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INFORMATION

May 19, 1981

To: Members of the Executive Board
From: The Acting Secretary
Subject: Malaysia - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Malaysia.

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

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 1981 Article IV Consultation

Prepared by the Staff Representatives for the
1981 Consultation with Malaysia

Approved by H. Neiss and Donald K. Palmer

May 19, 1981

I. Introduction

The 1981 Article IV Consultation discussions with Malaysia were held in Kuala Lumpur during April 6-16, 1981. The Malaysian representatives included the Deputy Minister and the Deputy Secretaries-General of the Treasury, the Governor and Deputy Governor of Bank Negara Malaysia; the Secretary-General of the Ministry of Labor and Manpower, the Secretary-General of the Ministry of Energy, Telecommunications, and Posts; the Deputy Secretary-General of the Ministry of Trade and Industry; the Deputy Director General of the Economic Planning Unit, and other senior officials. The staff team consisted of Mr. Bahram Nowzad (Head - ETR), Messrs. Otani, Di Calogero, and Lee (all ASD), and Mrs. Lopez (Secretary - ETR).

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

II. Report on the Discussions

The discussions with the Malaysian authorities covered two broad areas: recent economic developments and prospects for the immediate period ahead, and certain topics and issues that have a broader bearing for the formulation of longer-term economic policies.

1. The economic setting

Developments in the Malaysian economy must be viewed against the background of the remarkable performance of the past decade. This period was characterized by simultaneous achievements on a number of economic fronts. real output increased at an average annual rate of 8 per cent; the increase in prices was kept to an average rate of 6 per cent; the balance of payments and foreign reserve position showed continuous strength with the current account on average in surplus and an overall balance in consistent surplus, and a significant degree of diversification was attained as

reflected, for instance, in the share of manufactured exports in total merchandise exports which increased from 12 per cent at the beginning of the decade to 21 per cent in 1980.

These developments, reflecting the pursuit of innovative yet prudent policies by the authorities and the effective exploitation of the country's wealth of natural resources, including the emergence of Malaysia as a net oil exporter in the mid-1970s, created an environment of growth and price stability which in turn facilitated progress towards the broader social and economic objectives of the Government. Most importantly, the economic climate described above fostered advance towards the socioeconomic goals embodied in the New Economic Policy (NEP) launched in 1971, namely (a) the reduction and eventual eradication of poverty and (b) a restructuring of society, including a reduction in the existing imbalances in employment (so that the sectoral and occupational structure of employment will reflect the racial composition of the population), increase in the share of Malaysians in the ownership of the economy's productive capital, and increase in the share of the Malay and other indigenous groups (the Bumiputeras) in the economic activity of the nation. Considerable progress towards these twin goals was achieved during the 1970s, with a substantial decline in the incidence of poverty, and an improvement in the economic status of the Bumiputeras in several areas.

These achievements are all the more notable given the turbulent state of the international economy--one marked by recession and inflation--in which the Malaysian economy had to function; indeed, the degree of openness of the economy increased during the decade with trade (average of exports and imports) accounting for 60 per cent of GNP in 1980 as compared with 45 per cent in 1970.

A consideration of some issues relating to longer-term developments is included in section 4.

2. Principal developments in 1980

a. Output and prices

The sustained expansion of the Malaysian economy continued for the fifth consecutive year in 1980 with an increase in real GDP of 8 per cent, or slightly below the pace in 1979 (Table 1 and Chart 1). The major stimulus to growth in 1980 was domestic demand which increased by about 13 per cent in real terms while exports of goods and services in real terms increased by only 4 per cent. Economic activity was strong in the first half of the year with buoyant export demand, in the second half, however, because of sluggish economic activity in industrial countries, external demand slackened considerably for Malaysia's principal export commodities, with substantial falls in the prices of rubber, palm oil, and timber. The effect of this was partially offset by the expansionary impact of fiscal policy.

Table 1. Malaysia: Output, Prices, and Foreign Trade, 1979-81

(Per cent change from previous year)

	Average 1971-79	1979	1980	1981 <u>2/</u>
Real GDP	8.0	8.5	8.0	7.4
Agriculture	5.3	4.0	0.2	3.0
Mining	5.9	15.0	-3.4	-2.0
Manufacturing	12.3	12.0	12.7	12.1
Construction	9.6	14.0	13.0	12.5
Consumer prices	<u>6.0</u>	<u>4.0</u>	<u>6.7</u>	<u>7.0</u>
Merchandise exports	<u>22</u>	<u>42</u>	<u>16</u>	<u>15</u>
Volume	<u>7</u>	<u>14</u>	<u>2</u>	<u>8</u>
Prices <u>1/</u>	14	24	14	6
Merchandise imports	<u>19</u>	<u>30</u>	<u>34</u>	<u>24</u>
Volume	<u>9</u>	<u>19</u>	<u>14</u>	<u>13</u>
Prices <u>1/</u>	10	9	19	10
Terms of trade	<u>4</u>	<u>14</u>	<u>-4</u>	<u>-4</u>

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

1/ In Malaysian ringgit.

2/ Staff estimates based on data provided by the Malaysian authorities.

The rapid economic expansion of recent years has been accompanied by the emergence of supply shortages in certain sectors, in particular with regard to skilled manpower and certain materials used by the construction industry. The latter was the fastest growing sector of the economy in 1980. The domestic prices of the principal construction materials are government controlled and this has effectively discouraged imports and may have contributed to the emergence of parallel markets for some items. The authorities have taken a number of measures to alleviate this situation, including the lowering of the duty on cement and an increase in the price of steel bars to encourage production. Other measures have been introduced to enhance the long-term productive capacity of the cement industry and the 1981 budget provides incentives for on-the-job training programs for construction workers.

Consumer prices rose by 6.7 per cent in 1980 as compared with an average annual increase of around 4 per cent in the preceding two years. A major factor in the acceleration of inflation--although moderate by international standards--was the sharp increase in import prices (reflecting to a considerable degree the rise in energy prices), which in 1980 were estimated to have risen by around 19 per cent in contrast to 9 per cent in 1979 (Chart 1). The continued expansion of domestic demand, and in particular the emergence of certain supply shortages, have also contributed to the acceleration of inflation in 1980. Since the consumer price index includes a number of food items whose prices are controlled (about 19 per cent of the total weight) it may somewhat understate the actual rate of inflation. In order to measure price movements more accurately, the authorities are preparing a new wholesale price index and a revised consumer price index. The staff expressed concern that price controls may have led to certain distortions in the market and thus contributed to the emergence of supply bottlenecks. The Malaysian authorities have expressed their intention of reducing the scope of price controls.

b. Balance of payments

For the first time in five years the current account of the balance of payments recorded a small deficit of M\$412 million in 1980 (Table 2 and Chart 2). This deterioration of the current account resulted largely from the fall in exports in the second half of the year, mainly because of the weakening in demand referred to above, while import demand continued to be strong. Reflecting these trends, total export growth in 1980 slowed to 17 per cent from 42 per cent in the preceding year, while import growth rose from 30 per cent in 1979 to 34 per cent in 1980. The terms of trade deteriorated by about 4 per cent. Furthermore, the deficit on services and transfers continued to increase by about 20 per cent, mainly on account of higher net payments in respect of freight and insurance.

Substantial capital inflows more than compensated for the decline in the current account and the overall balance of payments recorded a surplus of about M\$1 billion. These flows, which were almost three times the level of 1979, represented mainly a large increase in corporate investment and substantial capital inflows by commercial banks especially during the second half of the year. Foreign exchange reserves at the end of the year stood at M\$10.3 billion, representing 5.3 months of imports, this represents a fall in the relative level of reserves which, on average during the preceding three years, had been the equivalent of 6.8 months of imports.

The exchange rate of the ringgit, which is determined on the basis of an undisclosed basket of the currencies of Malaysia's major trading partners, depreciated during the last quarter of 1980 reflecting the considerable weakening of the balance of payments during that period. The Malaysian authorities' policy is not to resist basic forces in the exchange market and to intervene solely for the purpose of smoothing out temporary fluctuations.

Table 2. Malaysia: Balance of Payments

(In billions of ringgit)

	1977	1978	1979	1980 <u>1/</u>	1981 <u>2/</u>
Current account	1.3	0.3	2.3	-0.4	-2.8
Trade balance	3.9	3.6	6.6	4.7	3.4
Exports	14.9	16.9	24.0	28.0	32.2
Imports	-11.0	-13.3	-17.4	-23.3	-28.8
Services and transfers	-1.6	-3.3	-4.3	-5.2	-6.2
Capital account	0.5	1.3	1.1	2.9	4.5
Errors and omissions	-1.0	-1.0	-1.6	-1.5	-1.5
Overall balance	0.8	0.6	1.8	1.0	0.2
<u>Memorandum items:</u>					
External reserves	6.8	7.4	9.2	10.3	
(In months of imports)	(7.4)	(6.7)	(6.4)	(5.3)	

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

1/ Preliminary.

2/ Staff estimates based on preliminary data provided by the Malaysian authorities.

In discussing trade policies, the Malaysian authorities expressed concern about the impact of protectionist trade measures in other countries on Malaysian exports. They are of the view that processed or manufactured exports (for example, textiles, pineapples, and plywoods) have been adversely affected by protectionist measures in some industrial countries. Manufactured exports rose by about 24 per cent in 1980, compared with a 32 per cent increase in 1979 and were, according to the Malaysian authorities, below the level they could have reached in the absence of restrictive measures.

c. Financial policies

As in previous years, budgetary policy in 1980 continued to exert a countercyclical influence. In the face of the relative slowdown in external demand, the 1980 budget was strongly expansionary (Table 3).

Table 3. Malaysia: Overview of Federal Government Operations,
1976-81

	1976	1977	1978	1979	1980 <u>1/</u>	1981 <u>2/</u>
(In billions of ringgit)						
Total revenue and grants	6.1	7.8	8.8	10.5	13.5	15.8
Total expenditure and net lending	8.1	10.2	11.2	11.9	17.5	21.6
Overall deficit	-2.0	-2.4	-2.4	-1.4	-4.0	-5.8
Financing (net)						
External	0.4	0.5	0.6	0.7	0.3	2.5
Domestic	1.6	1.9	1.8	0.7	3.7	3.3
(In per cent)						
Memorandum Item:						
<u>Ratios to GNP</u>						
Total revenue	22.7	25.1	25.3	24.4	28.8	28.0
Total expenditure	30.0	32.8	32.1	27.8	37.4	38.3
Overall deficit	7.3	7.7	6.8	3.4	8.6	10.3

Source: Data provided by the Ministry of Finance.

1/ Preliminary estimate.

2/ Latest estimate.

The overall budget deficit increased from 3.4 per cent of GNP in 1979 to 8.6 per cent in 1980. Although the share of the Government in GNP rose sharply in 1980 to about 37 per cent--and is estimated to increase marginally to 38 per cent in 1981--the medium-term outlook as envisaged in the FMP (1981-85) calls for a larger role for the private sector in the Malaysian economy, in particular private investment; accordingly, the share of Government in national income should decline during the mid-1980s. Total expenditure rose by almost 50 per cent in 1980 reflecting a 35 per cent increase in current expenditure and a 66 per cent rise in capital expenditure and net lending. The former was due in part to the impact of the public service salary and pension adjustments in July and increased security and defense expenditure. The rise in development expenditure and

net lending was related to government efforts to step up the implementation of development projects in the last year of the TMP. Revenue increased by 30 per cent or M\$3 billion associated with an increase of direct taxes of more than 40 per cent and of indirect taxes of about 30 per cent; nontax revenue declined by about 8 per cent. The high growth of direct taxes reflected the strong performance of the economy in 1979 (the base for 1980 income taxes) while indirect taxes benefited from the introduction of an export duty on petroleum in April which netted about M\$700 million. The sharply increased deficit of M\$3.7 million was almost totally financed from domestic sources with about M\$1 billion each from the banking system and the Employees Provident Fund, and the remainder from other sources.

In addition to petroleum, export duties are also levied on rubber, tin, palm oil, and other exports. Given the increasing sophistication of the Malaysian economy, and the leading role which commodity exports are to play in the years ahead, the staff inquired whether reliance on export duties for about 20 per cent of total revenue should not be re-examined and alternative revenue sources investigated. The Malaysian authorities have welcomed this suggestion and the Fund staff is pursuing this matter with them.

The principal objectives of monetary policy in Malaysia have been to provide sufficient liquidity for the growth of the economy with relative price stability, and to use the tools of monetary management to counteract the effects of disturbances from the external sector. Consistent with this approach, narrow money (which has been considered as the more relevant monetary aggregate in Malaysia) increased by 15 per cent in 1980, or at about the same rate as the growth in nominal GNP (Table 4). The growth of quasi-money was, however, much more rapid, the 34 per cent increase in this aggregate represented several factors, including the repatriation of funds by the national petroleum company, rising interest rates on deposits, and further monetization and monetary deepening of the economy. The major source of growth in overall liquidity was domestic credit expansion with only a minor impetus from the increase in net foreign assets. This was a significant departure from the previous year when the increase in foreign assets was the major source of liquidity expansion. The increase in domestic credit reflected the rapidly increasing demand for loans by the private sector to finance investment expenditures, land development, and housing, as well as the expansionary fiscal policy referred to above.

Reflecting an upsurge in business and investment activity, rising interest rates abroad, and a gradual weakening of the external position, the money market in 1980 became considerably tighter as shown by the significant fall in both the average ratio of the commercial banks' free reserves and the ratio of liquid assets to total deposits, and by a considerable increase in interest rates on loans and deposits. In the conduct of interest rate policy in 1980 and early 1981, the monetary authorities have had to weigh domestic and external considerations. The former requires a level of interest rates which is adequate to mobilize

savings as well as to encourage investment in productive capacity; the external considerations, on the other hand, would imply a level of rates high enough to avoid large capital outflows, given the substantial differential in interest rates between domestic and international financial markets.

Table 4. Malaysia: Monetary Aggregates, 1977-80

(Percentage change during the year)

	1977	1978	1979	1980
Net foreign assets	10	6	37	2
Domestic credit	18	24	10	49
Contribution by:				
Net claims of government <u>1/</u>	1	-2	-14	9
Credit to private sector <u>1/</u>	17	26	24	40
Narrow money	17	18	17	15
Quasi-money	16	18	29	34

Source: International Monetary Fund, International Financial Statistics.

1/ Percentage contribution.

These considerations require a selective monetary policy that will accommodate economic activity while discouraging capital flight. To implement such a policy, the authorities have made use of several instruments. As the money market tightened considerably, Bank Negara conducted open market operations, and entered into swap arrangements with a number of commercial banks. These banks in turn provided swap facilities (with a premium on the forward ringgit in order to compensate for the interest differentials) to branch offices of foreign banks. Some foreign banks had been alerted to the deterioration of their capital base in relation to loans outstanding and had agreed on a capital adequacy formula which led to an inflow of funds from their parent banks or from markets abroad, thus allowing them to sustain their loan operations. Furthermore, Bank Negara had advised commercial banks not to lend to their customers for outward arbitrage.

Despite considerable increases in domestic interest rates, there continues to be a sizable differential between domestic and international interest rates. However, the authorities see little danger of substantial outflows of funds. This is because, inter alia, a considerable part of private sector savings in Malaysia is contractual (contributions to the Employees Provident Fund), and small savers, who contribute the bulk of savings, are not sensitive to interest rate differentials. Moreover, as far as commercial banks are concerned, the swap facilities explained above largely offset the interest rate differential.

The monetary authorities have also adopted a selective approach with regard to credit policy, encouraging banks to lend for productive purposes but advising against lending for speculation in the stock and property markets. Bank Negara had in 1979 established guidelines on the direction of lending to the priority sectors, such as the Bumiputera community, agricultural food production, and small-scale enterprises. By the end of 1980, the commercial banks as a group had complied with all of these guidelines. In December 1980 a set of qualitative guidelines outlining the criteria for granting loans for construction and housing was also issued in order to dampen speculative demand in these sectors.

d. Energy policy

Malaysia is a net exporter of petroleum and petroleum products although, on the basis of present estimates of the authorities, there is a possibility that it will become a net importer of oil by the middle of this decade. The authorities are keenly conscious of the need for a comprehensive, long-term, energy plan founded on the conservation of oil-based energy and the development of non-oil energy sources. As regards the former, government policies include tax incentives for industries to replace energy-inefficient equipment, progressive road taxes related to engine size, and a public relations campaign to promote conservation. Moreover, the Government has introduced policies to curtail the production of oil and to lengthen the life of known reserves, this led to a decline in production of about 3 per cent in 1980. Essential petroleum products, such as diesel fuel and kerosene, which are used mostly by low-income groups and by the agricultural sector, receive a government subsidy. In 1980 this amounted to about 60 per cent of the market price for both kerosene and diesel fuel.

Malaysia has large known reserves of natural gas; about half of the gas reserves are earmarked for exports, but the authorities are considering increased domestic use of natural gas in the future. Malaysia is also endowed with great potential for generating hydroelectric power. However, full exploitation of this potential must await solution of the technical problems of transmitting hydroelectric power from eastern Malaysia, where almost 90 per cent of the hydropotential is located, to Peninsular Malaysia where almost 90 per cent of potential demand is located. The authorities estimate that by 1990 about 40 per cent of total energy consumption will be met by natural gas and hydropower.

3. The outlook for 1981

The Malaysian economy will continue to expand in 1981, though at a slightly slower rate, with the increase in real GDP estimated at 7-8 per cent. The forecast growth of domestic demand--at 11 per cent in real terms--should provide the main support for the expansion of output; exports of goods and services are estimated to increase by about 7 per cent in real terms. The authorities expect the rate of increase in consumer prices in 1981 to remain at about 7 per cent. However, as the impact of external inflation should abate considerably, the rate of price increase in 1981 could moderate somewhat.

The Malaysian authorities' financial policies in 1981 will again be designed to offset the effects of sluggish economic activity in industrial countries. To this end, the government budget will exert an expansionary impact on demand as expenditures are expected to increase by 24 per cent reflecting a 26 per cent rise in current expenditure and a 20 per cent increase in capital expenditure. Therefore, the overall deficit is estimated to increase to 10.3 per cent of GNP. In contrast to 1980, the 1981 budget deficit will be financed in large part through external borrowing, it is the intention of the authorities to have recourse to this source for about M\$2 billion of the total forecast deficit of M\$5.8 billion.

With the expected weakening in the balance of payments, the principal source of increase in liquidity will, as in 1980, be domestic credit expansion. The authorities anticipate a gradual reduction in the growth of credit to the private sector to about 30 per cent and an increase in the money supply of 13-14 per cent, with the increase in total liquidity estimated at about 20 per cent.

The balance of payments prospects for 1981 are considerably less favorable when compared to the record of the past few years. In view of the expected continued weakness in commodity prices and the strong demand for imports, the authorities envisage a much lower trade surplus amounting to about M\$3 billion, this assumes an increase in exports of about 15 per cent and in imports of about 24 per cent. Moreover, a further sharp increase in the deficit on services and transfers is projected, resulting in a record current account deficit of M\$3 billion for 1981. The overall balance, however, is expected to be broadly in equilibrium reflecting in major part substantial capital inflows mainly in the form of market borrowings abroad.

4. Economic policies in the longer-term perspective

The launching of the Fourth Malaysia Plan (FMP) in early 1980 afforded an opportunity for a discussion of a number of economic issues with the authorities that have implications beyond the immediate future. The FMP sets forth the general macroeconomic policy framework and the main lines of economic strategy for the first half of the 1980s.

The basic policy objectives of the authorities under the FMP involve no major departures from those of the past decade: they are to promote the further development and diversification of the economy and, in this way, to make further progress towards achievement of the fundamental socioeconomic goals set forth in the New Economic Policy, as described in section 1. In broad terms, the FMP foresees an average annual growth in real GDP of 7.6 per cent with continued expansion in both industrial and agricultural production, and a further diversification of the economy. The leading sector will be manufacturing, followed by public utilities (electricity, gas, and water), construction, government services, and transportation. The principal impetus to aggregate demand is to come from exports, private investment, and public consumption, exports are projected to increase by about 10 per cent a year in real terms while private investment and public consumption are targeted for annual increases of 8 per cent and 9 per cent, respectively.

While, as noted above, the FMP entails no basic departures in economic philosophy or strategy, certain changes in emphasis are evident. One such change involving development strategy, and with potential implications for other sectors of the economy, is a greater emphasis on import substitution in heavy industries and in service industries. As regards the former, the Malaysian authorities believe that the relative abundance of the required resources, in particular energy, as well as the trend of relocating heavy industries in developing countries, favor their establishment in Malaysia. Moreover, such industries would strengthen linkages within the manufacturing sector. They are aware, however, that while the domestic market could support an expansion of some heavy industries, in other cases there would also be a need to export to reach a viable level of production. The possibilities of heavy industries relocating some of their activities in Malaysia as well as the encouragement of joint ventures are being explored. Moreover, a Heavy Industries Corporation has been established as a private corporation, with an initial capital contribution from the Government, its purpose is to coordinate and promote activities in this area.

As regards the shift in emphasis towards import substitution in heavy industries, the staff expressed the view that to the extent this promotes diversification, including linkages with the existing industrial structure, it will make a contribution to the development of the Malaysian economy. Such industries are, however, typically capital-intensive, require a substantial market, and involve the commitment of substantial resources.

With regard to the services sector, the Government's strategy is to promote import substitution and eventually exports in certain areas, in particular shipping and insurance. The possibilities in these areas are considered to be substantial by the authorities, for instance, it is estimated that in respect of freight Malaysia could earn about M\$5 billion by 1985 compared to current receipts of about M\$400 million. For the purpose of encouraging domestic activities in this field, a Council on Malaysian Invisible Trade has recently been established.

Broadly speaking, the long-term prospects of the Malaysian economy are a function of three sets of factors: the resource base of the economy, external economic developments, and economic policy measures of the Government. As regards the first, Malaysia is fortunate in being endowed with a strong resource base; it is now a major world producer and exporter of rubber, palm oil, tin, and timber, and a net exporter of oil. In addition to its primary product base, the diversification that has taken place during the past decade has given Malaysia a significant potential in manufactured exports.

With respect to the second aspect, given the relatively modest expansion expected for economic activity in industrial countries in the years ahead, the medium-term prospects for Malaysia's primary products are not buoyant and, as already indicated, a deterioration in the terms of trade is forecast for the immediate period ahead. As regards manufactured exports, the international market is likely to become increasingly competitive as more countries enter the field. At the same time, protectionist pressures are likely to persist in a number of major markets. These potential developments present a challenge for the Malaysian economy, they underscore the importance of maintaining competitive export prices, of seeking new markets, and of being alert to changing patterns of demand for Malaysia's exports.

The cornerstone of the Government's macroeconomic policy remains the promotion of economic growth in an environment of relative price stability. In the financial area, this involves pursuit of policies to meet the needs of an expanding economy while, at the same time, mitigating the effects of undesirable international developments and disturbances that may threaten domestic stability. The Malaysian authorities have to date demonstrated skill in both areas. In particular, through the pursuit of countercyclical financial policies, they have succeeded to a large extent in shielding the domestic economy from external disturbances. They are aware that complete insulation is not feasible; however, perseverance with policies that have withstood the test of experience will have an important bearing for stability and growth in the years ahead.

III. Staff Appraisal

The Malaysian economy in 1980 continued its impressive record of recent years in all principal areas. Output continued to grow at a healthy rate and the rate of inflation, though higher than the remarkably low rate of previous years, was moderate by international standards. The authorities have continued to follow prudent financial policies designed to meet the needs of an expanding economy while counteracting the impact of external disturbances. The balance of payments continued to be strong with capital inflows more than offsetting a small current account deficit and resulting in an overall surplus of M\$1 billion. Exchange rate policies have sought to smooth out fluctuations in the rate without resisting basic market trends. In sum, the staff believes that the authorities should be commended for the general management of

the economy which has contributed to the favorable developments above; the maintenance of vigorous growth and price stability has not only facilitated further progress towards the authorities' broader socioeconomic goals, but has also made a contribution to international adjustment.

The economic prospects for 1981 are, on the whole, somewhat less favorable although the economy should be in a position to continue the expansion of recent years. Given the openness of the Malaysian economy and in particular the volatility of its major export commodities, any projections are necessarily subject to a considerable margin of error. However, on the basis of the expected stance of economic policy and of assumptions regarding external developments, the staff is in broad agreement with the general expectations of the authorities. The countercyclical approach of fiscal policy, involving a somewhat larger budget deficit to compensate for weak external demand, and the stance of monetary policy involving an increase in money supply of about 15 per cent for the year and a gradual reduction in credit expansion, are consistent with the anticipated growth in real GDP of 7-8 per cent and an inflation rate of about 7 per cent.

The balance of payments situation, however, is expected to be less favorable in 1981, in view of the continued weakness in the prices of Malaysia's major exports on the one hand, and the growing import needs of the economy, on the other. The record current account deficit projected for 1981 is expected to be largely covered by capital inflows, including about M\$2 billion in external market borrowing; Malaysia's outstanding external debt and debt service ratio are relatively low and the additional borrowing should create no debt servicing difficulties. The overall position, on the basis of the above, would be in approximate balance although at present the authorities foresee a small deficit.

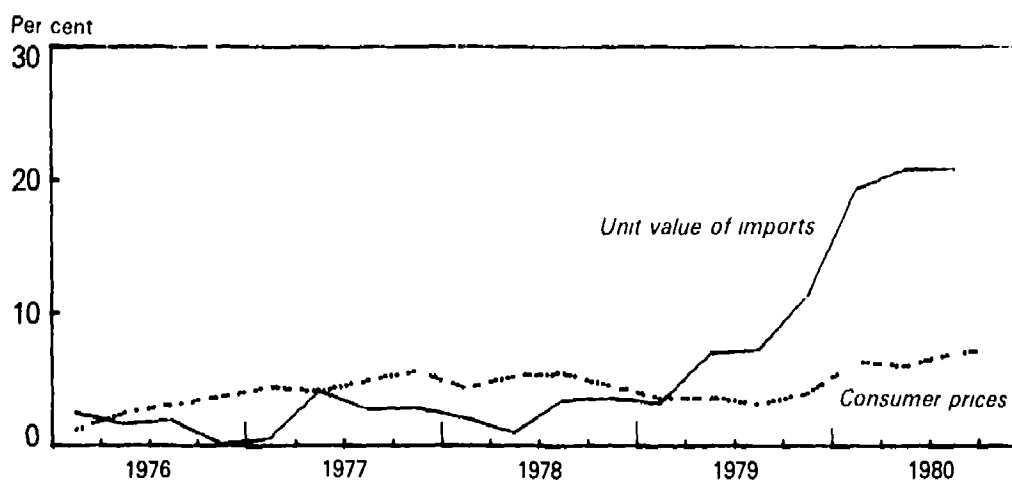
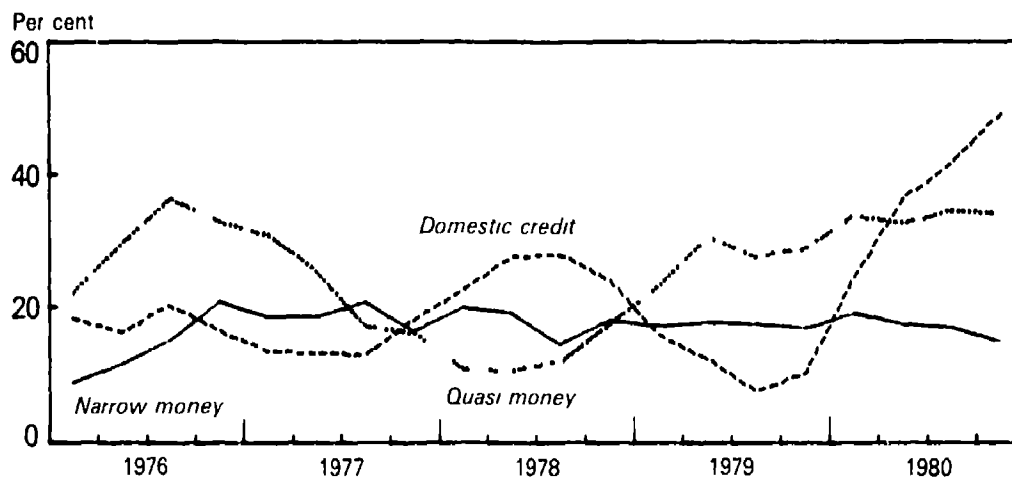
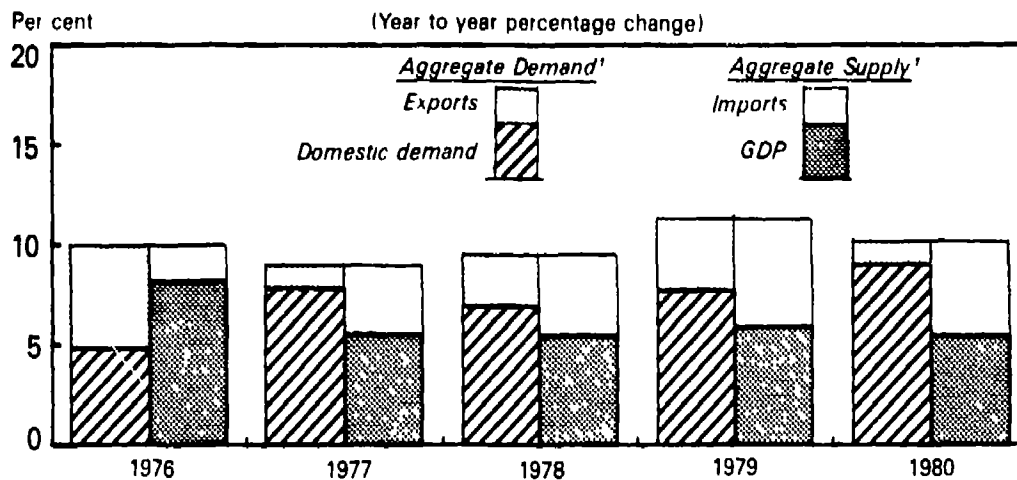
In view of its dependence on trade and the variability of its exports, Malaysia has traditionally maintained a relatively high level of external reserves. The level of reserves in terms of imports has fallen in the past year to the equivalent of about five months of imports. The staff believes that the current level of reserves relative to imports, though lower than in previous years, is not a cause for concern.

While, as the foregoing demonstrates, no issues of critical concern confront the Malaysian economy at present, there are a number of matters affecting the longer-term prospects of the economy that may merit some attention. In considering these points, the continuing transition of Malaysia into an increasingly open, developed, monetized, and sophisticated economy must be kept in view. As already indicated, the export sector is to play a leading role in the years ahead; in view of the relatively unfavorable international environment the maintenance of export competitiveness will clearly remain a matter of high priority. Other areas that merit attention include the price control mechanism, and the protection accorded to existing import-substitution industries, as policies in both

areas have important implications for resource allocation in the economy. In the monetary area, the staff supports the greater flexibility in domestic interest rates evidenced in the past year.

Although immediate prospects may not be as favorable as in the recent past, the achievements attained over the past years provide a sound basis for future economic development and further progress towards the Government's socioeconomic objectives.

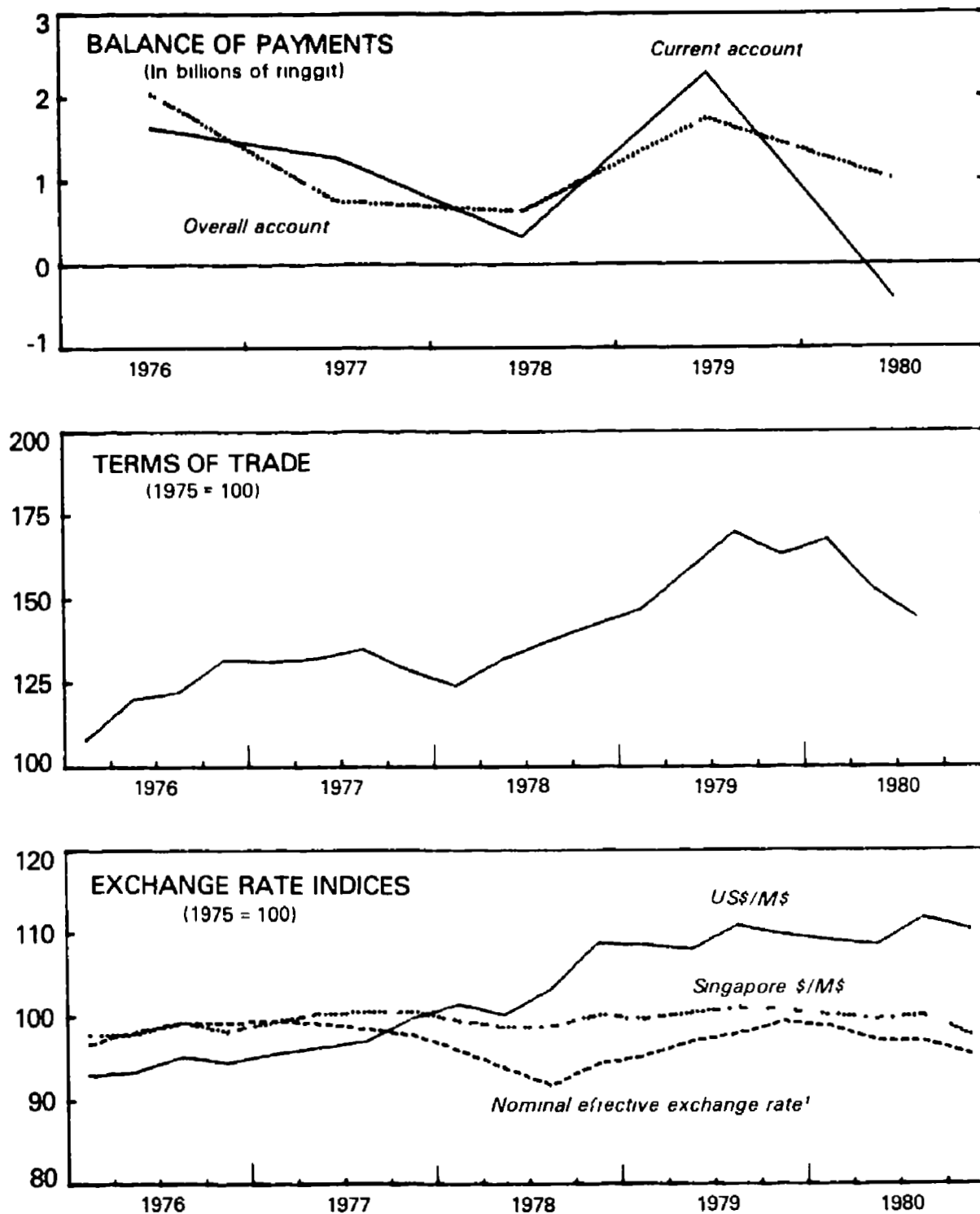
CHART 1
MALAYSIA
SELECTED INDICATORS OF
MACROECONOMIC VARIABLES, 1976-80



Sources: Data provided by the Malaysian authorities and IMF data fund

¹Shaded areas indicate contributions of the components

CHART 2
MALAYSIA
EXTERNAL INDICATORS, 1976-80



Sources: Data provided by the Malaysian authorities, IFS data fund, and staff estimates.

¹Based on the 1975 trade weights.

MALAYSIA

Basic Data 1/

Area:	127,581 square miles
Population (1980):	13.60 million
Average annual rate of growth of population (1976-80):	2.7 per cent
Per capita GNP (1980):	SDR 1,288

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
<u>Selected aggregates as per cent of GNP 2/</u>					
Gross domestic investment 3/	22.6	24.2	26.4	26.4	30.8
Manufacturing production	17.5	18.0	19.1	20.3	21.0
Narrow money 4/	19.4	19.7	20.6	19.9	19.8
Broad money 4/	47.2	47.8	50.1	50.7	55.7
Federal Government revenue and grants	22.7	25.1	25.3	24.4	28.8
Federal Government expenditure and net lending	30.0	32.8	32.1	27.8	37.4
Exports of goods and services	53.8	52.2	52.9	60.5	61.9
Imports of goods and services	43.0	43.5	47.3	50.7	58.6

Annual percentage changes of selected
economic indicators 2/

Gross national product (1970 prices)	10.8	7.1	7.0	9.2	8.2
Consumer price index	2.6	4.7	4.9	3.6	6.7
Federal Government revenue and grants	20.6	27.0	13.0	18.9	28.6
Federal Government expenditure and net lending	17.3	25.7	9.4	6.6	46.7
Narrow money	20.9	16.5	18.2	17.2	15.0
Broad money	27.7	16.4	17.9	24.1	26.7
Merchandise exports, f.o.b.	47.2	11.5	13.9	41.7	16.9
Merchandise imports, f.o.b.	14.8	14.9	21.4	30.4	33.9

Money and credit

(In billions of ringgit)

Broad money	<u>12.8</u>	<u>14.9</u>	<u>17.5</u>	<u>21.7</u>	<u>27.5</u>
Narrow money	5.3	6.1	7.2	8.5	9.8
Quasi-money	7.5	8.7	10.3	13.3	17.8
Net foreign assets	5.7	6.3	6.7	9.1	9.3
Net credit to Government 5/	1.1	1.2	1.0	-0.7	0.5
Credit to private sector	7.5	9.0	11.6	14.6	20.2

Malaysia: Basic Data (Concluded)

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
<u>Federal Government budget 6/</u>						
	<u>(In billions of ringgit)</u>					
Revenue and grants	6.1	7.8	8.8	10.5	13.5	15.8
Expenditure and net lending	8.1	10.2	11.2	11.9	17.4	21.6
Of which: capital expenditure	(1.3)	(1.8)	(2.0)	(2.5)	(5.0)	(6.0)
Financing requirement	<u>2.0</u>	<u>2.4</u>	<u>2.4</u>	<u>1.4</u>	<u>4.0</u>	<u>5.8</u>
External borrowing	0.4	0.5	0.5	0.7	0.3	2.5
Domestic borrowing	1.6	1.9	1.9	0.7	3.7	3.3
Of which: banking system	(--)	(0.5)	(-0.1)	(0.9)	(1.1)	(1.1)
<u>Balance of payments 7/</u>						
	<u>(In billions of SDRs)</u>					
Trade balance	1.3	1.3	1.2	2.3	1.7	1.2
Exports, f.o.b.	4.5	5.2	5.9	8.3	9.9	11.4
Imports, f.o.b.	-3.2	-3.8	-4.6	-6.0	-8.2	-10.2
Current account balance	0.6	0.4	0.1	0.8	-0.1	-1.0
Capital movements (net)	0.4	0.2	0.5	0.4	1.0	1.6
Errors and omissions	-0.4	-0.3	-0.4	-0.5	-0.5	-0.5
Overall balance	0.7	0.3	0.2	0.6	0.4	0.1
<u>Central Bank reserves (end of year)</u>						
In billions of SDRs	2.1	2.4	2.6	3.2	3.6	3.7
In months of imports	7.9	7.4	6.7	6.4	5.3	4.4

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

1/ Components may not add up to totals because of rounding.

2/ Data for 1980 are estimates.

3/ Includes changes in stocks.

4/ End of year.

5/ Federal and State Governments.

6/ Data for 1981 are latest estimates.

7/ Data for 1981 are staff estimates.

Malaysia: Relations with the Fund (As of April 30, 1981)

Status: Article VIII.

Date of Membership: March 7, 1958.

Quota: SDR 379.5 million.

Fund holdings of ringgit: SDR 263 million (69.3 per cent of quota)

SDR position: SDR 123.7 million, or 88.9 per cent of net cumulative allocation of SDR 139.04 million.

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

Direct distribution of profits from gold sales (July 1, 1976 to July 31, 1980): US\$29.55 million.

Exchange system : The ringgit is pegged to an undisclosed composite of currencies of Malaysia's major trading partners, and the weighting reflects the importance of currencies used in settlement as well as trade shares. Margins of 2.25 per cent are maintained, but occasionally and for relatively short periods, the rate has been allowed to exceed margins. The representative exchange rate of the ringgit under Rule 0.2 is the mid-point between the buying and selling rates for the U.S. dollar quoted at noon on the Kuala Lumpur foreign exchange market; the mid-point at end-1980 was M\$2.2224 per US\$1. Malaysia has accepted the obligations of Article VIII, Sections 2, 3 and 4. Payments and transfers for current international transactions are free of restrictions except to Israel and South Africa. Capital transactions above certain limits require prior approval, approvals are freely given except for investments by Malaysian residents in Israel and South Africa.

Last Article IV consultation: The Executive Board discussed the staff report on July 9, 1980. Staff discussions were held during April 7-15, 1980 (SM/80/134, SM/80/142).

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: Relations with the IBRD

(In millions of U.S. dollars)

IBRD lending:	(As of December 31, 1980)	
Total debt outstanding:	1,006.3	
Disbursed:	489.5	
Total commitments in 1980:	105.00	
Total disbursements in 1980:	88.0	
Total commitments (1976-80)		<u>Per cent</u>
Agricultural and rural development	265.0	51
Power	72.0	14
Education	73.0	14
Transportation	48.0	9
Urbanization	26.0	5
Sewage	21.5	4
Population	<u>17.0</u>	<u>3</u>
Total	522.5	100

Technical assistance:

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

Recent economic and
sector missions:

Manufacturing sector mission, February-March 1980. Rural poverty mission, February-March 1979.