</u>							
<u>Memorandum items:</u>							
Total revenue	24.4	25.4	24.2	27.9	28.7	28.4	27.4
Total expenditure	30.7	32.2	27.5	34.6	44.4	45.1	42.2
Overall deficit	6.3	6.8	3.3	6.6	15.7	16.7	14.8
External	(1.6)	(1.6)	(1.6)	(0.6)	(5.3)	(8.0)	(7.8)
Domestic	(4.7)	(5.2)	(1.7)	(6.0)	(10.4)	(8.7)	(7.0)

Sources: Data provided by the Ministry of Finance; and staff estimates.

1/ Preliminary actual.

2/ Staff estimates.

3/ Includes statistical discrepancy that arises mainly from the timing differences in recorded between the Treasury and the Central Bank.

Table III. Malaysia: Monetary Aggregates, 1979-83
 (Percentage change during the year)

	1979	1980	1981	1982	1983 <u>1/</u>
Net foreign assets	36.5	2.7	-17.7	-0.7	...
Domestic credit	10.3	49.9	31.1	23.4	...
Net claims on government <u>2/</u> (absolute change in billions of ringgit)	-1.7	1.2	1.9	2.2	...
Credit to the private sector	25.9	39.0	22.7	16.9	16.0-17.0
Total liquidity	24.1	26.2	16.6	17.6	17.0-18.0
Narrow money	17.2	15.0	12.9	13.3	11.0-13.0
Quasi-money	28.9	33.4	18.7	19.8	20.0-20.5

Sources: Data provided by the Malaysian authorities; and IMF, International Financial Statistics.

1/ Official projection.

2/ Includes State governments.

Table IV. Malaysia: Balance of Payments and External Debt, 1978-83

(In billions of ringgit)

	1978	1979	1980	1981 <u>1/</u>	1982 <u>1/</u>	1983 <u>2/</u>
Balance of payments						
Current account	0.3	2.3	-0.5	-5.5	-7.8	-6.4
Trade balance	3.6	6.6	4.8	--	-1.4	0.5
Exports	(16.9)	(24.0)	(28.0)	(27.0)	(28.1)	(30.9)
Imports	(-13.3)	(-17.4)	(-23.3)	(-27.0)	(-29.5)	(30.4)
Services & transfers (net) <u>3/</u>	-3.3	-4.3	-5.3	-5.4	-6.4	-7.0
Capital account	1.3	0.7	3.2	5.9	8.8	7.4
SDR allocation	--	0.1	0.1	0.1	--	--
Errors and omissions	-1.0	-1.2	-1.7	-1.6	-1.6	-1.3
Overall balance	0.6	1.9	1.1	-1.0	-0.6	-0.3
Outstanding external debt						
Publicly guaranteed	5.763	6.230	6.755	10.747	16.673	22.193
Private sector	<u>1.884</u>	<u>2.184</u>	<u>2.768</u>	<u>3.823</u>	<u>7.181</u>	<u>9.071</u>
Total	7.647	8.414	9.523	14.570	23.854	31.264
Memorandum items:						
Gross external reserves <u>4/</u>	7.5	9.3	10.4	9.9	9.4	9.1
(In months of imports) <u>4/</u>	(6.8)	(6.4)	(5.4)	(4.4)	(3.8)	(3.6)
Current account balance						
(As per cent of GNP)	0.9	5.4	-1.0	-10.0	-13.4	-10.1
Outstanding debt						
(As per cent of GNP)	22.0	19.4	19.1	27.9	41.0	49.1

Source: Data provided by the Malaysian authorities.

1/ Four LNG tankers delivered in 1981 and one delivered in 1982 to the Malaysian National Shipping Company at a cost of about M\$1.8 billion are not included in imports and the capital account. However, their financing is included in statistics on external debt.

2/ Estimates.

3/ Includes payments of factor services.

4/ Gross external reserves converted at end-of-period exchange rates.

Table V. Malaysia: Indices of Exchange Rate Developments, 1975-82

(1980 = 100)

	Ringgit Per U.S. Dollar	Nominal Effective Exchange Rate <u>1/</u>	Real Effective Exchange Rate <u>1/</u>
1975-77 (Average)	113	111	86
1978	106	112	89
1979	101	106	93
1980 I	101	100	98
II	101	101	102
III	98	99	99
IV	100	100	101
1981 I	104	103	104
II	107	104	104
III	101	102	101
IV	102	98	97
1982 I	106	98	95
II	107	97	94
III	108	96	93
IV	109	95	92

Sources: IMF, International Financial Statistics; and staff estimates.

1/ All the currencies are expressed in terms of the U.S. dollar before computing the exchange rate indices of the ringgit on the basis of the currencies of Malaysia's major competitors. A larger numerical value reflects a depreciation. The competitor countries are Indonesia, Korea, the Philippines, Singapore, and Thailand and the weights are based on each country's exports to the rest of the world.

Malaysia: Relations with the Fund (As of April 29, 1983)

Status: Article VIII.

Date of Membership: March 7, 1958.

Quota: SDR 379.5 million (proposed quota under the Eighth General Review: SDR 550.6 million).

Fund holdings of ringgit: SDR 579.0 million (equivalent to 152.6 per cent of quota).

Use of Fund resources: In September 1981, Malaysia purchased the equivalent of SDR 189.8 million or 50 per cent of funds under the Compensatory Financing Facility. Under the Buffer Stock Financing Facility, Malaysia purchased the equivalent of SDR 58.5 million on June 23, 1982 and additional SDR 113 million on March 11, 1983.

SDR position: SDR 111.5 million, or 80.2 per cent of net cumulative allocation of SDR 139.05 million.

Gold distribution: 159,165.213 fine ounces (four distributions).

Direct distribution of profits from gold sales (July 1, 1976 to July 31, 1980): US\$29.56 million.

Exchange system: The ringgit is pegged to an undisclosed composite of currencies of Malaysia's major trading partners, and the weighting reflects the importance of currencies used in settlement as well as trade shares. Margins of 2.25 per cent are maintained, but occasionally and for relatively short periods, the rate has been allowed to exceed margins. The representative exchange rate of the ringgit under Rule 0-2 is the mid-point between the buying and selling rates for the U.S. dollar quoted at noon on the Kuala Lumpur foreign exchange market; the mid-point at end-April 1983 was 2.3105 per US\$1. Malaysia has accepted the obligations of Article VIII, Sections 2, 3 and 4. Payments and transfers for current international transactions are free of restrictions except to Israel and South Africa. Capital transactions above certain limits require prior approval; approvals are freely given except for investments by Malaysian residents in Israel and South Africa.

Last Article IV consultation: The Executive Board discussed the staff report on June 23, 1982. Staff discussions were held during April 15-26, 1982 (SM/82/106; SM/82/112).

Technical assistance: The Fund has provided technical assistance to Malaysia through its Asian Department, Bureau of Statistics, Central Banking Department, and Fiscal Affairs Department.

Malaysia: Relations with the IBRD

(In millions of U.S. dollars)

IBRD lending: (As of March 31, 1983)

Total commitments	1,457.8
Disbursed:	901.7
Total commitments in 1982:	209.2
Total disbursements in 1982:	121.1
Total commitments (1978-82)	

		<u>Per cent</u>
Agricultural and rural development	348.3	61
Power	136.3	22
Education	78.6	12
Transportation	13.0	2
Urbanization
Sewage
Population	<u>17.0</u>	<u>3</u>
Total	629.2	100

Technical assistance:

The IBRD provides technical assistance to Malaysia through its standard lending operations for projects. In addition, it is the executing agency for a large UNDP technical assistance project designed to improve project planning.

Recent economic and sector missions:

Macroeconomic Developments mission in June 1982; the Malaysian Statistical System Mission, April 1983; Agricultural Prices, Taxes and Subsidies mission, May 1983.

MALAYSIA

Basic Data 1/

Area:	127,581 square miles
Population (1983):	14.1 million
Population growth rates (1978-82):	2.5 per cent per annum
Per capita GNP (1982):	US\$1,763

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
<u>Selected aggregates</u> <u>as per cent of GNP 2/</u>						
Gross domestic investment <u>3/</u>	25.8	27.7	30.3	34.7	36.4	34.3
Gross savings	26.5	32.5	29.2	24.8	23.0	24.1
Narrow money <u>4/</u>	20.9	19.6	19.6	20.0	21.4	21.9-22.2
Broad money <u>4/</u>	50.5	49.9	55.4	58.9	59.2	69.2-69.8
Federal Government revenue and grants	25.4	24.2	27.9	28.7	28.4	27.4
Federal Government expenditure and net lending	32.2	27.5	34.6	44.4	45.1	42.2
Federal Government overall deficit	6.8	3.3	6.6	15.7	16.7	14.8
Exports of goods and nonfactor services	53.3	59.8	61.5	55.0	54.7	55.7
Imports of goods and nonfactor services	47.6	50.1	58.4	61.5	63.9	61.2
Current account balance	0.9	5.3	-1.0	-10.0	-13.4	-10.1
Outstanding external debt <u>4/ 5/</u>	22.0	19.4	19.1	27.9	41.0	49.1
<u>Annual percentage changes of selected</u> <u>economic indicators 2/</u>						
Gross domestic product (1970 prices)	6.7	9.3	7.8	6.7	4.6	5.0
GNP deflator	5.2	13.8	6.6	2.7	1.9	4.6
Consumer price index	5.0	3.5	6.7	9.7	5.8	5.0-6.0
Federal Government revenue and grants	13.0	18.8	33.1	13.5	4.5	5.5
Federal Government expenditure and net lending	9.4	6.6	44.5	41.6	7.5	2.3
Narrow money	18.2	17.2	15.0	12.8	13.3	11.0-13.0
Broad money	17.9	23.4	27.9	17.1	16.3	17.0-18.0
Net domestic credit	24.2	10.2	49.9	31.2	23.3	...
Government <u>6/</u>	-1.9	-13.6	9.0	9.1	7.9	...
Private <u>6/</u>	26.1	23.8	40.9	22.1	15.4	16.0-17.0
Merchandise exports, f.o.b.	13.9	41.7	17.0	-3.9	4.0	10.1
Merchandise imports, f.o.b.	21.4	30.4	33.8	15.9	9.2	3.0
Terms of trade	1.0	8.8	0.3	-3.2	-5.0	-4.0

Malaysia: Basic Data (Concluded)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
	<u>(In billions of ringgit)</u>					
<u>Federal Government budget 7/</u>						
Revenue and grants	8.8	10.5	13.9	15.8	16.5	17.4
Of which: petroleum revenue	(0.9)	(1.0)	(2.8)	(4.6)	(5.4)	(4.0)
Expenditure and net lending	11.2	11.9	17.2	24.4	26.3	27.0
Of which: development expenditure	(3.6)	(4.0)	(7.3)	(11.1)	(10.4)	(9.9)
Financing requirement	2.4	1.4	3.3	8.6	9.7	9.4
External borrowing	0.5	0.7	0.3	3.4	4.8	...
Domestic borrowing	1.9	0.7	3.0	5.2	4.9	...
Of which: banking system	(-0.1)	(-1.2)	(2.0)	(1.2)	(1.7)	(...)
	<u>(In billions of U.S. dollars)</u>					
<u>Balance of payments 7/</u>						
Trade balance	1.5	3.0	2.2	--	-0.6	0.2
Exports, f.o.b.	7.3	11.0	12.9	11.7	12.0	13.4
Imports, f.o.b.	-5.8	-7.9	-10.7	-11.7	-12.6	-13.2
Invisibles (net)	-1.4	-1.9	-2.4	-2.3	-2.7	-3.0
Current account balance	0.1	1.0	-0.2	-2.4	-3.4	-2.8
Capital movements (net)	0.6	0.3	1.5	2.6	3.8	3.2
Overall balance	0.3	0.9	0.5	-0.5	-0.3	-0.1
<u>Reserves and external debt 4/7/</u>						
Gross official reserves	3.3	4.0	4.5	4.2	3.9	3.8
(In months of imports)	(6.8)	(6.4)	(5.4)	(4.4)	(3.8)	(3.6)
Total external debt	3.3	3.8	4.4	6.7	10.2	13.6
Public sector	2.5	2.8	3.1	5.0	7.1	9.7
Private sector	0.8	1.0	1.3	1.7	3.1	3.9
Debt service ratio 8/	...	5.6	3.5	6.3	9.2	12.7

Sources: Data provided by the Malaysian authorities and staff estimates.

- 1/ Components may not add up to totals because of rounding.
 2/ Data for 1982 are estimates and forecasts for 1983.
 3/ Includes changes in stocks.
 4/ End of year.
 5/ Debt of maturity of one year and above; includes the existing coverage of private debt.
 6/ Rate of contribution to the increase in net domestic credit.
 7/ Data for 1983 are staff forecasts based on preliminary official data.
 8/ Relative to exports of goods and services.