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November 10, 1975

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report for the 1975 Article VIII Consultation

Attached for consideration by the Executive Directors is the staff report for the 1975 Article VIII consultation with Malaysia.

This subject will be brought to the agenda for discussion on a date to be announced.

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INTERNATIONAL MONETARY FUND

MALAYSIA

# Staff Report for the 1975 Article VIII Consultation

Prepared by Staff Representatives for the
1975 Consultation with Malaysia

Approved by W. John R. Woodley

November 7, 1975

## I. Introduction

The 1975 Article VIII consultation discussions with Malaysia were held in Kuala Lumpur during September 18-29, 1975. The Malaysian representatives included officials of Bank Negara Malaysia, the Treasury, and other government departments. The Mission met with the Deputy Prime Minister, who is also Minister of Finance. Mr. Abdul Malek, Advisor to the Executive Director for Malaysia, attended the meetings as an observer. The staff mission consisted of Messrs. Andreas Abadjis (ASD), Sheetal K. Chand (FAD), Kano Yamamoto (ASD), Hans O. Roden (ASD), and Mrs. Carole Chew (secretary).

## II. Summary of Recent Developments

The momentum generated by the economic boom of 1973 carried through the first part of 1974, but the tempo of economic activity slowed down later in the year, and recessionary tendencies became evident in early 1975. This shift in economic conditions was brought about by the sharp decline in foreign demand for Malaysia's principal export commodities, especially rubber and timber; there was a marked decline in export prices, and the output of export goods was curtailed. Industrial production began declining in late 1974, and in March-May 1975 it was 8.0 per cent lower than a year earlier. Although inflation continued to be a matter of concern, combatting recession became the principal task of economic management in 1975, and the authorities took several measures to stimulate the economy. Economic activity is expected to show some recovery in the last quarter, and real GNP is projected to grow by 1 per cent in 1975, compared with an increase of 6.3 per cent in 1974.

The inflationary pressures experienced in 1973 and 1974 have been curbed, partly as a result of the Government's policies of restraining monetary growth and expanding the supply of food and other essential commodities. The annual rate of increase in the consumer price index, which had peaked at 24.0 per cent in March 1974, declined to 12.0 per cent in December, and to 3.4 per cent in August 1975 (Chart 1). During the first eight months of 1975, food prices declined, while most other components of the index showed modest increases. The main contributing factors to the 1973-74 inflation were the strongly rising external and domestic demand, and higher import prices. Available information indicates that wage increases, which in Malaysia are, generally, of a catch up with inflation type, had not been an autonomous inflationary factor. In fact, because of the decline in economic activity, it is unlikely that wage increases in 1975 will fully compensate for inflation. Although several industries, especially export industries, have laid off workers, the increase in unemployment has been moderate, and more recently, some increase in employment in certain manufacturing enterprises has been reported.

As a result of the strong measures of monetary restraint introduced in January 1974 and the slackening of credit demand in the latter part of the year, credit to the private sector increased by 15 per cent during 1974, compared with an increase of 52 per cent in 1973; similarly, the expansion in money supply (9 per cent) was much lower than the 38 per cent increase in 1973. The monetary authorities began easing their credit policy in November 1974, and more important steps in the same direction were taken in February 1975 and in subsequent months. Credit demand by the private sector was sluggish in the first four months of 1975, but picked up in May-July, partly for seasonal reasons, and during the seven months, credit increased by 7 per cent. During the same period, net credit to Government increased by 13 per cent, whereas net foreign assets recorded a small decline. Money supply rose by only 2 per cent and total liquidity (money plus quasi-money), by 7 per cent.

Current revenues of the Federal Government increased by nearly 40 per cent in 1974, owing partly to the increased progressivity of export duties introduced in April of that year. However, the growth in expenditure was even more rapid, with the result that the overall deficit increased by 23 per cent to 6.4 per cent of GNP. The 1975 budget was presented in November 1974 and was intended to be stimulative, but actual developments in export prices and domestic economic activity were more unfavorable than expected at that time, revenue in 1975 is now estimated to be about 4 per cent below the original budget estimates for 1975. Total budget expenditure is expected to be 14 per cent higher than in 1974. The bulk of this increase comprises higher current expenditure; development expenditure is expected to be only 4 per cent higher than in 1974, indicating a decline in real terms. The overall deficit is expected to widen from the original budget estimate of M$1,259 million to M$2,142 million, or about 10 per cent of GNP.1/ The authorities intend to finance most of this additional overall deficit by foreign borrowing which would cover more than one third of the total deficit; the domestic banking sector would finance nearly 30 per cent of the total, and the remainder would be financed largely by the Employees Provident Fund and the National Savings Bank.

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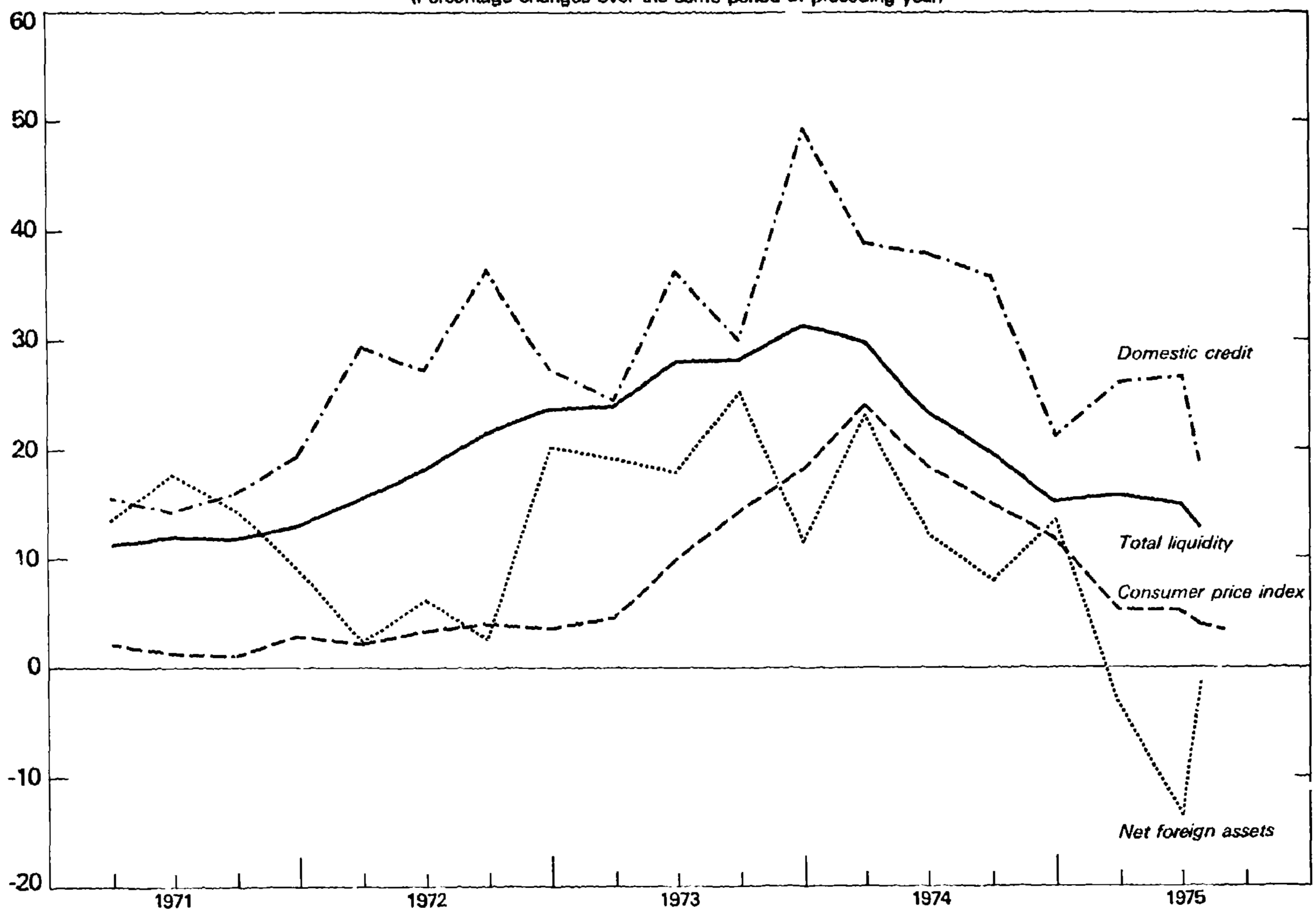
1/ During the years 1971-72, when the authorities were pursuing a countercyclical fiscal policy, the ratio of the overall budget deficit to GNP was of the same order of magnitude.

CHART 1

MALAYSIA

## CHANGES IN MONETARY AGGREGATES AND PRICES

(Percentage changes over the same period of preceding year)



As a result of strong domestic demand, a virtual stagnation in export volume, and a 4 per cent deterioration in the terms of trade, the current account of the balance of payments registered a deficit of SDR 227 million (3.4 per cent of GNP) in 1974, compared with a surplus of SDR 85 million in 1973 (Table 1). The net inflow of long-term capital increased substantially to SDR 390 million, mainly on account of new investments in petroleum projects and a copper mining project, and the balance of payments recorded an overall surplus (as measured by monetary movements) of SDR 132 million in 1974. During the first half of 1975, merchandise exports declined by about 20 per cent and imports by about 15 per cent, compared with the same period of last year. For the full year 1975, merchandise exports are expected to decline by 16 per cent and imports by 6 per cent, resulting in a trade deficit, the first in many years. The current account deficit is forecast to increase by 88 per cent to SDR 426 million (6.4 per cent of GNP). Long-term capital inflows, particularly on official account, are estimated to increase and almost exactly offset the current account deficit. Net errors and omissions are expected to show a larger debit of SDR 90 million, and the balance of payments is projected to show an overall deficit of SDR 83 million in 1975.

Official international reserves declined in the first five months of 1975, but increased appreciably in June and July reflecting the expansion in government medium-term borrowing abroad. In August, reserves amounted to SDR 1,302 million (SDR 74 million lower than in December 1974), and were equal to five months of projected merchandise imports (c.i.f.) in 1975.

Table 1. Malaysia: Summary of Balance of Payments, 1971-75

(In millions of SDRs)

| | 1971 | 1972 | 1973 | 1974 | 1975 Projection |
|---|---|---|---|---|---|
| Merchandise exports | 1,618 | 1,567 | 2,493 | 3,469 | 2,910 |
| Merchandise imports | 1,386 | 1,474 | 1,946 | 3,148 | 2,945 |
| Trade balance | 232 | 93 | 547 | 321 | -35 |
| Net services and transfers | -337 | -350 | -461 | -549 | -391 |
| Current account | -105 | -257 | 86 | -227 | -426 |
| Net nonmonetary capital | 212 | 247 | 197 | 390 | 434 |
| Errors and omissions | -67 | 40 | -183 | -30 | -90 |
| Allocations of SDRs | 20 | 20 | -- | -- | -- |
| Total | 60 | 50 | 99 | 132 | -83 |
| Monetary movements (increase -) | -60 | -50 | -99 | -132 | 83 |

Source: Central Bank of Malaysia.

During the past year, several items have been made subject to quantitative restrictions for protective purposes, and import duties have, on balance, been somewhat increased; the value of the restricted items was equal to about 4 per cent of total imports in 1973.

## III. Report on the Staff's Discussions with the Malaysian Authorities

### 1. Production and development planning

The recession in the industrial countries had a delayed impact on the Malaysian economy, but by the first quarter of 1975, production in most sectors of the economy had shown substantial declines. This delayed impact was due partly to the cushion provided by private investment expenditures which increased considerably in 1974, reflecting decisions taken during the boom year 1973.

The Malaysian representatives stated that business and consumer confidence appeared to be rising, owing to the relative stabilization of consumer prices and the relaxation of credit policy, and the end of the third quarter of 1975 might prove to be a turning point for the economy. By the second quarter of 1976, the economy was expected to be moving firmly upward, led by an expansion in rubber production; GNP was projected to grow by about 6 per cent in real terms.

In the energy field, oil production is expected to show a small increase in 1975, and a 10 per cent increase in 1976. In 1974, oil imports, both in value and volume terms, exceeded exports by relatively small amounts. Gasoline prices have been increased to reflect approximately oil prices in the international market, but diesel fuel and kerosene prices have been kept down. Regarding the development of other sources of energy, nuclear power generation is planned for the mid-1980s.

In connection with development policies, the Malaysian representatives stated that the Second Malaysian Plan (1971-75) had, on the whole, been a success. Despite the adverse economic developments in 1975, it is estimated that the target rate of growth of about 7 per cent per annum will be attained. However, with regard to the two guiding objectives of the Government's New Economic Policy, which had also been launched in 1971, viz., the eradication of poverty, and the correction of the economic imbalance between the Malay (bumiputra) and Chinese sectors of the population, the Plan's performance had been below expectations. Nevertheless, the economic situation of most poverty groups had improved, and the share of the bumiputra in the ownership and management of industry and commerce had increased appreciably.

While it was still too early to provide details of the Third Malaysian Plan (1976-80), the Malaysian representatives stated that its development strategy would be largely a continuation of that pursued in recent years,1/ but with greater emphasis on the eradication of poverty. In order to facilitate the quantitative appraisal of the poverty eradication program, eight

1/ Described in SM/74/241, pp. 10-12.

poverty categories had been defined comprising, among others, rubber smallholders, fishermen, urban poor, and agricultural workers. A greater share of Plan expenditure would be allotted to poverty eradication, and the shares of agriculture and industry would also be higher; correspondingly, the share of infrastructure expenditure would be lower. The Plan would aim at a higher rate of growth than in the past, and would rely more on private sector investment. Since it was intended to stabilize the proportion of public sector expenditure in total GDP at its present level (37 per cent), no major financing problem was expected as regards public sector investments, because of the relatively high elasticity of the tax system and the scope for mobilizing domestic resources, especially from increased social security contributions. Steps would be taken to curb the growth in public expenditure, for instance, by reducing duplication of effort among public sector agencies that had proliferated in recent years. Industrial development would focus more on labor-intensive industries based on domestic resources; priority would also be given to export-oriented industries.

2. Fiscal policy

The discussions centered on the use of the budget as an instrument of counter-cyclical policy. In reviewing the past two years, it appeared that actual budget performance had been relatively ineffective in achieving this objective. In 1974, the budget was expansionary even though aggregate demand had been buoyant during most of the year. Although the export boom had begun in early 1973, measures to reduce demand by making export taxes more progressive were undertaken only in April 1974. This restraining measure was counteracted by the large expansion in expenditure, and the overall budget deficit was 23 per cent higher than in 1973. For 1975, the authorities had intended the budget to have an antirecessionary impact. However, recent estimates indicate that the increase in current expenditure will be below average for the past five years, while real growth in development expenditure will probably be negative. It appears, therefore, that the increase in the overall budget deficit in 1975 was a consequence of the prevailing recessionary conditions rather than the result of discretionary anticyclical measures. Although in an economy so heavily dependent on exports, fiscal policy could not be expected to fully offset a sharp fall in export earnings, the staff team suggested that fiscal policy could have been more expansionary in 1975.

While the rapidity with which the economy had turned around contributed to the difficulties in conducting an effective fiscal policy, delays in the reporting of fiscal developments were also responsible. Thus, at the time the authorities presented the 1975 budget (November 1974), they were under the impression that the budget was sufficiently antirecessionary in the light of the outturn then expected for 1974. The staff mission said that efforts should be made to improve the timeliness of fiscal reporting, and suggested that in times of great uncertainty regarding developments abroad and in the domestic economy, budget flexibility was especially important. This could take the form, for example, of formulating alternative expenditure programs in advance so that they could be implemented promptly when the need arose. The Malaysian representatives explained that in early 1975, as evidence of recessionary tendencies mounted, efforts had been made to implement an expenditure program involving outlays on quick-yielding projects. Some success had been achieved, for example with projects for expanding production of vegetables and other foodstuffs, but difficulties had been encountered because of a lack of appropriate projects ready for implementation; the authorities were taking steps to remedy this situation.

Regarding the policy to be pursued in the immediate future, the staff team indicated that given the uncertainties surrounding the timing and strength of the economic recovery of the industrial countries, the time lag with which such a recovery would exert an impact on the Malaysian economy, and the lack of firm signs that a recovery was under way in Malaysia, the authorities should consider stepping up expenditures on ongoing projects as well as implementing additional projects during the next six months. These should be preferably of a labor-intensive character with short gestation periods, thereby permitting the authorities to reverse, if necessary, their expansionary policy in the event of a build-up of inflationary pressure in the latter part of 1976. The Malaysian representatives agreed and indicated that enhanced expenditure on low-cost housing would be of particular importance since the construction industry was depressed and the import content was low.

The staff team suggested that in a longer-term context, steps should be taken to render the budget, especially on the tax side, more responsive to changes in the current economic situation by, inter alia, changing the system of direct tax assessments from a preceding to a current year basis and by making certain taxes more progressive. The Malaysian representatives replied that they intended to make the budget a more effective automatic stabilizer and were planning to introduce a current year assessment scheme as soon as feasible.

The preliminary outline of the 1976 budget was reviewed. In the absence of new tax measures, current revenue is expected to grow by about 8 per cent, while current expenditure would increase by 5 per cent. Direct subsidies are expected to be much lower, mainly because the price of imported rice has declined, but there is considerable uncertainty regarding outlays on security expenditure in view of the resurgence in terrorist activity. Moreover, since the tentative estimate did not provide for any increase in wages and salaries of government employees, the staff team felt that it would be difficult for the Government to restrict the growth in expenditures to 5 per cent. As to development expenditure, the proposals will be presented in two stages, because parliamentary approval of the Third Malaysia Plan is not expected before March 1976. The budget will incorporate appropriations for spending on ongoing projects, while proposals for expenditure on new projects will be made in a supplementary budget following the approval of the Third Malaysia Plan. This splitting of expenditure appropriations will enable the authorities to take into account the extent of economic recovery in determining the amount of development spending after March. The Malaysian representatives expressed concern about the increasing recourse to foreign borrowing to finance development expenditure. The staff team opined that in view of the low foreign debt service ratio and the favorable medium-term export prospects, Malaysia was in a position to incur additional foreign debt to finance an effective anti-recessionary program.

The staff team discussed recent studies commissioned by the Government to evaluate tax incentives to industry as well as tariff protection, which indicated that in certain cases the benefits conferred were excessive. The Malaysian representatives stated that the authorities intended to exercise greater stringency in granting applications for tax incentives and to be more active in reducing excessive margins of tariff protection.

3. Monetary policies

During the past two years, monetary policy has, on the whole, been applied flexibly and in quick response to the changing economic situation; in November 1974, the monetary authorities took the first step toward easing the policy of restraint which had been pursued during the period of inflation. More important measures to relax credit were taken after the turn of the year. In February 1975 the ceilings on credit expansion of commercial banks and borrowing companies were abolished, and the statutory reserve ratio, as well as bank interest rates, were reduced. The statutory reserve ratio was reduced further in May, and bank interest rates were reduced again in May and August. As a result of these measures, commercial banks have become liquid and have been in a position to meet credit demand which, since May, has started to pick up. If, as expected, economic activity shows some ecovery during the last quarter of the year, the Malaysian authorities e..imate that credit to the private sector would increase by 14 per cent and money supply, by more than 8 per cent during the full year 1975.

The Central Bank has strengthened markedly its selective credit policy in order to channel funds to priority sectors. Since February 1975, commercial banks and borrowing companies have been required to extend a minimum of 50 per cent of the net increase of their loans to the bumiputra community (bumiputra individuals and bumiputra-controlled enterprises), for home ownership by individuals, and to the manufacturing industry. Moreover, banks have been required to increase the amount of funds devoted to small loans under the credit guarantee scheme. As a result, about 70 per cent of the total net increase in bank credit during the first seven months of 1975 has been directed to these priority sectors. The Malaysian representatives stated that the selective credit policy had played a significant role in assisting the bumiputra community to expand its business activity and improve its economic standing; this policy had helped to overcome the traditional prejudice of banks against lending to the bumiputra community. They added that selective credit policy to channel credit to the bumiputra community, small businesses, and housing loans would be continued because it contributed to the attainment of the objectives of the New Economic Policy. However, the preference given to credit extension to the manufacturing industry would probably be discontinued as soon as economic activity recovered.

The monetary authorities considered present monetary policies as being broadly appropriate, but were prepared, if necessary, to take additional steps to help stimulate the economy, including a further lowering of interest rates. Looking ahead to the latter part of 1976 when export demand might strengthen considerably, the staff team pointed to the need for continuing flexibility in credit policy. The Malaysian representatives remarked that the Central Bank Act had been amended recently to permit the Bank to issue its own securities in order to engage in open market operations. When the need arose, such securities would be issued in order to absorb excess liquidity. Regarding interest rates, the Central Bank favored a gradual shift to market-determined interest rates, but progress in that direction had not been made during the past year, partly because commercial banks had shown reluctance to reduce lending rates following reductions in the maximum interest rates on fixed deposits and minimum prime lending rate as required by the Central Bank.

With regard to measures to broaden the capital market in order to improve the mobilization of savings, the Malaysian representatives said that steps had been taken to enable the Employees Provident Fund to invest in shares of certain approved companies. They agreed with the staff mission's suggestion that public corporations should issue their own debentures in the market to obtain funds for their capital needs.

4. External policies

The expected appreciable decline in Malaysian exports in 1975, is due mainly to lower prices. Since about three quarters of Malaysia's exports go to the OECD area, a significant expansion in Malaysian exports in 1976 depends on an early economic recovery in the OECD countries; such a recovery would be reflected in Malaysian exports with a time lag of more than six months.

Despite the diversification of Malaysian exports, rubber exports continue to be the major item (30 per cent of total exports in 1974), and the rubber industry is the most important employer of labor in Malaysia; Malaysia's share in total world production of natural rubber was 44 per cent in 1974. In order to halt the sharp decline in rubber prices, the Malaysian Government announced in November 1974 a six-point program to reduce production and increase domestic stocks of rubber. The monthly average price of RSS1 rubber had fallen from a peak of M$2.65 per kilo in January 1974 to a low of M$1.12 per kilo in November. However, in September 1975 it averaged M$1.41 per kilo, and is expected to increase further in 1976. Although the restrictions on rubber production were eased in September, rubber output was expected to decline by about 10 per cent in 1975. Negotiations among members of the Association of Natural Rubber Producing Countries for the establishment of a buffer stock scheme for natural rubber are at an advanced stage; consuming countries will be invited to join the scheme.

Since the Government's policy is to give priority to export-oriented industries processing locally produced commodities, the share of processed goods in total exports is expected to rise significantly in the next few years. Among exports of primary commodities, rubber, palm oil, tin, and timber will continue to comprise the bulk of such exports, but petroleum and, to some extent, copper will become increasingly important.

Discussing the difficulties facing Malaysia's exports, the Malaysian representatives referred to the restrictions imposed by several industrial countries on textile exports under the Multifiber Textile Arrangement and to the introduction of a quota on Malaysian exports of rubber boots by Sweden. They also pointed out that the Malaysian pineapple, palm oil and plywood industries had been adversely affected by the gradual rise in the U.K. tariffs following its entry into the EEC. Palm oil exports to the EEC were facing additional difficulties because of the preferential tariff treatment accorded to exports of vegetable oil from certain African countries.

In contrast to export price developments, import prices continued their uptrend in 1975, although at a much lower rate, and the terms of trade are projected to record a substantial decline in 1975. Despite the adverse economic conditions in Malaysia and abroad, the inflow of private long-term capital is expected to be large. Regarding the possible adverse effects on foreign investment in Malaysia of the Amendment to the Petroleum Development Act of 1974 and the Industrial Coordination Act passed in April 1975, the Malaysian representatives stated that it was difficult to make an assessment. Discussions were in progress with the foreign oil companies regarding this Amendment, and in drawing up the regulations for implementing the Industrial Coordination Act the genuine concerns expressed by foreign and local entrepreneurs were being taken into account. Regarding international reserves, the longer-term objective is to achieve a higher ratio than the present one of about five months' imports. Medium-term export prospects are favorable, and the current account deficit as a percentage of GNP is expected to decline substantially in the course of the Third Malaysia Plan (1976-80).

Concerning the exchange system of Malaysia, the Malaysian representatives explained that the Malaysian dollar was pegged to a composite of currencies of Malaysia's major trading partners and that the weighting reflected trading shares as well as the importance of currencies in settlement. The authorities intervened to maintain the rate within margins of 2.25 per cent, but occasionally and for relatively short periods the rate had been allowed to exceed margins; this had occurred, for example, when there were relatively sharp movements in the U.S. dollar. However, the intention was to maintain margins and the rate had been brought back within the margins. The authorities did not wish to disclose details of the composition of the basket because of their fears of speculation affecting the rate. Although the authorities would like to see the present situation of general floating come to an end, they were relatively satisfied with the working of the Malaysian exchange system. On the whole, it had been possible to maintain stable market conditions in the short run, but it was felt that major industrial countries should act more decisively to dampen fluctuations in their currencies, which developing countries, like Malaysia, had difficulty in counteracting. The authorities believed that the current exchange rate of the Malaysian dollar was appropriate under the prevailing circumstances. The trade-weighted effective exchange rate of the Malaysian dollar computed by the staff rose by 5.7 per cent in 1974, but has declined in recent months, and in late October 1975 it was 5.9 per cent lower than at the end of 1974.

The forward market has been working satisfactorily in providing cover to traders, although there was room for further improvement. The cost of forward covering has been reduced as a result of a larger volume of transactions and increased competition among banks. The Central Bank does not participate in the forward market.

Export restrictions were intensified during the past year as additional commodities were made subject to such restrictions. The Malaysian representatives explained that export restrictions were imposed mainly on items for which domestic production could not meet domestic demand; several items on the restricted list were materials used by domestic industries. The purpose of the restrictions was to avoid shortages, including seasonal shortages, and price increases. The staff team commented that the supply shortages and sharp price increases which had led to the imposition of export restrictions in Malaysia and other countries in 1973-74 had moderated or disappeared. However, with the exception of sugar, Malaysia did not relax its export restrictions but instead imposed new ones. With regard to the intensification of import restrictions the Malaysian representatives explained that these restrictions had not been introduced for balance of payments reasons, but in order to protect domestic industry; they were considered temporary and were being constantly reviewed.

## IV. Staff Appraisal

A basic change in Malaysia's economic situation took place toward the end of 1974: owing to the decline in export demand, economic activity slowed down markedly from the boom conditions experienced in 1973 and early 1974, and the rate of inflation, which had reached a peak in March 1974, eased considerably. By the beginning of 1975, when recessionary tendencies became evident in the Malaysian economy, combating recession became the principal task of economic policy. Considering the heavy dependence of the economy on foreign trade (exports equal about 50 per cent of GNP), the Government's policies of the past two years have attained a large measure of success: the annual rate of inflation has declined sharply to 3.4 per cent, while the effects of the fall in export demand have been blunted by antirecessionary measures so that the increase in open unemployment has not been serious. Although no firm indications are as yet evident, the authorities expect the economy to turn around in the latter part of this year. A full recovery of the Malaysian economy is conditional on the upturn of economic activity in the industrial countries which would be transmitted to Malaysia with a lag of several months.

The Central Bank changed its policy stance in November 1974, and important measures to relax credit were taken in February and in subsequent months. The lifting of the credit ceilings and the lowering of statutory reserves and interest rates have improved the business climate and have made it possible for the banking system to provide financial support to an economic recovery. The staff welcomes the fact that the Central Bank is now able to issue its own notes to engage in open market operations; such operations will enhance the effectiveness of the Bank's system of credit control. During the past two years, monetary policy has, on the whole, been applied flexibly in response to changing economic conditions. However, it cannot be relied upon alone to counteract factors, such as a fall in export demand or a loss in real income, which depress aggregate demand; it has to be reinforced by fiscal policy in order to provide for effective demand management.

Examined in retrospect, budgetary performance has not been an effective factor in demand management during the past two years. In 1974, the budget was expansionary, although aggregate demand was buoyant during most of the year. In 1975, the much larger budget deficit expected appears to be a consequence of the prevailing recessionary tendencies that affected revenues adversely, rather than of discretionary anticyclical measures that would have further compensated for the fall in export demand. The staff believes that, in the circumstances, a more expansionary budget would have been appropriate. In view of the lack of clear indications of an economic upturn in Malaysia and the uncertainties regarding the timing and strength of the economic recovery in most industrial countries, the authorities agreed that it would be desirable to implement during the next six months additional projects of a labor-intensive character, that have low import content and short gestation periods. Since development appropriations for 1976 will be split into two parts, the authorities will be able to take into account economic developments in the first quarter of that year before deciding on the level of expenditure on new projects included in the Third Malaysia Plan. The staff team indicated that the use of government expenditure programs as an anticyclical instrument requires, inter alia, advance preparation of projects so that implementation can commence within a short period of time. In order to increase the budget's effectiveness as an automatic stabilizer the authorities intend to introduce a current year assessment scheme for income taxes.

The pursuit of a more effective antirecessionary policy raised the issue of financing a larger budget deficit. The Government's economic policies over the past several years have succeeded in achieving a high rate of growth without, at the same time, creating a debt service problem for the balance of payments. As a result of these policies, the debt service ratio is presently low, and in view of the favorable medium-term export prospects, the country is in a good position to incur foreign debt in sufficient amounts to finance additional development expenditures for an effective antirecessionary program.

The authorities have in the past taken steps to develop a capital market that would provide longer term investment funds. The staff indicated that in order to broaden the capital market and mobilize additional resources for the public sector's development program, public corporations which depend on the budget for financing their capital requirements should issue their own debentures on the market.

The trade account is expected to show a deficit in 1975, in contrast to the substantial surpluses recorded in recent years, and the current account deficit is expected to be considerably higher than in 1974. However, the medium-term prospects for traditional and oil exports are favorable. Moreover, the industrialization policy is now giving priority to industries which are export oriented and process local raw materials so that exports of processed goods are expected to increase their share in total exports. Nevertheless, in the years ahead the bulk of Malaysia's exports will continue to comprise primary commodities, and domestic incomes and demand will be subject to the sharp fluctuations in the prices of such commodities in the international market. Consequently, Malaysia is keenly interested in schemes aimed at stabilizing prices of primary commodities.

Currently, it is negotiating with other natural rubber producers for establishing a buffer stock scheme for rubber; consumer countries will be invited to join the scheme.

In the 1973-74 environment of sharp price increases and shortages, Malaysia had restricted the exportation of certain foodstuffs and other items in order to mitigate price increases in the domestic market. During the past year, additional items were placed on the restrictive list, although shortages had been eliminated and price increases had been curbed. The staff believes that measures which interfere with the flow of goods and tend to create differentials between domestic and international prices should be avoided.

During the past year, import restrictions were intensified in order to protect domestic industry; the authorities consider these restrictions temporary. The staff is of the opinion that in the present situation where many countries find themselves in balance of payments difficulties, special efforts should be made to avoid restrictions which aggravate the adjustment process of other countries. In this context, the staff notes that the authorities intend to be more active in reducing excessive margins of tariff protection extended to domestic industries.

Fund Relations with Malaysia

The former Federation of Malaysia became a member of the Fund on March 7, 1958. Its name was changed to Malaysia in September 1963, with the merger of Sabah, Sarawak, and Singapore. On August 9, 1965, Singapore seceded from Malaysia.

Malaysia's quota is SDR 186 million. In August 1971, Malaysia purchased SDR 7.29 million under the Fund's buffer stock scheme to pay its contributions under the Fourth International Tin Agreement. In October and November 1973, Malaysia repurchased SDR 7.24 million. In December 1974 and April 1975, Fund sales of Malaysian dollars totaled SDR 7.25 million. Currently, the Fund's holdings of Malaysian dollars amount to 71.1 per cent of quota.

Malaysia is a participant in the Special Drawing Account and has received three allocations totaling SDR 60.6 million. Malaysia was designated to receive SDR 1.0 million in the fourth quarter of 1974; on October 31, 1975 Malaysia's holdings totaled SDR 61.7 million, or 101.8 per cent of the net cumulative allocation.

Following the floating of the pound sterling, Malaysia informed the Fund on June 28, 1972, of its decision to use the U.S. dollar as the intervention currency with the parity rate at M$2.5376 = US$1. On June 21, 1973 the Malaysian authorities notified the Fund that as from that date they would not intervene in their markets to buy U.S. dollars at the lower margin of M$2.4805 per U.S. dollar. Presently, the Malaysian dollar is pegged to a composite of currencies of its major trading partners and the weighting reflects trade shares as well as the importance of currencies used in settlement. Margins of 2.25 per cent are maintained, but occasionally, and for relatively short periods, the rate has been allowed to exceed margins.

Malaysia accepted the obligations of Article VIII, Sections, 2, 3 and 4 on November 11, 1968. The 1974 Article VIII consultation discussions were held in Kuala Lumpur, August 5-16, 1974 (SM/74/233 and SM/74/241) and the Board discussion was held on November 11, 1974 (EBM/74/143).

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

# MALAYSIA

## Basic Data

| | |
|---|---|
| Area: | 128,370 square miles |
| Population (1974): | 12.1 million |
| Annual rate of growth of population (1974): | 2.7 per cent |
| Gross national product (1974): | SDR 6,770 million (M$19,600 million) |
| Per capita gross national product (1974): | SDR 560 (M$1,620) |

### Selected Aggregates as Percentages of GNP

| | 1971 | 1972 | 1973 | 1974 |
|---|---|---|---|---|
| Manufacturing production | 11.9 | 12.8 | 13.1 | 14.7 |
| Gross capital formation | 19.6 | 21.3 | 20.3 | 23.5 |
| Gross national savings | 16.8 | 15.8 | 21.8 | 19.2 |
| Money | 18.0 | 21.3 | 23.0 | 20.7 |
| Total liquidity | 39.7 | 45.4 | 46.8 | 44.5 |
| Federal Government tax revenues | 17.7 | 18.8 | 18.6 | 22.0 |
| Exports of goods and services | 46.5 | 41.6 | 49.3 | 56.8 |
| Imports of goods and services | 48.1 | 45.8 | 46.8 | 60.5 |

### Annual Percentage Changes in Selected Economic Indicators

| | 1971 | 1972 | 1973 | 1974 |
|---|---|---|---|---|
| Gross national product (constant prices) | 7.3 | 5.2 | 10.2 | 6.3 |
| Agricultural production | -3.1 | 6.5 | 12.2 | 5.4 |
| Rice production | 6.9 | 1.9 | 8.0 | 5.2 |
| Rubber production | 3.9 | -1.1 | 20.6 | 0.4 |
| Industrial production | 1.9 | 10.2 | 13.9 | 11.3 |
| Federal Government receipts | 5.5 | 20.8 | 16.4 | 39.6 |
| Federal Government expenditures | 24.7 | 23.7 | 3.6 | 36.2 |
| Money | 4.3 | 28.1 | 37.6 | 8.5 |
| Total liquidity (money plus quasi-money) | 13.2 | 23.5 | 31.2 | 15.3 |
| Bank credit to Government (net) | 403.4 | 192.0 | 29.5 | 69.5 |
| Bank credit to private sector | 14.6 | 17.2 | 52.1 | 15.1 |
| Total bank credit | 19.3 | 27.2 | 49.3 | 21.0 |
| Consumer price index | 2.9 | 3.7 | 18.2 | 12.0 |
| Merchandise exports (in SDRs) | -2.5 | 5.0 | 59.1 | 39.1 |
| Merchandise imports (in SDRs) | 6.5 | 12.7 | 32.0 | 61.8 |
| Unit value of exports (annual average) | -8.0 | -4.3 | 28.4 | 34.5 |
| Unit value of imports (annual average) | 7.0 | 4.6 | 16.0 | 41.5 |
| Trade-weighted effective exchange rate | ... | 2.7 | 7.6 | 5.7 |

## Federal Government Budget

(In millions of Malaysian dollars)

| | 1971 | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|---|
| Current revenue | 2,418 | 2,920 | 3,398 | 4,745 | 4,708 |
| Current expenditure | 2,519 | 3,068 | 3,341 | 4,230 | 5,000 |
| Foregin grants | 39 | 66 | 28 | 53 | 50 |
| Development expenditure | 949 | 1,223 | 1,106 | 1,827 | 1,900 |
| Overall deficit (-) or surplus | -1,011 | -1,305 | -1,021 | -1,259 | -2,142 |
| Deficit financing: Foreign (net) | 343 | 306 | 69 | 223 | 742 |
| Banking system | 210 | 327 | 306 | 514 | 617 |
| Other | 458 | 672 | 646 | 522 | 783 |

## Fund Position (October 31, 1975)

| | |
|---|---|
| Quota: | SDR 186 million |
| Fund holdings of Malaysian dollars: | 71.1 per cent of quota |
| SDR holdings as per cent of allocation: | 101.8 per cent |
| Exchange rate: | US$1 = M$2.5469; SDR 1 = M$3.0201 |