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#8

Minutes of Executive Board Meeting 76/4

3:00 p.m., January 16, 1976

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. P. Caranicas
	J. H. Kjaer
	T. Leddy
	A. Doizé, Temporary
	M. Finaish
B. J. Drabble	D. Lynch
R. Gavaldá	S. Sevilla
	W. M. Tilakaratna
	W. Temple-Seminario
K. Kawaguchi	M. Wakatsuki
B. Kharmawan	
P. Lieftinck	
H. R. Monday	J. B. Zulu
F. Palamenghi-Crispi	
E. Pieske	
W. S. Ryrie	
	G. Heyden Q., Temporary
	J. Foglizzo
R. J. Whitelaw	R. S. Deane

K. F. Magurn, Acting Secretary
B. J. Owen, Assistant

Also Present

Asian Department: Tun Thin, Director; W. J. R. Woodley, Deputy Director; A. Abadjis, J. Ahrensdorf, J. Chacko, A. G. Chandavarkar, S. Kanesa-Thasan, H. C. Kim, A. A. Mattera, H. O. Roden, S. Shah, J. A. Tillman, K. Yamamoto, H.-C. W. Yang. Exchange and Trade Relations Department: D. K. Palmer, Deputy Director. Fiscal Affairs Department: S. K. Chand. Legal Department: J. V. Surr. Research Department: C. F. Schwartz, Deputy Director. Western Hemisphere Department: S. T. Beza, J. Ferran, W. C. Prichard, F. van Beek, J. F. van Houten, G. Yadav. Advisors to Executive Directors: C. Bouchard, J. K. E. Cole, A. Malek. Technical Assistants to Executive Directors: V. Alipui, V. Amiel, S. Arancibia, M. Berger, D. Berthet, I. M. Cobbold, M. Danusaputro, B. Goos, R. Khonsary, H. Kuroda, A. K. Mullei, K. Nakayama, A. B. Nymark, S. K. Panya, M. Pietinen, E. Sacerdoti, D. M. Sullivan, S. P. Upasani, M. A. Wasfy, P. Zimmer.

1. CANADA - 1975 ARTICLE VIII CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/76/3, 1/16/76) their consideration of the staff report for the 1975 Article VIII consultation with Canada (SM/75/295, 12/16/75). They also had before them a report on recent economic developments in Canada (SM/75/304, 12/30/75; and Cor. 1, 1/8/76).

Mr. Drabble, responding to the questions that had been raised about Canada's current economic outlook, recalled that Mr. Cross had indicated that the U.S. authorities still thought that 4 per cent was the most likely outcome for the rate of real growth in Canada in 1975. That view was shared by a number of Canadian economists, both in the private and public sectors, although it was at the low end of the range. For that reason, he had indicated in his own statement a range of 4.5 per cent to 5.5 per cent. The information available showed that developments on the demand side were running ahead of expectations in the fourth quarter of 1975. In fact, housing starts and automobile sales in December appeared to be at higher levels, on a seasonally adjusted basis, than for any month in past history. Although it was unwise to make too much of one month's figures, they were an indication that the recovery was at least on track. On the other hand, as Mr. Cross had mentioned, industrial production had failed to show any recovery through October, the last month for which figures were available. There had been major disruptions in the industrial sector due to strikes in one of Canada's major industries, the pulp and paper industry. With the resolution of the strikes, some revival should take place belatedly. It should also be noted that industrial production, as in past cycles, had shown more weakness than total output as measured by real GNP.

As far as the current account prospects were concerned, Mr. Drabble agreed with Mr. Pieske that the Canadian authorities were being a little more cautious than at the time of the consultation. It would be bold to make any forecast for the Canadian balance of payments within a range of less than $1 billion. The deficit for 1976 might be anywhere in the range of $4 billion to $5 billion; in other words, the improvement might be very slight, as Mr. Pieske had suggested.

A number of questions had been raised on the prices and incomes program, Mr. Drabble continued. First, there was the question of whether the targets were too soft. Undoubtedly, one of the two aspects to be considered was the political judgment that had to be made about how low the target could be, particularly on the wage side, without risking the program's credibility. As the staff representative had commented at the morning meeting (EBM/76/3), the Anti-Inflation Board had been experiencing difficulties in keeping some of the settlements it had reviewed below the 12 per cent upper limit. The other aspect concerned the practical problem in Canada of the length of collective bargaining contracts, many of which ran for two or three years. As a result, there were a number of outstanding and legally binding contracts providing for step adjustments that it would have been difficult for the Government to challenge during the first year of the prices and incomes program. While there tended to be some front loading in such contracts, so that the increases in the second and third years were not as high as in the first year, those adjustments were already higher in some cases than the targets under the new program. Had the targets been set any lower, very difficult problems of inequity would have been posed.

The next question concerned the complexity and length of the program, Mr. Drabble recalled. He conceded that there were risks in a complex program because permitting differentials for various, no doubt, sound economic reasons tended to lead to misunderstanding and to a feeling on the part of the public that the program was inequitable. Such risks however were inevitable in a program of the duration envisaged because the rough justice that was acceptable in a one-year program was not tolerable in a program of two to three years' length. At the same time, the adoption of a three-year program was a recognition of the long collective bargaining cycle in Canada; a shorter program would not have caught all major wage contracts. It was also a recognition of the problems experienced by other countries with shorter programs which, although initially successful, had led to an immediate resurgence of inflation when the controls were lifted. In dealing with a situation where inflationary expectations had built up for several years, it had been felt essential to try to carry out a program of the length envisaged, difficult as it would be both as a political exercise and with respect to avoiding structural and other rigidities.

As for the general response of the public to the prices and incomes program, Mr. Drabble added, his impression was that it had been received with tolerance--even active support--by the business community and happily also by the provincial governments. The latter were an important employer of manpower, as all education and health services were under their control; provincial governments therefore had a good deal to gain if the program was successful, in terms both of their own budgets and labor of relations. The public seemed by and large to have accepted the need for the program. The initial reactions of the unions had not been encouraging, although it was not clear whether their opposition was as strong as the public statements of their leaders suggested. Moreover, the ability of individual unions to gain ground in the precontrol period varied widely; unions in some areas where high rates of wage increase were not attainable might be happier under the program.

The room for flexibility in the program was very limited, Mr. Drabble acknowledged. If there were too many exceptions to the guidelines, particularly on the wages side, the program would suffer from a serious loss of credibility. Further, there would be the risk, as the staff indicated, that actual price performance in 1976 might show only a marginal improvement over 1975. That would make it more difficult to keep the program in place for the second and third years. The coming two or three months would be a critical period. Labor settlements already being negotiated as the program was announced had presented a difficult problem, and major new settlements to be dealt with in the period immediately ahead would be a particularly important factor in the final outcome.

On fiscal policy, Mr. Drabble emphasized that the Canadian Government, in announcing its cutbacks in certain programs, had stated that the effort to exercise restraint would have to be a continuous one. Setting aside the fact that statistics on government subsidy payments had been inflated by the way in which oil prices had been handled, Mr. Lieftinck had been right to note the tendency for some years toward a rapid growth in transfer payments, leading to high rates of consumption. Both economists and the business community were conscious of the problem and, as some of the Government's recent statements about expenditure and the need to leave room for private sector investments showed, the authorities in Ottawa were also aware of it. The Government of Canada, in formulating its own fiscal policy, accepted the fiscal stance of the provinces, much as it did the position of the private sector. However, the prospect that a number of provincial governments were affected by some of the concerns influencing the Federal Government made a more cautious fiscal policy at the provincial level possible. That possibility was reinforced by the provinces' concern for their credit rating in international markets, which was of great importance to them.

As for monetary policy, Mr. Drabble noted that until the middle of 1975, the authorities had felt they were on track; true, the increase in M_1 in the first half of 1975 had been somewhat high, but it had followed an increase in the second half of 1974 that was below target. The volatility of M_1 in Canada made it desirable to assess performance over at least a 12-month period, but there was no doubt that, taking 1975 as a whole, the increase was greater than the authorities would have liked. The aberrant movement in the final months of 1975 was almost certainly connected with the national postal strike. It was an illustration of the short-run problems of monetary targets in the Canadian context.

The exchange rate policy of the Bank of Canada was an active one, Mr. Drabble observed, with the scale of intervention being based on the sharpness of movements within a daily framework. However, it did not involve leaning against the wind in any longer-run sense. Inevitably, as the staff representative had said, if there was an underlying trend in the rate, the intervention would tend most of the time to be on one side of the market rather than on the other. For that reason, there would tend to be a counterpart movement in reserves to any persistent movement in the rate. On the other hand, if the market tended to reverse itself sharply from day to day, the policy of the authorities would be to intervene equally strongly on the reversal as on the initial trend. For that reason, it was right to say that the policy objective of the Canadian authorities was the maintenance of orderly market conditions, even if a side effect of the policy was that a movement in the exchange rate over time would have an effect on reserves. He could not agree with the suggestion that that was contrary to the accepted principles of floating; indeed, it seemed to him entirely consistent with the ideas recently enunciated at Rambouillet.

As far as the more philosophical points raised by Mr. Wahl and others were concerned, Mr. Drabble commented that the Canadian position on exchange rates was not based on any simple notion that floating automatically solved all the problems associated with exchange rate movements, such as the extent to which the capital account, rather than the current account, should dominate the exchange rate outcome. Difficult questions still had to be faced regarding the appropriate mix of fiscal and monetary policy in that context. For example, if the pursuit of appropriate domestic monetary objectives produced an interest rate structure that encouraged too much capital to flow in, it was possible that the proper solution might be to adjust fiscal policy. The possibility that the exchange rate might tend to be at a higher level than was comfortable for the competitive position of a broad sector of Canadian industry--a problem touched on in the staff paper--might be relieved by a smaller financing requirement on the part of the Government of Canada, thus making possible a relatively lower structure of interest rates without necessarily bringing about undue monetary expansion. To some extent, the problem that had arisen in Canada from time to time was also associated with autonomous inflows of capital. Looking ahead, at such time that a decision was made to try to bring to the market some of the Arctic gas and oil reserves, it could be seen that the heavy investment outlays required would raise the question of where the Canadian economy would have to give. To a certain extent, it was the secondary manufacturing sector that usually gave, and the exchange rate tended to be the element that produced the adjustment. The alternative would be to consider pacing such large investment programs differently; the Government was at present facing the difficult problem of how rapidly it should go ahead with some developments because of the effect on the economy. Nevertheless, such problems would be just as difficult to solve with an exchange rate operated within declared margins.

Another question frequently mentioned in the Canadian context had been raised by Mr. Kawaguchi, Mr. Drabble recalled, namely, how much scope there was for an independent monetary policy given the closeness of the ties between the U.S. and Canadian money markets. It was not possible to be dogmatic on the question. There were clear limits but, in the short-term market, which was the most responsive to the moves of the monetary authorities, there was more freedom of maneuver than one might think. In general, short-term market flows were covered flows, and most of the time--although not always--the forward premium or discount tended to offset most or all of the short-term interest rate differential. For instance, in the fourth quarter of 1975, short-term rates in Canada had been averaging at least three percentage points higher than in the United States, and yet there had been no evidence of any significant short-term capital inflow. In fact, current estimates suggested that there might have been some outward movement of short-term money in that period. In 1975 it was the relative position of long-term rates, over which the monetary authorities had much less immediate influence, that had been important in attracting large capital inflows. A favorable long-term interest rate differential had led to heavy borrowing abroad by Canadian provinces and businesses. One reason why Canadian long-term interest rates were higher might be the higher level of inflationary expectations in the Canadian economy. Of course, Canadian borrowers in the U. S. market also took an exchange risk, but that did not seem to have been a deterrent to them. To the extent that there might possibly be too much inflow attracted by the relatively high level of long-term interest rates in Canada, a successful program to reduce the rate of inflation could be helpful.

Finally, on energy policies, Mr. Drabble referred to the remarks that had been made about whether present price levels provided an adequate incentive for the production of oil. There had been a tendency on the part of the provincial governments, as Mr. Wahl had suggested, to increase royalties each time the Government raised the domestic oil price so that the producing companies had received a limited share of the overall price increase. Lengthy negotiations between the Federal Government and the provincial governments seemed to have resolved the issue; in Alberta, in particular, where there were still attractive possibilities although little prospect of major finds, adequate incentives for exploration were again being offered. It was more difficult to come to grips with the question of price incentives for the development of frontier oil and gas. Given the large capital costs of building pipelines, it might well be that the necessary investment would have to be facilitated by permitting Canadian oil and gas prices to move up further. Gas prices had already been allowed to rise fairly sharply. But even the present international level of oil prices was not a strong enough incentive, with present technology, to make the development of the tar sands a really attractive investment for the private sector.

In conclusion, Mr. Drabble expressed his appreciation for the good will shown by the Executive Directors and for the thoughtful observations they had made, which he would be glad to convey to his authorities.

The Executive Directors concluded their discussion on the report for the 1975 Article VIII consultation with Canada.

2. MALAYSIA - 1975 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report for the 1975 Article VIII consultation with Malaysia (SM/75/269, 11/10/75; and Cor. 1, 1/14/76). They also had before them a report on recent economic developments in Malaysia (SM/75/290, 12/12/75; and Cor. 1, 1/14/76).

The staff representative from the Asian Department noted that a further correction should be made to the staff report. The figure for the original budget estimate of the overall deficit, given at the bottom of page 2 of SM/75/269, should be M$1,428 million and not M$1,259 million.

Mr. Kharmawan made the following statement:

> For a whole decade covering the period 1962-1972 Malaysia was in the enviable position of registering sustained economic growth at an average rate of 6 per cent per annum, while at the same time it was able to limit price fluctuations to an annual average of about 1 per cent and also succeeded in gradually building up reserves. The rate of economic growth accelerated in 1973, and in fact the world-wide recession reached Malaysia only in the second part of 1974. Its impact was both sharp and serious, interrupting Malaysia's rhythm of economic growth under conditions of a high degree of stability. The rate of growth of real GNP declined from 12 per cent in 1973 to 9 per cent in 1974 and is expected to be only 1 per cent in 1975. According to the staff's lucid, factual and comprehensive report covering 1975, real income after adjustment for changes in the terms of trade rose by 22 per cent in 1973 but would probably fall by 4 per cent in 1975. Malaysia is one of the most important primary producing countries in the world, leading in the export of such commodities as rubber, palm oil, timber and tin, and is expected to become a substantial exporter of oil as well. Malaysia's exports are crucial for its economy. Export volume rose by 19 per cent in 1973 but is expected to decline in 1975. Between mid-1974 and the second quarter of 1975 export prices went down sharply while import prices increased by 42 per cent in 1974 and continued to increase in the first half of 1975. Terms of trade worsened by 4 per cent in 1974 and are estimated to have declined by 12 per cent in 1975. As a consequence the current account balance changed from a surplus of SDR 85 million in 1973 to a deficit of SDR 227 million in 1974, and to a larger deficit in 1975 in the amount of around SDR 426 million. Not only did the balance of payments position of Malaysia deteriorate; so did

its exemplary price performance. Inflation abroad and the continuing buoyancy of the economy in 1973 resulted in a rapid increase of the consumer price index in 1973 which reached an unprecedented annual peak of 24 per cent in March 1974.

Malaysia's success in economic development was the result of wise fiscal, monetary and exchange rate policies, which were geared to provide sufficient incentives to production and investment while avoiding overheating in order to maintain price stability and to enable the country to build up reserves. The authorities rightly attach great importance to the latter objective in view of the uncertainty of the markets for primary products. Without the stability and reserves which Malaysia was able to build up over the years, it would be far more difficult for the country to attract the Funds from abroad necessary to close the current account gap and to prevent the economy from slowing down too much.

Malaysia's ability to manage its economy was put to the text in the period 1974-1975. The staff's conclusion is that "considering the heavy dependence of the economy on foreign trade (exports equal about 50 per cent of GNP), the Government's policies of the past two years have attained a large measure of success: the annual rate of inflation has declined sharply to 3.4 per cent, while the effects of the fall in export demand have been blunted by antirecessionary measures so that the increase in open unemployment has not been serious" (SM/75/269, p. 10).

Those policies were aimed at a prompt adaptation to circumstances. Monetary policy was restrictive in 1973 when inflation in the world and the domestic boom caused prices to rise; it was eased in late 1974 and especially in early 1975 when the recession reached Malaysia. Exchange rates, while floating, were kept relatively stable. Fiscal policies were aimed at alleviating cyclical swings. These policies were repeatedly stressed in the budget speeches of the Minister of Finance. He stated that "the 1975 budget was designed to be countercyclical, to combat recession, and yet not aggravate inflation."1/ And further, in referring to the 1976 budget, the Minister said: "...my basic budget theme is to be cautious, pragmatic and flexible, so as to respond promptly and effectively to the economic and financial changes and challenges as they arise."2/ The staff in appraising, not the budgetary objectives, but budgetary performance, made an observation that in retrospect the countercyclical impact of the budget could have been stronger. This is the well-known

1/ The 1976 Budget, p. 6.
2/ Ibid, p. 5.

problem of foresight and hindsight. While implementing its fiscal objectives in the course of 1975, the Government was faced with a deeper recession than expected so that current revenues, which were estimated to be 3 per cent higher than in 1974, might not be more than 1 per cent higher. The result was that the overall deficit estimated at 7 per cent of GNP (M$1,428 million) might turn out to be 10 per cent of GNP or M$1,978 million.

With continuing uncertainty in 1975 regarding the duration of the recession and the beginning of the recovery of the world economy, and bearing in mind the laudable concern of the authorities with regard to price stability, it is understandable that they, and I believe any other government, were cautious in pursuing their stated objectives.

But on the whole the direction of policies was right, and as a result the Malaysian economy, while having to bear the scars of the world-wide recession is basically in a sound situation, ready to resume its balanced growth as soon as the world economy permits. The 1976 budget is ready to pursue expansionary policies to support growth, employment and to improve income distribution. Monetary policies will be exercised in the same flexible manner as in the past, as also will exchange policies.

I believe that Malaysia is ready to participate and contribute to the expected upturn of the world economy while continuing to adhere to price stability and a cautious stance with regard to reserves and borrowing.

Mr. Ryrie, on behalf of his authorities, expressed sympathy with the Malaysian people on the tragic and untimely death of their Prime Minister.

He agreed broadly with the staff's appraisal, Mr. Ryrie continued. He wished particularly to welcome the success of the Malaysian authorities in bringing about a substantial reduction in the rate of inflation to what was a very low level by modern standards. The success was all the more striking because of Malaysia's high ratio of imports to GNP; many imports presumably came from industrial countries where rates of inflation were higher than the one prevailing in Malaysia. To a considerable extent, that success was the result of a judicious mixture of budgetary and monetary policies. The amendment of the Central Bank Act to enable the Central Bank to issue its own securities was a progressive step that ought to help the authorities to engage in open market operations with the object of pursuing their monetary policies more successfully.

The Malaysian authorities were forecasting a high rate of growth of about 6 per cent for 1976, Mr. Ryrie continued, although the staff apparently thought that they were being a little overoptimistic. Because of the forecasts of rather slower rates of growth in the industrial countries that had been considered in the Executive Board fairly recently, it would be interesting to learn whether the Malaysian economy could in fact be expected to grow by as much as 6 per cent. All the same, the fiscal deficit was fairly substantial, and the staff paper mentioned the possibility that the authorities might introduce special short-term and labor-intensive projects, presumably to provide employment quickly. Also, the staff seemed to believe that the budget deficit estimates might be understated.

Finally, Mr. Ryrie welcomed the intention to invite consuming countries to join in discussions on the establishment of a buffer stock scheme for natural rubber.

Mr. Kawaguchi remarked that it was reassuring to note that Malaysia, with its heavy dependence on exports, had again succeeded in managing its economy effectively, despite rapidly changing conditions in the world economy. It was especially commendable that the rate of increase in consumer prices had been dramatically reduced from 24 per cent in March 1974 to 3.4 per cent in August 1975. Not only short-term economic policy but long-term development planning seemed appropriate, with agriculture being given sufficient attention and industrial diversification being duly oriented toward both export and domestic markets. His only concern was that export and import restrictions should be liberalized or abolished as soon as possible.

Therefore, instead of commenting on the Malaysian economic policy, Mr. Kawaguchi said that he would address himself to the staff appraisal and policy prescriptions. First, the staff seemed to advocate a more active countercyclical fiscal policy. Specifically, it recommended the expansion of government expenditure and advance formulation of alternative expenditure programs in order to increase flexibility. The staff's view was understandable, but he doubted the wisdom of such a policy inasmuch as any increase in government expenditure was likely to be hard to decrease subsequently, owing to political and social pressures. Second, the staff had recommended that public corporations should issue their own debentures in order to finance their capital requirements, rather than depending on the budget. However, since independent financing might well mean the loss of financial control and not more efficient management, further study of the staff's suggestion might be necessary before action was taken. Third, the Malaysian authorities were concerned about increasing recourse to foreign borrowing, while the staff stated that Malaysia's debt service ratio was still low. He wondered whether it would be prudent or appropriate for Malaysia to increase its foreign borrowing. In sum, although he understood the position of the staff, a more practical approach that paid due regard to political and social constraints seemed to be needed.

In conclusion, Mr. Kawaguchi extended his condolences on the death of Prime Minister Tun Abdul Razak.

Mr. Gavaldá observed that the Malaysian economic situation was similar to that elsewhere in the developing world, and the problems faced by Malaysia were mostly those of the less developed countries. As a producer of raw materials, both agricultural and mineral, Malaysia was susceptible to the effects of world depression. Also, being export oriented, the Malaysian economy depended on the efficient financing of world trade. He was confident that Malaysia would find its way back onto the path of sustained economic growth now that the world-wide depression seemed to be coming to an end. He hoped that the adjustment policies of developed countries would not again contribute to choking the demand for the goods and services from the third world.

Mr. Pieske said that he agreed with Mr. Kharmawan that Malaysia's economic performance had been enviable. Its longer-run prospects also seemed to be excellent. Although Malaysia had not been spared the effects of the world recession, it had weathered it better than other countries, without a serious increase in unemployment and with at least a small positive rate of growth.

Against that background, Mr. Pieske said that he wished to offer a few critical comments. It was probably true that fiscal control could have made a somewhat greater contribution toward sustaining demand. On the other hand, there was a difference between foresight and hindsight, as Mr. Kharmawan had stated. When the Executive Board had discussed the 1974 Article VIII consultation with Malaysia on November 11, 1974 (EBM/74/143), the containment of inflation had been regarded as the central necessity. If there had been an error in judgment, the Malaysian authorities were not alone to blame. The statement in the 1976 budget message that fiscal policy in the coming year would be flexible and responsive to economic developments was welcome. The intention to introduce a current year assessment scheme for income taxes should not only lead to greater equity in taxation but should also improve fiscal demand management. Monetary policy had been flexible, although there had been long time lags between the reductions in interest rates and in reserve requirements by the Central Bank and the effect on interest rates in financial markets. Apparently, competition among commercial banks was not as keen as it might be.

Malaysia's dependence on exports made its external policies particularly important, Mr. Pieske observed. Even though its balance of payments situation was basically strong, economic development would continue to depend on foreign investment, and the Government might also have to borrow abroad again. Therefore, it was of great importance that the confidence of foreign investors be maintained. Recent measures, such as the Amendment to the Petroleum Development Act and the Industrial Coordination Act, seemed to have had some damaging effect on confidence and to have affected private investment. His authorities hoped that Malaysia would resume its traditionally liberal policies, including the promotion of foreign investment, which had benefited the country so visibly. In the same vein, he supported the staff's views on the desirability of removing existing restrictions on exports and imports.

Mr. Tilakaratna said that the staff papers and Mr. Kharmawan's statement related the story of the sound economic policies followed by the Malaysian authorities. Malaysia was typical of a rapidly developing economy whose growth momentum and relative price stability had been interrupted by the world-wide recession. The authorities had attempted to follow countercyclical fiscal and monetary policies with a large measure of success. He agreed with the staff that an antirecessionary fiscal policy could be followed more effectively if alternative expenditure programs were formulated in advance so that they could be implemented promptly when the need arose. In that connection, the two-stage presentation of the development budget for 1976, even though it was for other reasons, should give the authorities a high degree of flexibility in their antirecessionary policy, especially in the somewhat uncertain conditions of 1976.

He had also been impressed, Mr. Tilakaratna continued, by the success of the selective credit policies pursued by the authorities in order to promote the growth of priority sectors of the economy, as well as by the programs to eradicate poverty that were being implemented through the budget. The policy toward the economically weaker part of the population was an essential element of development policy if socially balanced economic growth was to be achieved. The initiatives taken by the Malaysian authorities to promote the establishment of a buffer stock scheme for rubber were also welcome. His own authorities had been following that development keenly and had been collaborating on the scheme.

Although the international reserve policy of Malaysia was sound, Mr. Tilakaratna considered, it might be too conservative compared with the policies of Malaysia's neighbors. It was a matter of some disappointment that Malaysia's export efforts were being hampered by the export restrictions being imposed by industrial countries.

Finally, Mr. Tilakaratna expressed his condolences on the death of the Prime Minister.

Mr. Temple-Seminario commented that Malaysia's economic situation was a typical example of exogenous factors being basically responsible for a decrease in GNP. Malaysia should not be expected to carry the whole burden of those external effects. The solution he favored was perhaps to be found in schemes aimed at stabilizing the prices of primary commodities. If that were to be the generally accepted approach, the Fund should see what it could do to help, even if by indirect means.

Finally, Mr. Temple-Seminario said that he wished to convey his condolences to the Malaysian authorities on the loss of their Prime Minister.

Mr. Monday observed that in recent years the Malaysian economy had enjoyed a spectacular growth rate, a healthy balance of payments position, and a sound budgetary performance. However, a basic change had occurred in late 1974 when a severe decline in economic activity followed a fall in export demand for Malaysian products, leading to negative expectations on the part of businessmen for 1975 and a change in the stance of economic policy. Thus, 1975 had been a year of combating recession.

The Government's antirecessionary program seemed to have achieved some degree of success, Mr. Monday continued. The loss of employment had been relatively nominal, and the impact of other adverse economic effects stemming from the fall in export earnings had also been substantially reduced. The authorities' success in significantly reducing the rate of inflation was a major contributory factor. In addition, the authorities should be commended for their flexible demand management policy, particularly their use of monetary policy. For instance, the Central Bank had eased its stance early in 1975 when recessionary tendencies became evident. The lowering of statutory reserve requirements and interest rates, together with the lifting of credit ceilings, provided a timely "shot in the arm" to an ailing economy and improved the chances of an early recovery.

In welcoming the positive role of the Central Bank in demand management policy, Mr. Monday said that he wished to underline the emphasis in the staff report on the need to adopt a more effective fiscal policy that would reinforce the impact of monetary policy on demand management as well as facilitate an early economic recovery. In that connection, the Malaysian authorities should be encouraged to pursue a more expansionary budgetary policy as a means of offsetting downward pressure on aggregate demand. Again, he agreed with the staff that because of the sound debt management policies of the authorities, the debt service ratio was currently low; the favorable medium-term export prospects of Malaysia meant that it could safely incur foreign debt in a sufficient amount to finance a larger current budget deficit and additional development expenditures, so that it could carry out an effective antirecessionary program.

However, one serious problem confronting the Malaysian authorities was the uncertainty of the timing and strength of economic recovery in the industrial countries, Mr. Monday stated. That uncertainty made it difficult for the authorities to determine the appropriate level of budgetary expenditure for 1976, consistent with domestic and international economic developments during the year. Therefore, it seemed to him that the authorities had been wise in deciding to split development appropriations for 1976 under the Third Malaysia Plan into two parts, so that account could be taken of both internal and external developments in the third quarter of 1975 and the first quarter of 1976 before the level of expenditure on new projects in the plan was determined. He also welcomed the authorities' recognition that it would be desirable to implement additional projects of a labor-intensive character, with a low import content and short gestation periods, until the full impact of economic recovery in the industrial countries made itself felt in the domestic economy. In addition, he supported the intention to assess income taxes on a current year basis and to use the budget more effectively as an instrument of anticyclical economic policy.

The slump in economic activity in 1975 was expected to turn the trade account around and substantially increase the current account deficit for that year, Mr. Monday observed. But, as the staff had pointed out, the medium-term prospects for additional exports and the export of oil were favorable; moreover, the industrialization policy now gave priority to industries that were export-oriented and processed local raw materials so that exports of finished goods were expected to represent an increasing share of total exports. However, since, in the short run, Malaysia would continue to rely rather heavily on the export of traditional primary commodities, the world market prices of which were subject to violent fluctuations, he fully shared the desire of the authorities to seek the establishment of schemes aimed at stabilizing the prices of primary commodities, including a buffer stock scheme for rubber.

In conclusion, Mr. Monday joined other Executive Directors in extending his condolences on the death of the Prime Minister of Malaysia.

Mr. Lieftinck also expressed sympathy with Malaysia on the recent loss of the Prime Minister. Over the years, he had developed a great admiration for the way in which the Malaysian authorities had managed their economy. They should also be commended, in the face of the recessionary developments in 1975, for the action they had taken in order to stimulate the economy while at the same time combating inflation. The rate of increase of the consumer price index had peaked at 24 per cent in March 1975; it had declined to 12 per cent in December and to 3.4 per cent in August, a remarkable achievement.

The major problem remaining was to combat the recession, Mr. Lieftinck continued. He had certain reservations with respect to the staff's conclusions on the authorities' countercyclical policy, and particularly their fiscal policy. It was not in dispute that the authorities had followed a deliberate countercyclical policy, but the staff had concluded that both in 1974 and in 1975, the impact of external conditions had had a greater effect on the overall budget deficit than that of internal policy. Yet the main reason for the expansionary budget in 1974, at a time when contractionary countercyclical action would appear to have been called for, was the granting of considerable subsidies in order to cope with the sharp increase in the cost of living in 1974, when the rate of inflation had reached a peak of 24 per cent at one point. There were other factors, but the cost of the subsidies had had a significant impact on the budget deficit, which already in 1974 had reached 7 per cent of GNP. As for 1975, the staff considered that the increase of government expenditure had been insufficient to compensate for the income loss resulting from the reduced prices and volume of exports. While it was true that the increase in expenditure was less than the average in preceding years, the 7 per cent deficit in 1974 increased in 1975 to 10 per cent. The question to be considered was whether budget deficits of that size were appropriate or not. His own feeling was that in an economy that was so heavily dependent on imports and exports, there were certain limitations with respect to what could be done, by boosting internal purchasing power, to shift consumption and production to the domestic sector. Certainly, he would not advocate a vigorous short-run policy aimed at diverting resources from the external sector, and he doubted whether it was appropriate to state that the Government's policies should have been more expansionary in 1975. First, although the 3 per cent increase in the financial gap was in itself not substantial, it should be viewed not in relative but in absolute terms. Second, there were considerable constraints to the diversion of economic resources from an externally oriented economy to a more internally oriented one.

In conclusion, Mr. Lieftinck noted that Malaysia's prospects were promising. With the further expected expansion of the export sector, he hoped that the authorities would succeed in reducing the heavy financial gap of 10 per cent that had developed.

Mr. Drabble joined other Executive Directors in conveying to the Malaysian authorities his condolences on the death of the Prime Minister.

He too had generally been impressed by the wisdom displayed by the Malaysian authorities in their economic policies and in their efforts to diversify the economy. There must be very limited scope for an economy such as Malaysia's to offset the impact of the sharp swings that had occurred in the market prices of its principal primary products. The important progress that had been made in recent years toward the industrialization of the economy and the development of a manufacturing sector would obviously be helpful, as would any progress that could be achieved in the international arena toward finding a solution to the problem of the volatility of commodity prices. In the meantime, the severity of the swings of the past two or three years had inevitably had consequences for the conduct of the Malaysian economy. The authorities deserved considerable commendation for the way in which they had managed to reduce the rate of inflation to such a modest level without the need for elaborate prices and incomes measures.

As far as the possibility of a more effective use of fiscal policy was concerned, Mr. Drabble said that he had been interested in the questions posed by Mr. Lieftinck. Even in countries that had more scope for sophisticated countercyclical mechanisms, the timing and the lags in the response to such policies in particular gave rise to considerable difficulties. Such policies, far from being countercyclical, had sometimes tended to exacerbate cyclical swings.

In conclusion, Mr. Drabble expressed the hope that, given Malaysia's relatively strong capital account and the expectation of greater strength on the trade account as well, the authorities might be in a position gradually to phase out their export and import restrictions.

The staff representative from the Asian Department, in reply to Mr. Ryrie, said that the Malaysian authorities had estimated that the rate of growth in 1976 would be about 6 per cent, based on the available projections of growth in the industrial countries. The staff had no real misgivings about the estimate, partly because there had already been signs toward the end of the third quarter of 1975 that the Malaysian economy was recovering, and partly because the Malaysian authorities felt that even though the recovery of the industrial countries might be delayed somewhat in 1976, stocks of raw materials would be replenished in the early stages of that recovery. Thus, the impact on the Malaysian economy would be felt at a fairly early point. Also, rubber prices had improved in recent months and the authorities were optimistic about rubber exports.

In response to Mr. Kawaguchi's remarks on the staff suggestion regarding an increase in development expenditures, the staff representative noted that at the time of the consultation discussions, as mentioned in the staff report, the economic recovery had not taken hold firmly, and the staff had suggested an acceleration of certain development expenditures in the short term, particularly on projects with short gestation periods, so as to achieve flexibility in expenditures. The Malaysian authorities had agreed that there was scope in agriculture and also in low-cost housing, which had a low import content since local timber was used. The staff had felt that such an approach would not commit the authorities beyond March, when the new development plan would be ready, and the appropriate level of expenditures at that time could be given further consideration.

On foreign borrowing, the staff representative repeated that the Malaysian authorities' enviable position of having a low debt service ratio in relation to exports of about 2.4 per cent was due to the prudent and successful policies they had followed in the past. The staff view had been that, since the recession facing Malaysia was a temporary phenomenon, the authorities should not be constrained from following an effective antirecessionary policy because of a failure to contract foreign loans for the purpose. Not only was Malaysia's debt service ratio low, but medium-term export prospects were favorable. At the time of the consultation discussions, the new development plan was under preparation and a World Bank mission, also in Malaysia at that time, shared the favorable view of export prospects.

As for Mr. Lieftinck's remarks on fiscal policy, the staff representative agreed that in stating that the authorities could have followed a more expansionary policy in 1975, the staff had to some extent taken a retrospective view. Yet, it had already been evident before the middle of the year that inflation was under control and that there was scope for a more expansionary expenditure policy. For instance, the consumer price index, after increasing in January, had remained stable in February and had declined in March. Thus, over the first quarter of 1975, there had been no increase in prices, and in the second quarter, prices had declined. By September, compared with December 1974, prices were up by only one half of 1 per cent. At the same time, the demand for credit had been sluggish, rising by only 1.5 per cent in the first quarter of 1975, with the money supply increasing by only 1 per cent during that period, and by another 1 per cent in the second quarter. Moreover, looking back at the performance in previous years, it would be seen that in 1971 and 1972, when exports had fallen by 2.7 per cent and 3 per cent respectively, an anticyclical policy had been followed, with expenditures being increased in 1971 by 25 per cent and in 1972 by 24 per cent. Exports represented about 50 per cent of Malaysia's GNP, so that fiscal policy was geared closely to the behavior of exports. In 1975, exports had declined by 13 per cent, and it was striking that, in a period of recession, development expenditures had increased by only 1 per cent in current terms. It was for that reason that the staff felt fiscal policy could have been more effective in 1975, particularly since Malaysia had previously followed a successful countercyclical expenditure policy.

The Acting Chairman said that he wished personally to join in the many expressions of condolence to the Malaysian authorities on the tragic and unexpected passing of their distinguished Prime Minister.

Mr. Kharmawan said that he wished first of all to express, on behalf of his Malaysian authorities, deep appreciation to the Acting Chairman and to the Executive Directors for their condolences on the passing of the Prime Minister. He had been a great statesman and his loss would be felt not only in Malaysia but in neighboring countries as well.

In response to Mr. Pieske's observation on the investment climate in Malaysia, Mr. Kharmawan noted that the relationship between developed and developing countries generally, when viewed against the background of the colonial past, had naturally not yet been stabilized. Yet he believed that with good will a mutual understanding could be reached, as experience in many countries had demonstrated. The Malaysian authorities of course had to take account of sensitivities on the score of foreign investment in Malaysia, but the Prime Minister, whose death was presently being mourned, had stated in a speech at the Malaysian investment seminar on October 27, 1975 that: "the Malaysian Government is committed to a system where the private sector's role is a prerequisite for continued and rapid industrial development. On the Government's part, I wish to reiterate here, our commitment to assist the private sector in every way possible to fulfill this role, so that it can be true partners in our progress and development. This is the cornerstone of our industrial policy, to which my Government is fully committed and will adhere...in the future." He continued, "Malaysia's success story is generally acknowledged, and a major element in that story, also generally acknowledged, is the Government's pragmatism and fairmindedness, as well as our recognition of the important role of foreign private investment in our industrial development programme. No Government can be so foolish as to change a tested formula for success. My Government will therefore ensure, through the laws that we promulgate, and the policies we implement, that economically and politically, Malaysia continues to be a sound base for investment." The then Deputy Prime Minister, and Minister of Finance, had also stated in his budget speech that: "the Government alone cannot, and should not, be responsible for all industrial growth. Private investors, both domestic and foreign, are better equipped by virtue of their knowhow and capital to expand investment. I am aware that there are administrative and other problems. However I wish to assure the private sector that the Government is anxious to accelerate the pace of industrialization. We welcome both domestic and foreign private investment and enterprise, and I would personally welcome all concrete and positive proposals that the private sector may have, to achieve our common aim of promoting and expanding private investment and industrial growth."

Those quotations represented the official policy of the Malaysian authorities, Mr. Kharmawan added. Any problems in the field of foreign investment should be seen as temporary and localized. The standing policy of the Malaysian Government was to keep the way open for both domestic and foreign investment. There had been some problems of interpretation concerning the agreement reached between the Malaysian Government and the oil company concerned, but those had been solved and operations had already been resumed or would resume shortly.

As far as Malaysia's import restrictions were concerned, Mr. Kharmawan stated that they were temporary and under continuous review. Of course, there would always be certain restrictions, as part of the industrial development strategy, so that legitimate protection could be given to infant industries.

He had already commented in his opening statement on the staff's observations with respect to budget policy, Mr. Kharmawan recalled, but he was grateful for the understanding shown by Mr. Lieftinck and others in that respect. With hindsight, it could always be said that certain measures should have been taken. But when changes in policy were being implemented, future developments could not be known with any certainty, and he believed it was better to err, if at all, on the cautious side. In that respect, the continuous concern of the Malaysian authorities had been to maintain price stability as a major feature of Malaysia's economic development. A more dynamic economic development policy over the decade 1962-1972 might have led to a rate of growth of 10 per cent, rather than the 6 per cent achieved, but price fluctuations would probably have been more than the recorded 1 per cent average. Jolted for the first time by what they considered to be hyperinflation, the authorities had managed to bring the rate of inflation down from 24 per cent to about 3 per cent, thus re-establishing price stability. If further expansionary measures had been taken, the price performance might have been quite different. Another essential feature of the policy of price stability adhered to by the Malaysian authorities, was the need to ensure the stability of workers' income and thus a peaceful relationship with the working population. In addition, the deficit at the end of 1974 had already been high. Therefore, he believed that the Malaysian authorities deserved credit for taking a cautious approach when they were in the middle of implementing a new fiscal policy.

Finally, Mr. Kharmawan thanked Executive Directors for their constructive observations, which he would convey to his authorities.

The Executive Directors concluded their discussion of the report for the 1975 Article VIII consultation with Malaysia.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 76/78, May 26, 1976

H. JOHANNES WITTEVEEN
Chairman

W. LAWRENCE HEBBARD
Secretary