FOR AGENDA

SM/79/75

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March 19, 1979

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report for the 1979 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1979 Article IV consultation with Malaysia.

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

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

Malaysia

Staff Report for the 1979 Article IV Consultation

Prepared by the Staff Representatives for the 1979 Consultation with Malaysia

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

March 15, 1979

I. Introduction

The 1979 Article IV consultation discussions were held in Kuala Lumpur during February 2-14, 1979. Malaysia has accepted the obligations of Article VIII, Sections 2, 3 and 4. Discussions were held with the Governor of Bank Negara Malaysia, the Secretary General and the Deputy Secretary General of the Treasury, the Secretary General of the Ministry of Trade and Industry, the Director General of the Economic Planning Unit, and other senior officials. The staff team consisted of Messrs. P.R. Narvekar (ASD), G. Szapary (ASD), B. Aghevli (ASD), B. Short (CBS), and Mrs. M. DeLaney (ASD).

II. Report on Discussions

The consultation discussions focused on the short-run objectives of Malaysia's financial policies. Sections 1 to 3 provide a framework within which to consider these objectives and policies, outlining the perspective from recent history, the directions in which longer-term policies are steering the economy, and the immediate international economic environment. The short-run objectives of financial policies, the instruments of these policies, and the consistency of the objectives and policies inter se, are reviewed in sections 4 to 6.

1. The perspective from recent history

Malaysia's economic performance over the past decade has been remarkable in terms of growth and diversification of aggregate output and the record of price stability and balance of payments strength. When, in the early 1960s, the outlook for natural rubber--which then accounted for over half of total exports and over a quarter of total output--turned sharply adverse, the prospects for the economy seemed to have been seriously jeopardized. However, the authorities responded with an aggressive program of rubber replanting designed to increase the yield, quality, and competitiveness of the product and, at the same time, of developing a new export commodity--palm oil. A vigorous exploitation of timber resources was also begun. The manufacturing sector was strongly promoted; this sector not only expanded in size but also matured progressively into an export orientation. In the 1970s, petroleum production increased sharply. The changing structure of the economy is dramatically evident in the changing structure of exports, as shown in Table 1.

Table 1. Malaysia: Export Pattern, Selected Years

(Per cent of total exports)

	1966-70	1971-75	1976-78
Rubber	36	28	22
Petroleum	3	6	14
Other primary products 1/	39	41	38
Manufactures	10	14	18
Other	12	11	8

1/ Tin, palm oil, lumber and timber.

Aggregate output has increased in the 1970s at an average annual rate of almost 8 per cent, a rate representing some acceleration over the already respectable rate of the 1960s. The improvement in per capita output has been even faster, as the rate of population growth, which had slowed from 3.5 per cent in the mid-1950s to 3 per cent in the mid-1960s, slowed further to 2.4 per cent in 1976.

The acceleration of growth has been accompanied by a sharp increase in the rate of investment in the 1970s (Table 2). This increase has been helped by some net inflow of foreign savings but it has been largely matched by a domestic savings effort. The sharp increases in domestic investment and savings rates have been achieved without an undue strain on resources. The annual rate of inflation did increase from an average of just over 1 per cent in the 1960s to about 7 per cent in the 1970s. However, the price movements in the 1970s reflected largely the impact of imported inflation, especially in 1973 and 1974; in none of the other years has inflation exceeded 5 per cent.

Table 2. Malaysia: Investment, Savings, Growth and Price Performance, 1961-79

	Annual Averages 1961-70	Annual Averages 1971-78	1977	1978 (Estimate)	1979 (Forecast)
			(As per cent of GNP)		
Gross domestic investment	16.2	24.3	24.2	26.3	28.4
Domestic savings	16.3	23.9	28.5	27.1	26.3
Foreign savings, net inflow	-0.1	0.4	-4.3	-0.8	2.1
			(Percentage change per annum)		
GNP, real terms	6.4	7.8	7.1	7.4	8.0
Prices	1.1	6.7	4.7	4.9	...

The remarkable record of price stability over the years can be attributed largely to cautious domestic financial policies. A currency board arrangement was in existence until 1967 under which the supply of currency to the economy could increase only when it was matched by increases in the currency board's foreign assets. The Central Bank took over the currency issue function in 1967; in the years since then as well, the increase in reserve money has been more than fully accounted for by increases in the net foreign assets of the Bank. The Government's deposits with the Bank have exceeded its borrowing from it, and commercial bank borrowing from the Bank has been negligible. Even in terms of the expansion of total liquidity in the economy, the contribution of increases in net foreign assets, at about a third, has been unusually high by international comparison.

These cautious financial policies have kept the external payments position strong even as a liberal trade and payments system has been maintained. During the 1970s, export volume has increased by an average of about 5 per cent per annum, and as the deterioration in the terms of trade--which had been so marked in the 1960s because of the persistent fall in rubber prices--slowed, an equivalent increase in imports could be accommodated. The current account and overall positions of the balance of payments have fluctuated but the latter has been in persistent surplus. The foreign exchange reserve position has been strong.

Respectable as the rate of output growth was in the 1960s, little dent was made in that decade in the problem of unemployment and underemployment or poverty generally. This was in part because of the accelerating growth of the labor force which reflected the high birth rate of earlier years and in part because of the persistent fall in rubber prices which adversely affected the predominant smallholder sector. It is in this sector, along with paddy and other subsistence farming, that poverty is concentrated.

In the 1970s, however, notable progress has been made in these areas. Eradication of poverty has been accorded the highest priority among policy objectives. As the various programs designed to relieve poverty especially the programs to open up new land for the landless and poor farmers have come to fruition, and as the position of the rubber sector has strengthened both because of productivity gains and higher prices, the incidence of poverty has declined. The growth of the labor force has continued to accelerate in the 1970s. Nevertheless, there is evidence that the rate of unemployment and underemployment has declined in recent years.

2. The framework set by long-term objectives

The principal long-term economic objectives of the Malaysian authorities have been set out and quantified for the target year 1990 in the New Economic Policy which was enunciated in 1970. One of these objectives is to reduce the incidence of poverty. Despite the relatively high per capita income (SDR 930 in 1978) and the recent alleviation of poverty, much still remains to be done to ensure that the minimum basic needs are available to the entire population. The other principal objective is to restructure employment, occupation, and the ownership of capital in such a way as to eliminate the long-established identification of ethnic groups with economic function--of the Malays and other indigenous groups (the bumiputras) with smallholder agriculture, and the Chinese and Indians with the more modern and rapidly growing sectors of the economy. As a result of their limited participation in these latter sectors, the Malays make up the largest section of the poor. The necessary restructuring is to be brought about through direct regulation, and the provision of incentives and preferences as well as other policies described in the next three paragraphs.

The authorities attach more importance to the equitable distribution of the benefits of development than to the growth of aggregate output as such. Since poverty is concentrated in the traditional agricultural sector, direct programs to reduce poverty focus principally on public investment to improve the productivity of the small farmer and to provide basic needs to the poor. In this respect, an important new factor has emerged, with potential favorable implications. The evolving demand/supply balance in the world rubber economy portends the emergence of a shortage and a continuation of strong prices in the next several years. This prospect is actually the result of a sharp slowing down in the last few years in the growth of rubber output in Malaysia--the last major replanting cycle there having been completed by the mid-1960s. In view of the bright outlook for rubber prices, the country is now facing the question of how much relative emphasis should be placed on diversification away from rubber, principally into oil palm, and on increasing rubber output further. Recently, the replanting grant to rubber smallholders has been increased, and research on improving tapping techniques and increasing the yield of trees has been intensified. In addition, new land is being brought under rubber cultivation. Given the ample land resources that are still unutilized, the acreage under rubber can be increased along with that under oil palm.

National self-sufficiency in rice by 1980 is a target of the Third Malaysia Plan (1976-80) but it appears unlikely now that this target will be attained. The authorities state that while rice self-sufficiency is desirable for strategic reasons, the primary objective of promoting rice production is to provide farmers with an increased source of income through double cropping.

Although the growth of total output per se is not their primary objective, the authorities recognize that the alleviation of poverty and social restructuring can come about only in an environment of rapid economic growth, especially the rapid growth of the sector with high per capita productivity, i.e., manufacturing. While there are still growth possibilities in import-substituting industries, further development of the manufacturing sector will have to be even more export-oriented than it has been in the recent past. In their investment approval and incentive policies, the authorities attach the highest importance to the criteria of export potential, labor absorption, and regional balance. The present structure of tariffs and tax incentives is now being reviewed in preparation for the Fourth Malaysia Plan.

As indicated earlier, an important aspect of the recent diversification of the economy has been the development of the oil and gas sector. This sector will continue to expand as exploration and drilling continue, new wells are developed, refinery capacity is increased, and the LNG plant--on which work is about to commence--comes on stream in the next several years. However, the authorities feel no particular urgency to maximize production of oil and gas since the country has other adequate sources of foreign exchange and domestic tax revenue. Proven oil resources are in any event limited. The authorities, therefore, attempt to balance the need for petroleum revenues to finance development the need to conserve oil, a depletable resource, thus seeking to achieve imum rate of production. The rate of oil and gas production in all fiel currently subject to the approval of Petronas, the national oil company. The policy is to restrict production in those wells in which the gas-to-oil ratio is high, since most of the gas now has to be flared. In the meanwhile, plans are being developed for using gas in power generating stations.

3. The immediate international economic environment

Despite the weaknesses in the world economy, the external situation that Malaysia faces this year is not unfavorable. Most important, the world market price for rubber is likely to rise further in 1979. The markets for tin, logs, and sawn timber are also expected to continue strong. Following the OPEC price action effective January 1 of this year, Malaysia has raised the prices of its crudes, the average increase for the main grades having been 6 per cent. Further increases are planned for the rest of the year, the average increase for the year as a whole being presently placed at 15 per cent. The recent events in Iran have made it possible for Malaysia to charge a premium for the high grade crudes that it exports. Of the principal exports, only palm oil is expected to experience a price fall in 1979, following upon a fall in 1978.

Another favorable factor is the relative ease in international capital markets from which Malaysia has already benefited in the past year, largely through refinancing earlier higher cost borrowing. This policy of refinancing is likely to continue in the current year.

There are, however, important unfavorable factors as well. The likely slowdown in world economic activity in the current year is expected to affect adversely the export of manufactures. The authorities stress that tariffs, quantitative restrictions, and certain other regulations abroad affecting the export of textiles, footwear and canned fruits are a continuing problem, the intensity of which has increased during the past year. It is noteworthy, however, that Malaysia's exports of manufactures nevertheless increased substantially in 1978 and are expected to increase further in 1979 but at a reduced rate.

The countries that are the principal sources of Malaysia's imports, taken as a group, are likely to experience a significant degree of inflation in 1979. Given the openness of the Malaysian economy, with imports being equivalent to well over 40 per cent of GNP, and given the strong preference of the authorities to avoid inflation, this element in the world economic outlook is particularly unfavorable.

4. Objectives of short-run policies

The principal objectives of Malaysia's economic policies during the current year are two. The first is to achieve an increase of about 8 per cent in aggregate output. Such an increase should not be difficult to achieve, given the present and prospective strength of world demand for Malaysia's principal exports and the rate of growth of aggregate output recorded in recent years.

The second objective of short-run policies is to increase investment further. Private investment has only recently recovered from a dull period, and although the authorities are generally satisfied with the present strength of the investment sentiment, they would like to continue to give it strong encouragement. After having declined in 1975 and increased only slightly in 1976, private investment expenditure recovered vigorously in 1977 and 1978 but was only about 3 per cent higher in the latter year than in 1974. However, recent trends have been favorable. Investment approvals granted in 1978 were substantially higher than in 1977, and the Central Bank's periodic surveys indicate a progressive strengthening of investment intentions in the manufacturing sector.

The recovery of private investment is attributable to the continued strength of external demand, the sustenance of internal demand by expansionary fiscal policies, Central Bank policies designed to ensure the ready availability of bank credit, and the gradual exhaustion of excess capacity in many sectors. In addition, according to the authorities, the uncertainties in the business community which might have been created by the provisions of the Industrial Coordination Act of 1975 were eliminated by the amendment of the Act in April 1977 and its flexible implementation.

In the current year, the authorities intend to press ahead with public investment as well, both in support of private investment and in furtherance of other objectives such as the eradication of poverty. The size of the public sector is relatively large in Malaysia but its growth has been achieved without any crowding out of the private sector. Indeed, the authorities have always seen the role of the public sector, at least in part, as that of supporting the development of the private sector. Government investment plans for 1979 are discussed further in the next section.

The authorities would like to achieve their investment and growth objectives while avoiding, ideally, any price increase at all and while maintaining the strength of the balance of payments position. However, the importance attached to the objective of promoting investment is such that, if necessary for this purpose, they would tolerate a small price increase and some loss of foreign exchange reserves.

The objective of the authorities with regard to foreign exchange reserves needs elaboration. At the end of 1978, official reserves were equivalent to 6 1/2 months of 1978 imports. The authorities stress that because of the openness of the economy and its heavy dependence on primary products for exchange earnings (exports account for about half of GNP and five primary products, for almost two thirds of total exports), they would feel more comfortable with a higher level of reserves. This was especially true as long as international price stabilization arrangements were not in place for the principal export products and access to the Fund's Compensatory Financing Facility was not easier. Also, in their view, the high international credit standing of the country depends critically on its strong reserve position. However, the authorities stress that they are conscious of the need to monitor continuously the costs and benefits of reserve holding. Moreover, they have no active policy or time-bound program for increasing reserves. In particular, reserve accumulation is by no means an overriding criterion of balance of payments policy in 1979. Reserves would be increased as and when the opportunity arises but not at the expense of other economic objectives such as investment and growth. Indeed, the authorities would be prepared to draw down reserves in support of well-designed development programs or any other requirement of national policy, although they would not like reserves to fall below a minimum level of, say, three months' imports.

5. Instruments of financial policies

a. Credit policy

The Central Bank has pursued an expansionary credit policy in the last few years, with the objective of stimulating private investment. The statutory cash reserve requirement was reduced in three steps, from 10 per cent in early 1975 to 6 per cent a year later; reserve requirements applicable to finance companies were also reduced, in two steps from 7 per cent to 4 per cent. The Bank also reduced interest rates; for instance, the prime rate of commercial banks was reduced in four steps, from 10 per cent at the beginning of 1975 to 7.5 per cent by mid-1977. At the same time, the maximum rates allowed to be paid on bank deposits were also reduced.

As the recovery in private investment gathered strength in the spring of 1978, there was a tightening of the liquidity position of banks. In order to relieve this tightness, so as to enable banks and finance companies to sustain their lending activity and to prevent an increase in interest rates, the Central Bank granted temporary advances to commercial banks and also rediscounted a sizable amount of Treasury bills. Further, in December 1978, it reduced the cash reserve requirement by another one percentage point to 5 per cent for commercial banks and by 1.5 percentage points to 2.5 per cent for finance companies.

In order to help improve the efficiency of the banking system, commercial banks were permitted, beginning in October 1978, to set their own interest rates on deposits and lending, other than lending to special groups and for priority purposes, i.e., the bumiputra community, small-scale enterprises, and the purchase of homes by individuals. However, at the time that interest rates were freed, the Central Bank made it clear that it would maintain careful watch over the interest rate levels of banks. It also made known to banks its strong opinion that the existing level of interest rates on deposits and lending was appropriate to the objective of sustaining steady economic growth and its expectation, therefore, that no general increase in the level of rates would be justified. Since the freeing of interest rates, deposit rates have increased marginally while the prime and preferential rates have remained unchanged at 7.5 per cent and 7 per cent, respectively.

For 1979, the authorities would like to continue to ensure that the credit requirements of the private sector will be met. They believe that the fungibility of money notwithstanding, an expansion of liquidity arising from factors other than bank credit expansion cannot be counted upon to meet the investment needs of the private sector. Nevertheless, they believe that a much smaller increase in credit than in 1978 (30 per cent) would be adequate for 1979 (20 per cent). The liquidity position of the banking system is expected to be adequate to sustain this lending, but should it fall short, the authorities plan to take steps such as a further reduction in the cash reserve requirement and increased Central Bank lending. They consider that the stigma previously attached to commercial bank rediscounting from the Central Bank has tended to disappear.

b. Budgetary policy

The stance of budgetary policy in the past few years has been expansionary, public expenditure having been substantially stepped up in view of the lagging private investment. Total federal government expenditure virtually doubled during the period from 1974 to 1978 and, as a proportion of GNP, increased from 28 per cent to 32 per cent. The share of capital expenditure in the total increased from 15 per cent to 21 per cent. However, the increase in expenditure did not require any particular increase in bank financing; over the years, tax revenues--other than those arising from taxes on foreign trade--have evinced a high degree of income elasticity and the Employees' Provident Fund has proved a growing source of borrowing.

For 1979, the budgetary strategy continues to be one of promoting steady economic growth and improving income distribution in an environment of stable prices. The authorities consider that notwithstanding the recent recovery in private investment, public investment should continue to increase. Capital expenditure in the budget for 1979 is 13 per cent higher than in 1978. Moreover, it is expected to be stepped up further once the mid-term review of the Third Malaysia Plan, which is now in an advanced stage, has been completed. In doing so, the authorities will have moved away more decisively from a purely contra-cyclical role of fiscal policy to the longer-run objectives of economic growth ard the eradication of poverty. The increase in public investment will in part be designed to help the private sector; in order to stimulate growth in private industry, outlays on infrastructure, such as telecommunications, water supply and electricity, will be increased. At the same time, programs of support for agriculture and rural areas generally will continue. The budget also includes the grant of a reinvestment allowance to industrial firms amounting to 25 per cent of expenditure for expansion during the next three years; previous incentives for industrial investment catered largely to newly-established enterprises.

In the view of the authorities, the difficulty in stepping up public investment is not a stringency of budgetary resources but rather the usual lag in identifying and implementing the particular kinds of projects that would minister to the socio-economic objectives of the Government. In particular, projects that would benefit the lowest income groups are, as in other countries, particularly difficult to identify and implement; this is especially so since Malaysia has already passed the stage of basic infrastructure development.

The overall deficit of the Federal Government (the excess of total expenditure and net lending over current revenue) would continue to be substantial in 1979, amounting to almost a third of total expenditure. However, as indicated earlier, these deficits have not necessitated excessive borrowing from the banking system. For the current year, the authorities have not published their financing plan. The resources available from the Employees' Provident Fund can be expected to continue to grow in the normal course. As for foreign borrowing, the two main criteria of the authorities are to obtain the best possible terms and to maintain a presence in foreign markets. However, now that the credit standing of the country has been firmly established abroad, they do not consider it necessary to make firm commitments and enter the market early, for this could lead to overborrowing. The authorities intend to limit borrowing from the domestic banking system to an amount which, taken together with other factors affecting the monetary situation, would be consistent with their price and balance of payments objectives.

c. Exchange rate policy

The ringgit is linked to an undisclosed basket of currencies of Malaysia's major trading partners; the weights are based on trade shares and the importance of currencies used in settlement. In terms of the trade-weighted basket computed by the staff, the ringgit depreciated slightly in 1978, while in terms of the U.S. dollar, the intervention currency, it appreciated by 7 per cent. For 1979, the policy would continue to be for the Central Bank to moderate fluctuations in the value of the ringgit in terms of the official composite.

In order to help in the appraisal of exchange rate policy, the staff reviewed the real exchange rates relevant to the primary product export sector and the import-substituting sector--defined as the ratios of the domestic price index to the indices of export and import prices in domestic currency (Chart 1). In the absence of data on the prices of manufactured exports, the exchange rate relevant to the import-substituting sector may also be regarded as an indicator of the exchange rate applicable to these exports. Both rates depreciated by about 2 per cent in 1978. Over the longer run, 19/1-78, both rates have depreciated substantially, a development that would have, by itself, induced resource flows into these sectors. The share of the primary product export sector in total output has been maintained over this period at about 30 per cent, while that of manufactured exports has risen from 4 per cent to about 10 per cent. It is, of course, difficult to measure the import-substituting sector, but it seems likely that it has also expanded. On the whole, however, the flow of resources into the export- and import-substituting sectors has been just enough to yield balance of payments surpluses of the magnitude needed to maintain the country's foreign exchange reserves during the 1970s at an average level of about seven months of imports, a level that cannot be regarded as being excessive for Malaysia.

6. The consistency of financial objectives and policies

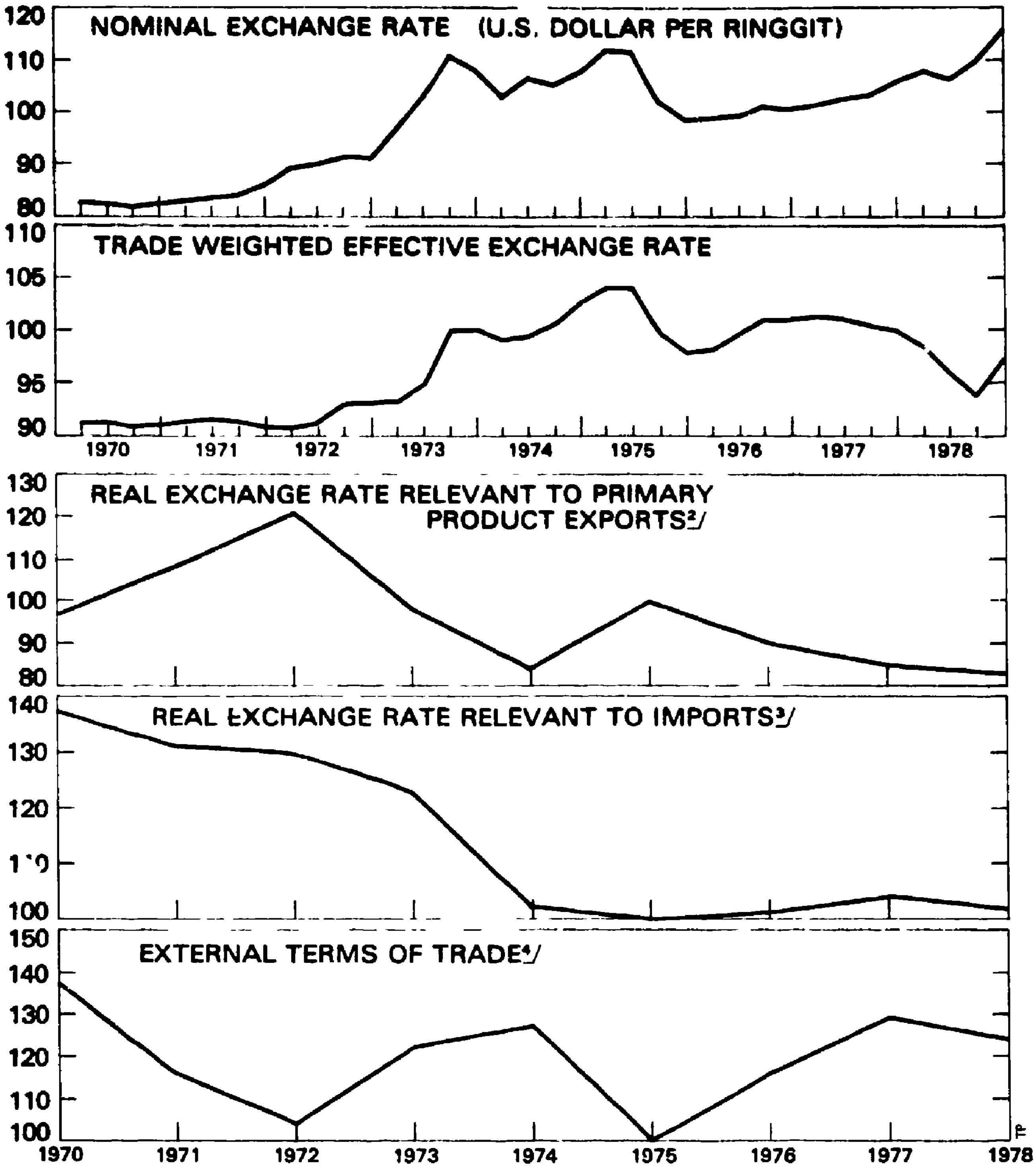
The authorities estimate that given their financial and exchange rate policies and the international economic environment as described above, an overall balance of payments surplus of about M$400 million (SDR 140 million) would be recorded in 1979, smaller than in each of the three preceding years (Table 3). Export earnings have shown a healthy growth in recent years, increases of about 12 per cent having been recorded in both 1977 and 1978; an even larger increase can be expected for 1979. However, imports also have picked up sharply. In 1978, the increase may have been close to 25 per cent--most of it in volume terms--reflecting largely the recovery in domestic economic activity. Some slowing down in the growth of imports may occur in 1979 but the increase is nevertheless likely to be substantial. The large current account surpluses that were recorded in 1976 and 1977 probably disappeared in 1978 and a deficit is likely to be recorded in 1979. However, the net capital outflow represented by the increase in Petronas' holdings of foreign exchange, although still large, was much smaller in 1978 than in the previous two years as the company repatriated a large portion of its earnings. In 1979, the national airlines and shipping company are expected to borrow substantially abroad but, on the other hand, the foreign exchange holdings of Petronas are also expected to increase substantially.

CHART 1

MALAYSIA

NOMINAL AND REAL EXCHANGE RATES 1/ AND EXTERNAL TERMS OF TRADE

(1975=100)



1/ Increase represents appreciation

2/ Ratio of domestic prices to export prices (export unit value of primary products adjusted for export duties)

3/ Ratio of domestic prices to import prices

4/ Ratio of export prices (export unit value of primary products) to import prices

Table 3. Malaysia: Balance of Payments and Reserves, 1974-79

(In billions of ringgit)

	1974	1975	1976	1977	1978	1979
					(Staff estimates)	
Balance on current account	-0.9	-0.4	1.7	1.4	-0.1	-0.8
Trade balance	0.7	0.9	3.8	3.7	2.7	2.2
Exports, f.o.b.	(10.0)	(9.0)	(13.3)	(14.9)	(16.5)	(18.8)
Imports, f.o.b.	(-9.3)	(-8.1)	(-9.5)	(-11.1)	(-13.8)	(-16.6)
Services and transfers (net)	-1.5	-1.4	-2.1	-2.4	-2.8	-3.0
Capital movements (net)	1.2	1.3	0.8	0.5	1.7	2.1
Errors and omissions	0.1	-0.7	-0.4	-1.1	-1.0	-1.0
Allocations of SDRs	...	...	...	...	...	0.1
Overall balance	0.4	0.2	2.1	0.8	0.6	0.4
Gross official reserves 1/	3.9	4.1	6.4	6.9	7.5	7.9
(In months of imports)	(5.0)	(6.0)	(8.1)	(7.4)	(6.5)	(5.7)

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

1/ End-period level.

The staff would broadly agree with the official estimate of the likely overall surplus in 1979, although it can be viewed as somewhat conservative. If the surplus turned out in fact to be of this magnitude, official reserves at the end of 1979 would be equivalent to 5.7 months' imports, a lower ratio than at the end of 1978.

The estimated balance of payments outcome for 1979, together with the expansion of credit to the private sector that the authorities consider appropriate and the prospective budgetary position, would yield a rate of monetary expansion that, in the light of the estimated output growth, would be broadly consistent with a small price increase. The historical relationship between money, output and prices in Malaysia has been analyzed in the accompanying RED paper. On the basis of this relationship, the staff would estimate that the 8 per cent increase in output that is likely to take place in 1979 would result in increases of approximately 10 per cent in the public's demand for narrow money and 13 per cent in that for broad money, both in real terms. On the other hand, if the net foreign assets of the banking system increase by the expected amount, bank credit to the private sector increases by about 20 per cent, and the budgetary position vis-a-vis the banking system is in approximate balance, the supply of broad money is likely to increase by about 18 per cent. Such an outcome would be consistent with a price increase of about 5 per cent. Should the authorities wish to keep the price increase even smaller, the monetary expansion will have to be correspondingly smaller; similarly, if any of the monetary flows mentioned above behave differently, compensating adjustments would be needed elsewhere. The authorities have indicated that in order to keep the price increase small, they would take all such measures as are necessary.

In addition to any price increases arising from the monetary expansion being in excess of the increase in the demand for real money balances, there is the possibility of price increases arising from increased import prices. Staff estimates place the likely increase in import prices in 1979 at about 8 per cent. Given Malaysia's balance of payments position, exchange rate policy would be the appropriate instrument to deal with such imported inflation. The authorities are somewhat skeptical about its effectiveness on the ground that the price effects of an appreciation are often not passed on to consumers; nevertheless, they do not rule out the use of exchange rate policy for moderating imported inflation.

III. Staff Appraisal

Over the years, Malaysia's economic policies have been remarkably successful. An impressive rate of output growth has been maintained and a striking diversification achieved of the pattern of output and exports, with the economy maturing from a primary product specialization. Investment and domestic savings rates have been sharply stepped up in the seventies. Thanks to cautious domestic financial policies and a liberal trade and payments system, the record of price stability has been excellent. At the same time, the strength of the external payments and reserves position has been maintained and a very high international credit rating attained.

The country has no critical short-run macro-economic problems. In the long-run context, of course, rapid growth and development of the economy remain pressing needs. The authorities are firmly committed to policies for reducing poverty and eliminating ethnic and regional imbalances in economic opportunity and well being. Public expenditure policies and certain aspects of credit policies are among the instruments used to attain these objectives. It is also recognized that progress toward these objectives would be facilitated in an environment of continued rapid growth of aggregate output and that such growth would require, in turn, high rates of investment--in particular, investment in the manufacturing industry.

The stagnation of private investment after 1974 had been a cause for concern and the basis for expansionary budgetary and credit policies. Partly as a result of these policies, private investment has recovered strongly during the past two years and the authorities are now satisfied with its present tempo and pattern. They have nevertheless not altered the basic stance of their financial policies. Public investment is being stepped up further, partly in support of private investment and partly in pursuit of other objectives, and the Central Bank has recently reduced the statutory cash reserve requirements lest credit stringency become a constraint on investment.

There is, however, little danger that any significant excess demand pressures will emerge in 1979. Financial policies have been traditionally very cautious. Public sector needs will probably continue to be adequately met from the yield of the tax system, which has proved elastic with respect to income growth, and from borrowing from provident funds and foreign sources. The Central Bank has in the past demonstrated its ability to act flexibly and it has the necessary monetary policy instruments at its command. An economy as open as Malaysia's is highly susceptible to the impact of world inflation and, also, the familiar lags of monetary policy exist in Malaysia as elsewhere. Nevertheless, with the high priority that the authorities attach to the maintenance of financial stability, it is unlikely that inflation will be allowed to become a problem. For the current year, the probable magnitude of various monetary flows appears consistent with an aggregate monetary expansion that would, in light of the likely output growth, help keep any increase in prices within limits broadly acceptable to the authorities.

The staff can reiterate its view expressed last year that the Malaysian authorities are making a contribution to the international adjustment process by their policy of promoting economic growth in an environment of price stability and by maintaining a liberal trade and payments system. Their domestic financial and exchange rate policies have not only contributed to achieving the necessary diversification of the economy but also made possible the maintenance of a strong payments position with moderate increments to exchange reserves that have kept the growth of the latter more or less proportionate to the growth of imports. The present level of reserves in relation to imports is not excessive and the official policy with regard to the accumulation and use of reserves seems to the staff to be suited to the country's needs and consistent with its international obligations.

Fund Relations with Malaysia

Quota:	SDR 253 million.
Transactions with the Fund:	Malaysia made purchases from the Fund in the super gold tranche and under the Buffer Stock and Compensatory Financing facilities. Sales of Malaysian currency in Fund operations amounted to SDR 6.9 million in 1977 and SDR 3 million in 1978.
Fund holdings of ringgit:	78.8 per cent of quota at end-February 1979. The renumeration norm is 81.6 per cent.
SDR position:	Holdings at end-February 1979 were SDR 72.1 million, or 82.9 per cent of net cumulative allocations.
Gold distribution:	Malaysia has received gold from the Fund by way of distribution amounting to 119,414.4 fine ounces; it received US$8.3 million in direct distribution of profits from gold sales.
Exchange system:	The Malaysian ringgit is pegged to an undisclosed composite of currencies of Malaysia's major trading partners. The weights are based on trade shares and 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. The representative exchange rate of the Malaysian ringgit under Rule 0.3 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-February 1979 was M$2.2080 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, Rhodesia and South Africa. Capital transactions above certain limits require prior approval; approvals are freely given except for investments by Malaysian residents in Israel, Rhodesia, and South Africa.
Last Article VIII consultation:	The Executive Board discussed the Staff Report on March 8, 1978. Staff discussions were held during December 8-13, 1977, SM/78/37.
Technical assistance:	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 1/

Area:	127,581 square miles
Population (1978):	12.9 million
Annual rate of growth of population (1976):	2.4 per cent
Per capita GNP (1978):	SDR 930

	1974	1975	1976	1977	1978
Selected aggregates as per cent of GNP 2/					
Gross domestic investment 3/	29.8	24.2	22.6	24.2	26.3
Manufacturing production	16.1	16.4	17.5	18.0	18.8
Narrow money 4/	17.5	19.4	17.5	18.1	19.3
Broad money 4/	37.1	43.3	42.1	44.6	46.5
Federal Government revenue and grants	21.7	23.4	22.6	24.9	23.8
Federal Government expenditure and net lending	28.3	32.0	29.7	32.8	31.9
Exports of goods and services	50.5	47.1	53.8	52.2	51.2
Imports of goods and services	50.3	46.6	43.0	43.5	46.4
Annual percentage changes of selected economic indicators 2/					
Gross national product (1970 prices)	7.7	2.2	10.8	7.1	7.4
Consumer price index	17.4	4.5	2.6	4.7	4.9
Federal Government revenue and grants	40.7	6.8	20.7	26.6	5.6
Federal Government expenditure and net lending	34.5	12.0	16.2	27.0	7.5
Narrow money	8.5	7.3	20.9	16.5	18.2
Broad money	15.2	14.6	27.7	16.4	17.9
Merchandise exports, f.o.b.	38.0	-10.0	47.8	12.0	10.7
Merchandise imports, f.o.b.	64.9	-12.9	17.3	16.8	24.3
Money and credit					
	(In billions of ringgit)				
Broad money	8.7	10.0	12.8	14.9	17.5
Narrow money	4.1	4.3	5.3	6.1	7.2
Quasi-money	4.7	5.7	7.5	8.7	10.3
Net foreign assets	3.5	3.7	5.7	6.3	6.7
Net credit to Government 5/	1.0	1.3	1.1	1.2	1.0
Credit to private sector	5.3	6.1	7.5	9.0	11.6

	1974	1975	1976	1977	1978	197[illegible]
Federal Government budget 6/						
	(In billions of ringgit)					
Revenue and grants	4.7	5.1	6.1	7.7	8.2	9.0
Expenditure and net lending	6.2	6.9	8.0	10.2	11.0	12.1
of which: capital expenditure	(0.9)	(1.1)	(1.3)	(1.7)	(2.6)	(2.6)
Financing requirement	1.4	1.8	1.9	2.5	2.8	3.1
External borrowing	0.2	0.9	0.4	0.5	0.6	...
Domestic borrowing	1.2	0.9	1.5	1.9	2.2	...
of which: banking system	(0.4)	(0.2)	(--)	(0.5)	(-0.1)	...
Balance of payments 7/						
	(In billions of SDRs)					
Trade balance	0.2	0.3	1.3	1.3	0.9	...
Exports, f.o.b.	3.5	3.1	4.5	5.2	5.7	...
Imports, f.o.b.	-3.2	-2.8	-3.2	-3.9	-4.8	...
Current account balance	-0.3	-0.1	0.6	0.5	--	...
Capital movements (net)	0.4	0.5	0.3	0.2	0.6	...
Errors and ommissions	--	-0.2	-0.1	-0.4	-0.3	...
Overall balance	0.1	0.1	0.7	0.3	0.2	...
Gross official reserves (end of year)						
In billions of SDRs	1.4	1.4	2.2	2.4	2.6	[illegible]
In months of imports	5.0	6.0	8.1	7.4	6.5	...

Sources: Data provided by the Malaysian authorities and staff estimates.
1/ Totals may not add up to components because of rounding.
2/ Data for 1978 are estimates.
3/ Includes changes in stocks.
4/ Average quarterly amounts outstanding.
5/ Federal and State Governments.
6/ Data for 1979 are budget estimates.
7/ Data for 1978 are staff estimates.