SM/79/83
Correction 2

CONTAINS CONFIDENTIAL INFORMATION

May 2, 1979

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Recent Economic Developments

The following corrections have been made in SM/79/83:

Page 10, line 3: for "subject to licensing" read "subject to control"

Page 12, last para., lines 7 and 8: for "Teachers' Provident Fund" read "insurance companies"

Page 17, para. 2, line 1: for "the largest financial intermediary," read "the monetary authority,"

lines 10-12: for "The merchant banks...from major corporations." read "Discount houses are... from the corporate sectors as well."

Page 18, 2nd full para., line 8: for "April 1, 1979." read "May 2, 1979."

Page 22, 1st full para., line 3: for "the first half" read "the second half"

Page 29, last para., lines 4 and 5: for "Inward investment is subject to prior approval by the Foreign Investment Committee, and" read "Inward investment covered by the guidelines of the Foreign Investment Committee issued on February 20, 1974 regarding the acquisition of assets, mergers, and takeovers requires the approval of this Committee."

Corrected pages are attached.

Att: (6)

Other Distribution:
Department Heads

Table 2. Malaysia: Consumer Price Index for Peninsular Malaysia, 1970-78

		(1967 = 100)[1/]	Rate of change for preceding 12-month period (*in per cent*)
1970		101.3	1.9
1971		102.9	1.6
1972		106.2	3.2
1973		117.4	10.6
1974		137.8	17.4
1975		144.0	4.5
1976		147.8	2.6
1977		154.8	4.7
1978		162.4[2/]	4.9
1977	I	152.9	4.4
	II	152.8	4.1
	III	155.7	5.0
	IV	157.9	5.6
1978	I	159.5	4.3
	II	160.9	5.3
	III	164.1	5.4
	IV	165.1[2/]	4.6

Source: Data provided by the Malaysian authorities.

1/ Period averages.
2/ Preliminary.

enhance competition and to allow the authorities to maintain surveillance over prices. In addition, certain essential goods (including sugar, cement, flour, fuels, and fertilizers) are subject to control, the purpose of which is to supervise their production and distribution. However, with the exception of rice, no other commodity is currently subject to direct price fixing.

b. Employment and wages

Total employment grew by 3.6 per cent in 1978, about the same rate as in 1977 (Table 3). The principal sources of new employment were the manufacturing sector--which accounted for over a third of all new jobs created in 1978--the Government, and the wholesale and retail trade sectors. Although the relative importance of these sectors has been increasing over the years, the agriculture, forestry and fishing sector still accounts for about 44 per cent of total employment. Largely as a result of the rapid expansion of the manufacturing and government sectors, the rate of unemployment has declined from an average of about 7.2 per cent of the labor force in 1971-75 to 6.2 per cent in 1978. However, considerable underemployment continues to exist.

Malaysia does not compile a wage index and available information on wages is fragmentary. Industrial relations were fairly stable in 1978 as a result of the large number of wage agreements negotiated between labor unions and employees since 1976, which provided improved pay and employment benefits to workers; collective agreements usually cover a period of three years. There were 211 collective agreements signed in 1978, compared with 151 in 1972 and 182 in 1976. The average wage increases granted in 1978 were 22 per cent in mining, 12 per cent in manufacturing, 10 per cent in agriculture, 9 per cent in commerce, and 8 per cent in transportation.

III. Domestic Financial Developments

1. Government finance

a. Structure of the public sector

The public sector consists of the Federal Government, 13 state governments, several local authorities (city, municipal, and town councils),1/ and a number of nonfinancial enterprises. The public sector's influence on the economy is relatively large; the consolidated expenditure of the Federal Government, state governments, and major public authorities represented over 40 per cent of GNP in 1978. The public sector is highly centralized, with the Federal Government playing a dominant role. In 1978, the Federal Government accounted for approximately three quarters of the public sector's consolidated expenditure and nearly 80 per cent of its overall

1/ Data for the state governments are available only in a summary form; data for local authorities are confined to three major municipalities and are aggregated with the major nonfinancial public enterprises (Appendix Tables V-VII).

Table 3. Malaysia: Employment and Labor Force, 1971-78

	Percentage change per annum				1978 1/
	1971-75 Annual average	1976 1/	1977 1/	1978 1/	Thousands of persons
Employment					
Agriculture, forestry and fishing	1.5	1.9	0.7	0.7	1,972.5
Mining and quarrying	0.1	1.7	0.1	1.1	90.2
Manufacturing	8.3	11.6	7.3	9.8	587.3
Construction	12.0	7.5	7.9	7.7	196.5
Utilities	5.1	5.1	5.1	4.9	27.7
Transport, storage and communication	6.3	3.3	5.9	4.4	207.9
Wholesale and retail trade	4.9	5.0	5.0	4.6	559.3
Finance and insurance	4.4	5.4	3.7	4.0	43.3
Government services	5.5	2.5	8.0	5.0	621.8
Other services	5.8	0.2	4.6	4.3	187.1
Total employment	3.8	3.9	3.7	3.6	4,493.6
Labor force	3.2	3.3	3.5	3.5	4,788.5
Unemployment rate (as per cent of labor force)	7.2	6.5	6.3	6.2	294.9

Source: Data provided by the Malaysian authorities.

1/ Estimates.

deficit. Furthermore, loans and grants from the Federal Government constitute a major source of finance of the state governments and public authorities. In 1978, such loans and grants financed about 36 per cent of the expenditure of state governments and 18 per cent of the expenditure of public authorities.

The role of the state governments has been relatively limited, mainly because of the constraints imposed by the Constitution on their revenue-raising powers; the revenue sources assigned to the state governments are few and relatively insignificant. Most of their revenue is derived from taxes and royalties on lands, mines and forests. Revenue derived from this source is limited in most states since only a few of them have significant mineral resources or forest reserves. The rest of the revenue is mostly derived from entertainment duties and certain fees and charges. As part of the general effort to step up public sector investment, the Federal Government intends to gradually expand the role of state governments. In line with this policy, state governments have been allowed since 1977, subject to the approval of the Federal Government, to borrow either domestically or overseas for a period not exceeding five years. However, the state governments have so far borrowed only limited amounts from domestic commercial banks. The operations of public authorities are closely monitored by the Federal Government. Some of the major public authorities are under the control of the Ministry of Public Enterprises which was established in 1977. In 1978, the operations of the principal public authorities continued to show a current account surplus.

b. Federal Government

(1) Fiscal trends during 1974-78

Movements in the major fiscal aggregates of the Federal Government have varied over the years, both in absolute terms and relative to GNP. These movements generally reflected changes in economic conditions as well as policy reactions to the business cycle. In recent years, however, fiscal policy has been increasingly oriented toward accelerating the tempo of development through increased public investment programs. Thus, fiscal policy has gradually moved away from a purely countercyclical policy to a phase where public investment is being stepped up from a longer-term consideration of growth.

During the period from 1974 to 1978, both total revenue and expenditure grew at a compound annual rate of about 15 per cent, with the overall fiscal deficit increasing from 23 per cent to 26 per cent of total expenditure (Table 4). The fiscal deficits were mainly financed by domestic borrowing, principally from the Employees Provident Fund which financed on the average about a third of the fiscal deficits during 1974-78. Other important sources of domestic borrowing were the National Savings Bank and the insurance companies (Appendix Table VIII). Net borrowing from the domestic banking system varied from year to year (Chart 1 and Appendix Table IX), but over the entire period 1974-78 it financed only a negligible part of the cumulative fiscal deficits. External borrowing consisted mostly of project loans from international development institutions and foreign governments. The use of market loans, which was significant in 1975, has subsequently become less important.

2. Monetary developments and policies

a. Structure of the financial system and recent institutional changes

The Malaysian financial system encompasses a relatively large variety of financial intermediaries. In addition to the Central Bank and commercial banks, there are several categories of near-banks (finance companies, merchant banks, discount houses, and the National Savings Bank); provident funds and insurance companies; specialized institutions for rural, industrial, and housing credit; credit cooperatives; and a pilgrims' saving fund. Although the Central Bank and commercial banks are still the predominant financial institutions, the Malaysian financial system has evolved to the stage at which other financial intermediaries have become important in mobilizing savings from the private sector and channeling them back to investors (Appendix Table XIII). At the end of 1977, these other intermediaries had extended one third of the credit received by the private sector, held two thirds of the financial system's claims on the Federal Government, and accounted for two fifths of the funds mobilized by the financial system from the private sector. The Malaysian financial structure is quite well developed compared with financial systems in other developing countries. Moreover, a considerable portion of the financial system is domestically owned. 1/

The Bank Negara Malaysia is the monetary authority, performing the usual functions of a central bank. Currency in circulation and deposits by the Federal Government constitute its largest and second largest liabilities. Government deposits have continuously exceeded the credit granted to it by the Bank. The Bank's assets are heavily concentrated in foreign assets. The commercial banks engage in the customary business of mobilizing deposits from and extending credit to the private sector. The finance companies also accept deposits--but not demand deposits--from the private sector and lend to it, specializing in hire-purchase and housing loans. Discount houses are secondary financial intermediaries which mobilize short-term funds from financial institutions, the corporate sector and the general public for investment in government securities. Merchant banks operate in wholesale banking and they are permitted to accept deposits from financial institutions and effective March 1, 1979, from the corporate sectors as well.

There is a well-developed market for funds conducted among financial intermediaries (Appendix Table XIV). The major lenders in this market are the finance companies which held 29 per cent of their total assets as claims on other financial institutions (besides the Central Bank) at the end of 1977. The largest borrowers are the merchant banks and discount houses which, respectively, obtained 79 per cent and 52 per cent of their total resources from other financial institutions at the end of 1977. The commercial banks also participate in the market as both lenders and borrowers, and about one fifth of the activity appears to be entirely among commercial banks.

1/ Twenty of the 37 commercial banks are locally owned and these banks hold over half of the commercial banks' total assets. Furthermore, less than one quarter of the finance companies' total assets is held by finance companies which are subsidiaries of foreign banks. Finally, over half of each of the merchant banks' paid-up capital is held by Malaysian investors.

A peculiarity of this market is the prominence of a specialized lending institution, the Agricultural Bank, which is both a lender and borrower. As deep as these figures indicate the market to be, they understate the activity in the market, because monthly turnover is many times the amount on deposit at any time. 1/

The Central Bank's direct participation in the money market conducted among financial institutions has been restrained, the amount of credit which the Central Bank has extended to the different types of financial institutions having been relatively small. However, it has assisted the evolution of the market by acting as lender of last resort from time to time and arranging to support the discount houses.

In its present form, the money market is essentially a market conducted among financial intermediaries. The only short-term money market instruments currently available to nonfinancial companies are deposits with the discount houses, because the minimum maturity of fixed deposits with the other financial intermediaries is one month. To retain short-term corporate funds in Malaysia, the Central Bank has authorized the commercial and merchant banks to issue bankers' acceptances and the commercial banks to offer negotiable certificates of deposit starting May 2, 1979. Although the maturity of these instruments will not be less than one month, it is anticipated that trading in the secondary market will generate the liquidity needed for them to become part of the short-term money market.

The on-lending by the merchant banks of short-term funds borrowed from other financial intermediaries has become a concern to the authorities, who had intended that merchant banks would concentrate on underwriting, loan syndication, investment counseling, and other "fee-based" corporate financial services, rather than behaving as intermediaries. In order to encourage the merchant banks to undertake more of the originally envisaged activities, the authorities have brought the merchant banks under the Banking Act. The main result of this measure is that the Central Bank has directed the merchant banks to generate at least 30 per cent of their income from fee-based activities by the end of 1981. The reorientation of the merchant banks is expected to increase the volume of funds raised by the private sector through new issues of securities. At present, the Malaysian market for new issues of securities is dominated by the Government, which obtained well over 90 per cent of the funds raised in the market in each of the last four years. In addition, through their issuance of bankers' acceptances, the merchant banks may offer the nonfinancial private sector access to the money market.

The Malaysian authorities have taken certain other measures to promote financial markets. They consider it logical that Kuala Lumpur should be the location of commodity markets for rubber, tin, and palm oil, since Malaysia is the world's largest producer of these commodities. Thus, they have already established a rubber exchange and are planning to set up a palm oil exchange.

1/ For example, the average monthly volume of deposits accepted by discount houses in the first 11 months of 1978 was M$6.8 million--more than 11 times their deposit liabilities at the end of 1977.

The commercial banks and finance companies must comply with three reserve requirements: first, a total liquid assets requirement; second, a primary liquid assets requirement; and third, a statutory (i.e., cash) reserve requirement (the definitions of the three reserve requirements, as well as changes in the percentages, are given in Appendix Table XV).

Since 1974, the Central Bank has reduced the statutory reserve requirement to ease monetary conditions in order to stimulate economic activity in general and private sector investment in particular. The commercial banks' statutory reserve requirement was reduced from 10 per cent to 5 per cent in four steps, the first three of which occurred between February 1975 and February 1976. The latest reduction of one percentage point, effective December 16, 1978, is estimated to have freed M$140 million in commercial bank reserves. Simultaneously, finance companies' reserve requirements were decreased in three steps from 7 per cent to 2.5 per cent. The most recent decrease of 1.5 percentage points, also effective December 16, 1978, is estimated to have released M$41 million in reserves.

In the past, the other two reserve requirements have served more as controls to channel funds into the money market and government securities than as instruments to regulate bank liquidity. To ensure that the two liquidity ratios more accurately measure the banks' liquidity positions, the liquidity requirements were revised effective March 1, with a three-month period of grace (Appendix Table XV). Had the new system been in effect at the end of November, the banks' liquid assets ratio would have been 24 per cent (4 percentage points higher than required), compared to 31 per cent under the old system (6 percentage points higher than required).

Until about mid-1977, the demand for credit was not strong enough to absorb the growth in bank liquidity. As a result, the excess liquidity of commercial banks increased by 12.5 percentage points from mid-1974 to mid-1977. During the same period, the banks' loans to deposits ratio fell by 8.5 percentage points (Chart 3). However, as the demand for credit started to pick up after mid-1977, the banks' excess liquidity began to decline and their loans to deposits ratio began to rise.

In pursuit of its expansionary policy, the Central Bank also wound down interest rates; for instance, the banks' prime rate was reduced in four stages from 10 per cent at the beginning of 1975 to 7.5 per cent effective June 2, 1977 (Appendix Table XVI). At the same time, the maximum rates allowed to be paid on various categories of bank deposits were also decreased. To increase the efficiency of the banking system, bank interest rates were freed from regulation on October 23, 1978, except for rates on loans to priority sectors and special groups (i.e., the bumiputra community, small-scale enterprises, and individuals for the construction and purchase of housing). By setting maxima on deposit interest rates and minima on banks' lending rates, the former regulations assured the banks of a minimum spread between their lending and borrowing rates. With the development and strengthening of the financial system, the authorities considered that such regulations were no longer necessary. Although interest rates have been freed, the Central Bank has made it clear that it will monitor their behavior and that it intends to use moral suasion to influence the level and structure of interest rates. Since October 1978 there have only been some very small increases in deposit interest rates.

The tightening of the banks' liquidity positions since the end of 1977 was also reflected in the interbank money market where interest rates increased noticeably. To relieve this situation, especially in the second half of 1978, the Central Bank actively purchased and rediscounted treasury bills from the banks and granted short-term loans directly to them. Although the banks were initially reluctant to sell or rediscount treasury bills, this reluctance was gradually overcome, and the Central Bank purchased or rediscounted M$1.4 billion in the course of 1978. With the lowering of reserve requirements in December, the banks' liquidity positions improved, so that the Central Bank was able to close the discount window, and consequently no rediscounts or loans to banks were outstanding at the end of the year.

d. Selective credit policy

When the Third Malayasia Plan was introduced in 1976, the Central Bank recast its selective credit policy to increase the flow of credit to manufacturing, food production, the bumiputra community, and individuals for the construction and purchase of housing. Appendix Table XVII outlines the measures taken in October 1976, as well as the previous provisions and the modifications made to the 1976 program. The 1976 measures appear to have had some success in redeploying banks' and finance companies' credit to priority sectors and special borrowers. On June 30, 1978, commercial banks' loans to the bumiputra community were 15 per cent (compared with the requirement of 12 per cent) of their total loans outstanding. In addition, thev had granted 21 per cent (requirement, 20 per cent) of their net increase in loans to the bumiputra community and 14 per cent (requirement, 10 per cent) to individuals for housing. However, although the extent of compliance varied from bank to bank, the commercial banks, as a whole, were unsuccessful in achieving the objectives for lending to manufacturing and food production--only 20 per cent (requirement, 25 per cent) of their net increase in credit had been extended to manufacturing, and 3 per cent (requirement, 10 per cent) to food production.

The finance companies have been successful in reaching the objectives for lending to the bumiputra community and to agriculture, manufacturing, building, and construction, but have not achieved the objective for loans to individuals for the construction and purchase of housing.

On October 23, 1978 the Central Bank announced substantial revisions to the commercial banks' credit guidelines (Appendix Table XVII). Essentially, they give the banks that had not complied with the previous guidelines an extension to the end of 1979 and reduce the combined targets for loans to food production and manufacturing from 35 per cent to 30 per cent of the net increase in loans. No revisions have been announced for the finance companies' directives.

6. Exchange rate developments

The Malaysian ringgit is pegged to an undisclosed basket of currencies of Malaysia's major trading countries. The weights are based on trade shares and the importance of currencies used in settlement; the composition of the basket has remained unchanged since September 1975. The authorities have intervened to maintain margins of 2.25 per cent, but occasionally and for relatively short periods of time, the rate has been allowed to exceed the margins. In terms of the trade-weighted effective exchange rate, computed by the staff, the ringgit depreciated by 2.6 per cent during 1978 (Table 7); in terms of the U.S. dollar, the intervention currency, it appreciated by 7 per cent.

During 1978, the real exchange rate relevant to the primary product export sector and the import-substituting sector--measured by the ratios of the domestic price index to the indices of export 1/ and import prices in domestic currency--depreciated by about 2 per cent. Over the longer run, 1971-78, both rates have depreciated substantially owing to the lower rate of increase of domestic prices compared to the prices of Malaysia's exports and imports.

The external terms of trade--as measured by the ratio of export unit value of primary products to import prices--have not changed significantly since 1970, although they have shown large year-to-year fluctuations, reflecting variations in Malaysia's commodity export prices.

7. Exchange and trade system

A detailed description of Malaysia's exchange and trade system is contained in the 29th Annual Report of Exchange Restrictions. Main features and significant changes since the last consultation report (SM/78/55, 2/24/78) are described below.

Malaysia maintains an exchange system free of restrictions on payments and transfers for current international transactions. However, payments for invisibles to and trade with Israel, Rhodesia, and South Africa are prohibited. Inward investment covered by the guidelines of the Foreign Investment Committee issued on February 20, 1974 regarding the acquisition of assets, mergers, and takeovers requires the approval of this Committee. Malaysian residents also require prior official approval for borrowing from nonresidents in either ringgit or foreign exchange. The proceeds of investments on resale may be repatriated freely. Permission is given freely for direct and portfolio investment by Malaysian residents in countries other than Israel, Rhodesia, and South Africa. The Central Bank administers the exchange control system, but commercial banks are authorized to approve payments abroad, except for repayment of foreign loans or the payment of interest on such loans. On July 1, 1977, customs procedures in the states of Sabah and Sarawak were harmonized with those prevailing in Peninsular Malaysia.

1/ Export prices were measured by the export unit value of primary products adjusted for export duties.

Table 7. Malayisa: Effective and Real Exchange Rates 1/ and External Terms of Trade, 1970-78

(1975 = 100) 2/

	1970	1971	1972	1973	1974	1975	1976	1977	1978
Trade weighted effective exchange rate 2/	93	93	95	102	105	100	103	102	99
Real exchange rate 3/ relevant to									
Export sector (primary products) 4/	97	108	121	98	84	100	90	85	83
Import-substituting sector 5/	137	131	130	122	102	100	101	104	102
External terms of trade 6/	137	117	103	123	126	100	115	129	125

Source: Based on staff calculations.

1/ Increase represents appreciation.
2/ Fourth quarter figures.
3/ Period averages.
4/ Ratio of domestic prices (CPI) to export prices (export unit value of primary products adjusted for export duties).
5/ Ratio of domestic prices (CPI) to import prices.
6/ Ratio of export prices (export unit value of primary products) to import prices.