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June 8, 1971

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report for the 1971 Article VIII Consultation

Attached for consideration by the Executive Directors is the staff report for the 1971 Article VIII consultation with Malaysia.

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

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INTERNATIONAL MONETARY FUND

Malaysia

Staff Report for the 1971 Article VIII Consultation

Prepared by Staff Representatives for the 1971
Article VIII Consultation with Malaysia

Approved by D.S. Savkar

June 7, 1971

I. Introduction

The 1971 Article VIII consultation discussions with Malaysia were held in Kuala Lumpur from April 19 to 30, 1971. The Malaysian representatives were led by Raja Tan Sri Mohar bin Raja Badiozaman, Secretary-General to the Treasury, Tan Sri Ismail bin Mohamed Ali, Governor of the Bank Negara Malaysia, Mr. Malek Ali Merican, Deputy Secretary-General, Treasury, and included officials of the Treasury, the Bank Negara Malaysia, the Economic Planning Unit, the Ministries of Commerce and Industry and Labor, the Department of Statistics and other government agencies. The staff team had also informal discussions with Tun Tan Siew Sin, Minister of Finance and with Mr. Ali bin Haji Ahmed, Assistant Minister of Finance. Mr. Hideo Suzuki, Executive Director for Japan, who has been designated by Malaysia to look after their interests at the Fund, attended the concluding session of the discussions as an observer. The staff team consisted of Messrs. Anand G. Chandavarkar, R.J. Niebuhr, and G.H. Jewayni.

II. Report on Discussions

1. Economic growth and development

Preliminary data for 1970 indicate that Malaysia's gross national product at current market prices rose by 6.3 per cent (about 6 per cent in constant prices) to M$11,821 million compared with an increase of 9.8 per cent in 1969. The rate of growth in 1970 was marginally lower than the average annual rate of growth of 6.5 per cent achieved during the First Malaysia Plan period (1966-70). The main impetus to growth in 1970 came from domestic sources whereas in 1969 the stimulus to economic expansion was provided largely by the export boom. There was an unprecedented upsurge of nearly 33 per cent in private investment, mainly in manufacturing and to a lesser extent in construction, in contrast to a decline of 4.9 per cent in 1969. This reflected the vigorous recovery of the economy after the setback in domestic investment following the civil disturbances in May 1969.

The year 1970 marked the completion of the First Malaysia Plan (1966-70) and the beginning of the Second Malaysia Plan period 1971-75. The First Plan provided the basic framework of an integrated national development plan, and despite wide fluctuations in the prices of Malaysia's major export commodities, particularly rubber, the record of growth during the Plan period was satisfactory. The cumulative total private investment in 1970 amounted to M$5,051 million or 78.3 per cent of the revised Plan target of M$6,449 million. Total public investment for 1966-70 was estimated at M$4,158 million, or 90.7 per cent of the revised Plan target of M$4,585 million.

As regards prospects for 1971, the Malaysian representatives indicated a plan target for GNP of M$12,668 million, i.e., a growth rate of 7.2 per cent for the year. They anticipated a rise of about 7 per cent in private fixed investment while inventory investment is expected to taper off to relatively normal levels as a reaction to the restocking boom of 1970. Domestic demand is likely to be the main stimulus to growth as it was in 1970.

The Malaysian authorities recognize that despite the substantial economic growth over the past several years, both unemployment and the economic imbalances between social groups and regions still persist to a considerable degree. Accordingly, the Second Malaysia Plan, which is still in the process of finalization, gives high priority to the reduction of economic disparities among major social groups and the expansion of employment while aiming at a minimum rate of growth of 6.5 per cent per annum in GNP. The Plan envisages a total investment of M$12,150 million, nearly 50 per cent higher than under the First Plan, of which public investment would amount to M$4,307 million.

The Malaysian representatives agreed that the attainment of Plan targets and policy objectives would be contingent on the development of more effective capability for implementation of public sector projects as well as on adequate response by the private sector to opportunities under the Investment Incentives Act 1968, which is the main policy instrument for promoting industrialization. They referred to the role of the Capital Investment Committee in streamlining the processing of investment proposals and in approving further incentives to accelerate private investment. As regards the rationale of import-substitution, the Malaysian representatives stated that although some of the industries such as textiles, cement, etc., were originally intended to cater for the domestic market, they were now increasingly being oriented to export markets.

2. Commodity problems and policies

The Malaysian representatives, expressing their appreciation of the Fund's increased attention to members' policies in the commodities' sphere elaborated on some of the main problems relating to rubber, tin, palm oil, and timber, which are of vital importance to Malaysia's economy and balance of payments, and hoped that the Fund would assist in finding constructive solutions for these in the international context.

There was a fractional decline (0.3 per cent) in rubber production in 1970 to 1,255,824 tons due to the decline in rubber prices as well as adverse climatic conditions in West Malaysia and Sarawak, and the security problems in parts of East Malaysia. Rubber prices declined from 70 Malaysian cents a pound in January 1970 to a low of about 48.3 cents a pound in October and despite a slight recovery thereafter declined to 49.1 cents in February 1971. The authorities had intervened to make purchases when the price of rubber fell to about 43 Malaysian cents a pound and although such purchases were still in process they were regarded as essentially transitional measures in a period of low and unrealistic prices. Currently, rubber stocks in Malaysia (155,000 tons in February 1971) were relatively high because of reprocessing of stocks due to flood damage in January 1971 and the disruption of transport from the eastern part of West Malaysia as well as the premium commanded by future over spot prices which had encouraged withholding of stocks for future delivery. The Malaysian representatives, however, expected that these temporary factors will soon be eliminated and stocks will return to the more normal level of 8 per cent of production.

The Malaysian representatives, however, expected that in 1971 rubber production would increase to within a range of 1.3 to 1.5 million tons given favorable labor conditions in East Malaysia and improved security in Sarawak. In view of recent developments in other rubber producing countries in Asia they thought that there might be some firming in rubber prices. Since developments in synthetic rubber were among the important influences on rubber prices, the Malaysian representatives were particularly interested in the possible repercussions of recent increases in oil prices on the cost of synthetic rubber and suggested this as a possible area of study by the Fund.

The authorities are pursuing a broad-based program of replanting with high-yielding varieties of rubber and wider use of premium grades of rubber (SMR) to adapt natural rubber to the needs of consumers. The replanting of small holdings of rubber (310,000 acres) posed special problems because of the small average holdings of five acres whereas an economic holding was ten acres. The annual target for replanting is to be raised from 45,000 acres to 120,000 acres with a replanting grant of M$750 per acre. With the adoption of better planting methods and the development of more productive clones, the average yield on estates in West Malaysia increased from 999 pounds per acre in 1969 to 1,016 pounds per acre in 1970.

The Malaysian representatives, however, emphasized that the effectiveness of domestic policies in maintaining the competitiveness of natural rubber is also contingent on appropriate measures in major consuming countries. They reiterated their concern with the announcement effects as well as the actual impact of disposals of rubber from the U.S. stockpile. Thus, the price of rubber had declined from 72 Malaysian cents a pound to 68 Malaysian cents a pound after the news of the stockpile releases had been leaked and had dropped further to 55 Malaysian cents a pound after the actual announcement. They were interested in an enduring long-term solution to the problem of stockpile releases and expected that the Association of Natural Rubber Producing Countries would put forward specific proposals to the U.S. authorities before July 1971. They also supported the idea of a "trigger price" for rubber which would suspend sales on a falling market. According to the Malaysian representatives another major issue was the structure of tariffs in the industrial countries which, while admitting natural rubber duty-free, imposed duties up to 21 per cent on natural rubber mixed with chemicals. This inhibited Malaysian rubber producers from producing rubber tailored to specific consumer requirements. In response the staff team pointed out that during the latest consultation discussions with the concerned member countries the views of the natural rubber producing countries on stockpile releases had been adequately expressed and this subject would be kept under continuous review by the staff along with other relevant aspects of primary commodity problems.

The production of tin recorded a small increase from 72,167 tons in 1969 to 72,630 tons in 1970. Although export prospects are regarded as favorable, due, among other factors, to the raising of the floor price by the International Tin Council, output is unlikely to show any perceptible increase because of the declining availability of tin mining land and continuing depletion of existing mines.

Although the authorities had not yet taken a final decision to resort to the Fund's buffer stock financing facility for financing part of Malaysia's contribution to the Fourth International Tin Agreement, the Malaysian representatives reviewed with the staff team the policy issues and procedures involved in a possible recourse to the facility through a super gold tranche purchase. They expressed the hope that the Fund would permit Malaysia to make use of the facility and thereby make it meaningful in terms of Malaysia's requirements as a leading tin producer.

Oil palm cultivation has grown rapidly in the past several years, largely in response to the official policy of agricultural diversification, with the result that Malaysia is now the world's largest commercial exporter of palm oil. The production of palm oil and kernels increased by 23 per cent and 17 per cent in 1970 to 424,000 tons and 90,920 tons, respectively. The Malaysian representatives referred to the problems likely to be encountered as a result of increased production of palm oil, such as the need for costly bulk storage and other equipment, the inadequacy of shipping space, restrictions on use of available "nonconference" shipping space, and the excessive increase in freight rates. They also expressed their concern at the possible loss of tariff preferences for palm oil in the U.K. market and the imposition of an added 6 per cent duty in the event of the United Kingdom's entry into the EEC.

Timber, which is the third largest earner of foreign exchange after rubber and tin, maintained its long-term upward trend in production during 1970. The output of saw logs (9,718,500 tons) and sawn timber (1,820,000 tons) was higher by 4 per cent and 9 per cent, respectively. The main problems of the logging industry arise from timber wastage and illegal tree felling. Therefore, the authorities are considering the grant of pioneer status and investment incentives to only those processing firms which use the less known timber species or engage in integrated processing where it is possible to reduce wastage to a minimum.

Output of rice (paddy) increased from 1,573,600 tons in the 1968-69 season to 1,658,800 tons in the 1969-70 season and the authorities expect that with the extension of double cropping in the three main irrigated areas of West Malaysia, the country would become nearly self-sufficient in rice by 1973. They are, however, also concerned about the economics of self-sufficiency in rice because local rice is relatively high cost, being M$40 to M$50 per ton higher than imported rice, and in the event of a decline in the price of local rice, marginal rice producers, particularly in nonirrigated areas, would be adversely affected. It is intended to establish a new authority to study all aspects of the long-term rice program.

Among minor crops, the output of fresh pineapples dropped by 8 per cent in 1970 to 276,500 tons due to declining productivity as a result of excessive proportion of overage plants. It is proposed to replant the holdings with newer high-yielding varieties. The authorities are apprehensive that exports of canned pineapples, which at present enjoy a preferential tariff in its largest market, the United Kingdom, might be adversely affected in the event of the U.K.'s entry into the EEC.

The authorities are pursuing a vigorous program of development of coconut and pepper cultivation and are also examining the prospects for other crops such as cashew nuts, tapioca, sago and bananas as part of a long-term policy of agricultural diversification.

3. Population, employment, wages and prices

The population of Malaysia is estimated to have increased by 2.7 per cent during the year ended June 1970 to 10.94 million as against a rise of 3 per cent during the preceding 12-month period. An officially sponsored population control program has been operating since 1966 under the aegis of the reorganized National Family Planning Board, which has undertaken an extensive program, covering about 3.5 million people, through utilizing rural health personnel operating statis and mobile clinics. Although the annual rate of population growth for West Malaysia has declined since 1966, the authorities are concerned about unemployment.

The steady deterioration in the employment situation, which is particularly pronounced in the age group 15-24 including school leavers, is evidenced by the rise in over-all unemployment from 6.6 per cent of the labor force in 1962 to about 9 per cent in 1970. The Malaysian representatives indicated that the labor force was projected to increase over the period 1970-75 at an annual rate of 3.2 per cent as compared to an annual increase of 2.9 per cent during the period 1962-68.

In the context of these trends the discussion focused on the short- and long-term policy measures to counter the growing volume of unemployment. The Malaysian authorities have taken a variety of short-term measures to promote employment such as requiring noncitizens to obtain work permits for specified periods (renewal being contingent upon a qualified Malaysian citizen not being available), extension of training schemes to improve skills, restrictions on overtime to a maximum of 32 hours per month per worker except in very special cases, (this has resulted in the creation of 11,895 new jobs to date) and the abolition of the payroll tax. To date, 5,025 workers from West Malaysia have been placed on rubber and on oil palm plantations in East Malaysia, an area of labor shortage, through the Migration Fund Board's program of assisted migration. This program has been successful but its further progress, according to the Malaysian representatives, will depend, among other things, an easing of the housing situation in East Malaysia. Regarding the scope for appropriate fiscal and other incentives for adoption of an "Intermediate Technology" using relatively labor-intensive production techniques in agro-based industries and social overheads, etc., the Malaysian representatives said that this was currently being studied by an expert committee. They, however, concurred with the staff team's observation that the choice of production techniques is a complex issue which has also to be assessed in terms of the optimum trade-off between increased output and efficiency and greater employment. For instance, their experience of more labor-intensive techniques in construction and transportation was not always happy. The authorities regard land development schemes based on extension of the area under cultivation and plantation as one of the most promising avenues of increasing employment.

Referring to wage and price trends, the Malaysian representatives stated that the average increase in wage rates in 1970 was about 3 per cent within a range of 2.5 to 5 per cent and most of these negotiated increases related to the rate for specific jobs and the capacity of the employer to pay. Significantly, changes in the cost of living had not generally been an issue in industrial relations, which reflected the general climate of price stability in the Malaysian economy. Despite increases in the prices of many imported manufactured goods, the retail price index for West Malaysia rose by only 1.4 per cent (to 108.6) above the level in 1969. Even this modest increase, which chiefly reflected the rent and transport components of the consumer price index, was due to domestic factors of a special nature. The increase in rent was due to an upward revision, the first of its kind in many years, in local and state government taxes on real estate. The increase in cost of transportation reflected the increase in road tax and driving license fees as well as higher excise duties on tires and tubes. On the other hand, prices of foodstuffs remained at about the same level as in 1969. The Malaysian representatives stated that although there was a seasonal rise in prices at the beginning of the year, aggravated by the shortages and distribution problems caused by the floods, they expected that consumer prices will remain relatively stable in 1971. They added that the authorities were intending to revise, in late 1972 or early 1973, the existing consumer price index, based on a sample survey in 1958, so as to take account of the changing pattern of consumption and prices.

Responding to the staff team's inquiries concerning the factors accounting for Malaysia's record of prolonged price stability, the Malaysian representatives stated that, in addition to the openness of the economy, this could be ascribed to the comparative stability of wage rates and the fact that such wage increases as had occurred had generally been consistent with increases in productivity.

As regards the possible scope for an incomes policy the Malaysian representatives thought that this policy instrument was of little significance in the Malaysian context. They did not consider that the efficacy of incomes policies had been demonstrated even in countries where they had been adopted. However, a Council on Pay and Conditions of Service with a research unit had been established to monitor and coordinate wage increases in the public sector. The authorities do not expect that the pay increases in the public sector in West Malaysia, in accordance with the recommendations of the Suffian Salaries Commission, (involving a total of 221,683 employees in all groups, industrial and manual) will influence wage levels in the private sector. The revision of the salaries and terms and conditions of service for government employees in East Malaysia and personnel in statutory and quasi-government bodies is still under way and the Government is awaiting the report of the reconstituted Aziz Salaries Commission on salaries of teachers in West Malaysia.

4. Public finance

The fiscal discussions focussed largely on the budgetary outturn for 1970 and the outlook for 1971 as well as on longer term policy measures to mobilize more resources for the public sector. Although the over-all deficit in the Federal Government's budget for 1970 was higher than in 1969 it was, as in the previous years, financed largely by domestic non-bank borrowing.

The better than expected outturn in current revenue in 1970 was largely due to higher collections from income tax, increases in yield from taxes on road transport, betting and sweepstakes, excises, and surtax on imports. The Malaysian representatives stated that the substantial increase in income tax receipts reflected the higher income accruals in 1969 owing to the export boom as well as improvements in the efficiency of the tax administration. They referred to the encouraging result of the anti-tax evasion campaign which yielded about M$12 million in 1970.

Table 1. Malaysia: Federal Government Finance, 1968-71

(In millions of Malaysian dollars)

	1968	1969	1970 Provi-sional Actual	1971 Revised Estimate
Current revenue	1,890	2,093	2,300	2,447
Current expenditure	1,791	1,929	2,148	2,495
Current surplus	99	164	152	-48
Development expenditure	608	604	633	762
Over-all deficit	509	440	481	810
Sources of finance:				
Foreign	97	171	34	
Domestic nonbank	152	305	368	
Bank financing	260	-36	79	
Central Bank	-85	-146	128	
Sale of foreign assets	70	43	25	
Commercial banks	275	67	-74	

Source: Data provided by the Malaysian authorities; financing items reclassified consistent with banking statistics.

The rise in current expenditure in 1970 was mainly due to larger outlays on defense and internal security, social services and debt charges. The Malaysian representatives indicated that there was actually a shortfall in current expenditure, largely under defense and internal security, due to delays in recruitment of personnel and postponements in delivery of ordered equipment. There was a substantial shortfall, estimated at M$151 million, in development expenditure in 1970. The authorities are concerned about the problem of accelerating public development expenditure, particularly in view of the persistent shortfalls in recent years, and have appointed a number of working groups to suggest remedial measures. A new directive, which allows government agencies to enter into contracts for development projects before appropriations have actually been made, is expected to speed up project implementation. The Malaysian representatives stated that efforts were being made to improve the monitoring of development expenditure but special problems of reporting were involved. They, however, did not expect any spectacular improvement in implementation capacity of the public sector in 1971 as the measures taken would take some time to be fully effective.

The budget estimates for 1971 show a higher over-all deficit compared with 1970 due largely to sizable increases in security expenditure consequent upon the British military withdrawal and the assumption of larger defense obligations by Malaysia. According to the Malaysian representatives the peak phase in defense personnel recruitment had already been reached and further increases in security outlays would mainly be on account of equipment purchases. As regards other items of current expenditure, an additional outlay of M$70 million is estimated for implementation of the salary increases recommended by the Suffian Commission.

The discussions on long-term fiscal strategy focussed on prospects for higher tax and loan receipts taking into account the requirements of the Second Malaysian Plan.

The Malaysian representatives recognized that the present tax structure, which was geared to the trend of earnings from Malaysia's traditional exports, had over time become increasingly insensitive to growth in domestic economic activity. It was therefore hoped to revamp it so as to make it more "growth-elastic" and appropriate technical assistance had been requested from the Fund. The authorities also expect a substantial rise in tax receipts with improvements in administration. A special investigation unit was being set up in the Treasury but there was pressing need for additional personnel for effective anti-evasion measures.

As regards the relative emphasis on taxation and borrowing, the Malaysian representatives indicated that a major guideline of policy was to aim at an excess of tax revenues over current expenditure so that a margin was available to finance development expenditure. While no specific proportions have been set, the authorities intend to undertake reasonable amounts of domestic and external borrowing. They have under consideration several proposals to stimulate domestic borrowing such as the issue of nonmarketable savings certificates, expansion of the coverage and rates of contribution to the Employees' Provident Fund (EPF), the largest holder of government securities, and an increase in investment ratios of financial institutions. The Malaysian representatives recognized that an increase in EPF rates of contribution (a one per cent increase is estimated to yield an additional M$30 million, net of tax loss) might conflict with the objective of keeping the cost of labor low as a means of stimulating more labor-intensive investment.

5. Monetary policy

There was a marked decline in the rate of growth of money supply from 13.3 per cent in 1969 to 7.7 per cent in 1970 (M$2,058 million as at end of December), which exceeded by only a slight margin the rate of economic growth of about 6 per cent during the year. In contrast to 1969 when the external sector provided the impetus to monetary expansion, the exceptionally large increase of 22 per cent in bank credit to the private sector (M$404 million) was the main source of expansion in 1970. Net bank claims on the public sector exerted a slight contractionary influence (-M$13 million). Commercial bank liquidity declined substantially due to the increase in credit to the private sector but despite this the liquidity ratio at the end of 1970 at 30.1 per cent was well above the minimum liquidity requirement of 20 per cent. Since the decline was to some extent an offset to the preceding year's excess liquidity and still leaves adequate margin for any desired credit expansion, the authorities did not regard it as cause for concern.

The Malaysian representatives pointed out that because of sustained monetary and price stability no major adjustments in monetary policy were required during 1970. The authorities were, however, actively reviewing ways and means of giving a developmental orientation to commercial bank lending policies and procedures so as to emphasize the viability of projects rather than the mere availability and quality of collateral. As part of this new emphasis, the authorities were encouraging commercial banks to increase term loans of three to five years to industry and facilitate extension of "character loans" to small scale enterprises. Term loans outstanding as at the end of 1970 amounted to M$158.5 million, an increase of 37.6 per cent at the end of 1969, and had risen further to M$197.9 million by the end of March 1971. The authorities favored a review of the traditional overdraft system which was not wholly suited for purposive lending and which often led to the creation of large unutilized credit positions thereby blocking credit to less favored customers.

To facilitate grant of term loans, a new category of medium-term commercial bank deposits had been introduced since January 2, 1971 and the response had been most encouraging. Their total outstandings at the end of March 1971 amounted to M$36.7 million, the bulk of which (M$25.4 million) were of 36 months maturity.

In view of these institutional developments and the possible risks of illiquidity of some of the term loans, the staff team inquired about the adequacy of refinancing facilities of the Central Bank, the evolution of an appropriate bank rate mechanism to define terms and conditions of access to central bank credit, and the possibility of establishing more specialized agencies to extend term credit taking into account the fact that commercial banks were not necessarily the most suitable institutions for this purpose, especially since the bulk of their deposits were of a short-term character.

The Malaysian representatives stated that the authorities were examining the scope for extension of rediscounting facilities not only for Treasury bills as at present but also for agricultural, commercial and industrial paper including refinance of term loans. They had, however, to proceed cautiously particularly as they had to overcome the strong prejudice of commercial banks against recourse to the "lender of last resort." But they hoped to develop gradually a bank rate mechanism geared to their specific requirements.

As regards specialized agencies for medium- and long-term industrial finance the Malaysian representatives referred to the role of the "Malaysian Industrial Development Finance Berhad (MIDFB)" and the regional development finance corporations in Borneo and Sarawak. They were also contemplating the establishment of commercial bank consortia to provide long-term finance.

There were no changes during 1970 in the structure or level of interest rates on commercial bank loans and deposits and the only measure affecting interest rates was a slight upward revision in the discount rates for Treasury bills other than the 12-month bills which remained unchanged at $5\frac{1}{2}$ per cent. With effect from April 6, 1970 the rates on Treasury bills with maturities of 91 days, 182 days and 273 days were raised from 4, $4\frac{1}{2}$ and 5 per cent to 5 1/8 and 5 3/8 per cent, respectively. According to the Malaysian representatives this upward adjustment was made to bring the rates more in line with prevailing rates abroad and thereby discourage any outflow of funds. Concurrently, it was also intended to check the decline in commercial bank holdings of Treasury bills which occurred late in 1969 and continued into the early part of 1970. However, with effect from March 31, 1971, rates on Treasury bills of 91 days, 182 days, 273 days and 364 days were reduced to 4 7/8, 5, 5 1/8 and 5 $\frac{1}{4}$ per cent per annum, respectively, following the decline in interest rates abroad. The authorities regard the development of the Treasury bill market more as a means of meeting the demand of the banking system for a liquid asset rather than as a source of seasonal finance for government since the ways and means position does not strictly warrant extensive recourse to this form of borrowing. The demand for Treasury bills has risen steadily with the rise in bank liquidity. Consequently the authorities are seeking to raise the statutory limit on Treasury bill issues from M$1,000 million to M$1,500 million. As regards the sales technique of Treasury bills, which at present are offered on "tap," the Malaysian representatives stated that although the introduction of Treasury bill auctions has been under examination for some time, the absence of organized groups of dealers had inhibited recourse to this device.

The Malaysian representatives were of the view that the present level and structure of interest rates of commercial banks in Malaysia were broadly appropriate. Although the money rates might appear to be low, the real rates in most cases were positive due to the stability of prices. Furthermore, there had been an impressive growth in financial assets at the prevailing rates of interest.

As regards the monetary outlook during the Second Malaysian Plan (1971-75) the Malaysian representatives indicated that the projected average annual rate of economic growth of 6.5 per cent was expected to be achieved without creating any monetary or price instability. A slightly higher annual increase of 7-8 per cent in money supply and of 12 per cent in private liquidity, had been projected as against the comparable figures of 6.5 per cent and 11 per cent, respectively, under the First Malaysian Plan.

6. External position and policies

Malaysia's balance of payments recorded only a modest surplus of M$124 million in 1970, in contrast to the unusually large surplus of M$530 million in 1969. This reflected a sharp increase of nearly 18 per cent in imports under the impetus of increased investment coupled with lower (15.1 per cent) export earnings from rubber which more than offset the higher receipts from exports of tin, palm oil and timber. The reduced surplus on merchandise account was accompanied by the traditional deficit on services and transfers.

The major factor accounting for reduced export earnings was the weakness of rubber prices over the greater part of 1970. Exports of iron ore recorded a very sharp fall in 1970 due to the closure of the two largest mines in Malaysia consequent on the exhaustion of the ore deposits. These mines accounted for about four-fifths of the total iron ore production in the country. Exports of manufactured and processed goods increased by nearly 20 per cent in 1970 to about M$540 million over the 1969 level of M$455 million.

All items of imports were substantially higher than in 1969 with the most substantial gains being recorded by imports of machinery, motor vehicles, iron and steel products, and chemicals.

The increase in the net deficit on services account in 1970 was primarily on account of larger freight and insurance payments arising from the combined effects of a higher level of imports and the rise in freight rates. The phased withdrawal of British military establishments in Malaysia was the other factor accounting for the deterioration in the services account.

As regards the large magnitude of "errors and omissions" in the balance of payments, the Malaysian representatives said that it was difficult to isolate the specific factors among several possible ones such as the under-recording of merchandise trade and nonrecording of invisible transactions within the sterling area. Some of it might represent outflow of capital but it would be difficult to quantify it or to relate it to differentials between foreign and domestic interest rates since such movements would also be influenced by confidence and security factors rather than yields alone.

Reviewing the balance of payments prospects for 1971 the Malaysian representatives said that they anticipated a rise in exports to M$5,215 million mainly through an increase in volume with a possible decline in average unit values of most of the major commodities. Imports are projected at a lower level due to increased import substitution, as for instance in the case of rice, decline in re-exports, reduced imports of capital goods, and a slower growth in investment relatively to the boom rate of the past year. They expected a decline of about M$80 million on net services as a result of the British military withdrawal; there would, however, still be some expenditure by Australian and New Zealand forces. They also forecast some increase in insurance and freight payments and persistence of large transfers abroad by immigrants. Official grants would depend on the success of the Malaysian Government in obtaining external aid for development and security purposes. Tourism was being actively promoted and fiscal incentives (pioneer status, etc.) were now being extended to hotel and tourist complexes. The statistics of tourists, which relied wholly on figures of arrivals, were not adequate and attempts were being made to refine them. On the whole, according to the Malaysian representatives, although the surplus on merchandise account in 1971 is expected to be about the same as in 1970 and the deficit on transfers reduced, the gain is expected to be more than offset by the substantially larger deficit on services account. As a result the surplus on current account would be smaller than that recorded in 1970.

The Malaysian authorities had not floated any foreign market loans in 1970 because interest rates having been generally high they had preferred to wait for rates to decline. They had been able to raise a US$50 million loan in 1971 in the U.S. market, at half of 1 per cent above the prime rate at the time of contract ($6\frac{1}{2}$ per cent), with a two-year grace period and repayable in three annual installments thereafter. The authorities were intending to raise more foreign loans in the near future, preferably of longer maturities. The basic rationale of external market borrowing, according to the Malaysian representatives, derived from a desire to establish Malaysia's external credit and market contacts. Also, as the ratio of external public debt service payments to export receipts in 1970 amounted to 3.3 per cent, external debt did not pose any problems of management. Malaysia's gross official reserves increased by US$25 million to US$945 million by the end of 1970, which represented about nine months of retained merchandise imports at the 1970 level. Total net reserves at the end of February 1971 were estimated at about US$894 million. The official expectation is that net external reserves in 1971, allowing for some increased inflow of private capital, would remain at about the same level as in 1970.

In the light of these trends the discussions on reserve policy focussed on the appropriateness of the level of reserves as well as their composition. The Malaysian representatives stated that although presently the external reserve position was strong it had to be viewed in the light of a variety of factors which together pointed to the maintenance of a high average level of reserves. Among these were the openness of the economy, past experience of wide fluctuations in export earnings, the maintenance of one hundred per cent cover for the currency and the need for an adequate contingency reserve to deal with speculative pressures and capital movements caused by non-economic factors, internal as well as external. Adverting to the experience of several developing countries, which initially had very substantial external reserves but which subsequently encountered serious foreign exchange crises, the Malaysian representatives added that they hoped to avoid such contingencies by maintaining a fairly high average level of reserves. They were also of the view that in evaluating the external reserves position it was pertinent to take into account the nature and composition of reserve changes as distinct from the mere size of reserves. Thus in the case of Malaysia a large part of the recent increase in reserves merely reflected foreign market borrowing. Moreover, given the statutory obligation to maintain a hundred per cent currency reserve, the balance which represented about five months retained imports could not be regarded as a very high level. The Malaysian representatives, however, agreed that given the need for accelerated development, use of reserves to meet part of the foreign exchange costs of productive projects was not objectionable provided it did not jeopardize over-all stability.

Under the Sterling Guarantee Agreement with the United Kingdom Government, effective September 25, 1968, the latter undertook to maintain the sterling value in terms of the U.S. dollar, of all official sterling reserves held by Malaysia in excess of 10 per cent of its total official reserves. Malaysia in return undertook to maintain at least 40 per cent of its total official external reserves in sterling, but during 1970 the proportion of sterling reserves to total official reserves ranged from 49.9 per cent to 52.1 per cent. The Agreement is due for renewal in September 1971 and the Malaysian authorities are currently reviewing with the United Kingdom authorities its possible extension for another two years. According to the Malaysian representatives, while the Agreement has so far worked satisfactorily, the high minimum proportion of sterling had hampered diversification of reserves, the need for which had become increasingly greater in view of the growing uncertainties about the future status of sterling balances in the event of Britain's entry into the Common Market. Moreover, according to them, the former predominance of sterling for invoicing and settlement of international transactions was gradually declining.

Malaysia maintains no restrictions on payments and transfers for current international transactions. This, coupled with the liberal administration of exchange and trade controls, has contributed materially to economic stability. There has been some increased resort to higher import duties on selected items, such as electrical consumer goods, petroleum and textile products, for protective reasons but tariff policy has been generally selective. The surtax on all imports, other than exempted categories, was raised from 2 to 4 per cent, effective December 22, 1970. There has been no intensification of quantitative restrictions on imports, which have generally been used to prevent excessive accumulation of inventories when additional tariff protection for a new domestic industry was being considered.

Malaysia has taken an active part in schemes of regional economic cooperation such as the Association of South East Asian Nations (ASEAN) and the Asian and Pacific Council (ASPAC). The Malaysian representatives thought that a clearing and payments arrangement on a subregional basis for small groups of countries in a comparable stage of development was a much more realistic prospect than any elaborate clearing arrangement or a regional reserve system for the ECAFE region as a whole. They indicated that an expert group was presently examining the feasibility of a clearing union for the ASEAN group (Indonesia, Malaysia, Philippines, Singapore and Thailand) while several permanent committees were actively reviewing proposals and projects relating to tourism, commerce and industry, transport and communications and finance. The Malaysian representatives particularly welcomed the recent decision to bring private sector activities within the ambit of ASEAN which would, among other things, facilitate bulk purchases of plant and equipment for the region as a whole, and thereby save foreign exchange.

III. Appraisal

The Malaysian economy maintained in 1970, as in past several years, a high rate of growth with relatively stable prices and a comfortable external reserves position, a conjuncture which amply testifies to the efficacy of the prudent and outward looking policies of the Malaysian authorities.

Therefore on the whole the economy has no immediate macro-economic problems of a serious nature other than the disconcerting growth of overt unemployment to about 9 per cent of the labor force, particularly among the lowest age groups and school leavers. This is rightly regarded by the Malaysian authorities as by far the most serious immediate problem facing the country, particularly in view of the much higher projected annual rate of growth of 3.2 per cent in the labor force over the period 1970-75. It exemplifies in a striking manner one of the basic dilemmas facing many developing countries, namely, that high rates of economic growth do not by themselves ensure rising levels of employment. This suggests a strategy of employment-generating growth and exploiting the scope for a labor-intensive technology in industry and agriculture through fiscal and other incentives. The choice of labor-intensive techniques, however, also needs to be assessed in the wider context of the optimum trade-off between economic efficiency and greater employment.

The Malaysian authorities recognize that the only enduring solution for unemployment in the long run is a much higher rate of economic growth, toward which the Second Malaysian Plan is expected to make an effective contribution. The staff, however, feels that this will be contingent on the development of a much more effective capability for implementation of public sector development coupled with an adequate response by the private sector to prevailing opportunities and incentives. These are essential prerequisites to higher levels of investment and growth which alone can furnish a viable basis for the achievement of the avowed objectives of the New Economic Policy including the narrowing of economic disparities between regions as well as social and racial groups.

The authorities are pursuing resolute and imaginative policies for diversifying the economy as well as maintaining the competitiveness of Malaysia's traditional exports of primary products. The growth of the manufacturing sector has been largely geared to the pace of import-substitution but its future viability will depend increasingly on its capacity to enter export markets. The long-term rationale of import-substitution in respect of rice also merits careful consideration in view of the fact that while the technical feasibility of self-sufficiency in rice in the near future is no longer in doubt, Malaysia is likely to be a high-cost producer of rice. The impressive rise in exports of manufactured goods in 1970 is a particularly gratifying development. The comparative stability of wage rates and prices in Malaysia would strengthen the capacity of nontraditional exports to compete in international markets. The problems faced by Malaysia as a leading exporter of rubber, tin, palm oil and tropical timber underscore the continuing need for constructive and meaningful international cooperation between producing and consuming countries as regards matters like stock disposal policies, reasonable stability of prices and access to markets.

The over-all fiscal position in recent years has not been a matter of concern but in view of the greater demands on the public sector in the Second Malaysian Plan, all avenues for raising additional resources for the public sector through taxation and nonbank borrowing will need to be continually explored. The proposal to issue nonmarketable savings certificates is therefore a welcome development which should be viewed as an integral part of a broad based savings program relying on a variety of savings media as well as on realistic interest rates and other incentives.

Monetary management has been well-oriented with a growing emphasis on promotional and developmental features on the lending and borrowing sides, notably the encouragement to term finance and "character" loans which represent a means of "monetizing" personal credit of customers who lack adequate conventional bank collateral. The new facility of medium-term fixed deposits offered by banks will help widen the range of savings media and help facilitate extension of term finance by commercial banks. The authorities hope to develop gradually an appropriate refinance and bank rate mechanism suited to local requirements.

The balance of payments position continues to be strong with no immediate problems likely to be caused by Malaysia's domestic policies. However, export earnings are vulnerable to significant fluctuations and policy decisions in the economies of the major industrial countries. The staff recognizes the validity of the various factors cited by the Malaysian authorities to justify maintenance of a relatively high average level of external reserves, notably the openness of the economy, fluctuations in export prices, and the need for a contingency reserve to deal with speculative pressures. At the same time the staff believes that a judicious reliance on external reserves to meet part of the foreign exchange costs of accelerated development would constitute a legitimate use of reserves, particularly if it does not jeopardize over-all stability.

Fund Relations with Malaysia

The former Federation of Malaya joined the Fund on March 7, 1958. Its name was changed to Malaysia on September 16, 1963 with the merger of Sabah, Sarawak, and Singapore. Subsequently, on August 9, 1965, Singapore seceded from Malaysia.

The initial quota of US$25 million was subsequently raised to US$186 million, the most recent increase, effective December 18, 1970, being in accordance with the proposals under the Fifth General Review. Of the present quota, a total of $41.1 million has been paid in gold.

The initial par value of the Malaysian dollar was established with the Fund at 0.290299 gram of fine gold per Malaysian dollar or M$3.06122 = US$1, effective July 20, 1962. There has been no change in the par value established with the Fund.

Malaysia has made no use of the Fund's resources, but $5 million Malaysian dollars have been purchased from the Fund by another member. The present Fund holdings of Malaysia dollars are equivalent to 75 per cent of quota.

Malaysia is a participant in the Special Drawing Account of the Fund, and received allocations of SDR 21.0 million on January 1, 1970 and SDR 19.9 million on January 1, 1970 and 1971, respectively. Malaysia has been designated to receive special drawing rights and has received SDR 2.3 million through this process. As of March 31, 1971 Malaysia's net SDR holdings totaled 43.3 million, which was equivalent to 106 per cent of its net cumulative allocations.

Malaysia accepted the obligations of Article VIII, Sections 2,3, and 4 of the Fund Agreement as from November 11, 1968. The previous (1970) Article VIII consultation discussions were held in Kuala Lumpur, June 15-24, 1970 (SM/70/169, 8/7/70 and SM/70/170, 8/10/70) and the Board discussion was held on September 9, 1970 (EBM/70/86).

During the past six years the Fund has provided technical assistance to Malaysia through its Central Banking Service, Fiscal Affairs Department, and Bureau of Statistics. Two experts from the central banking panel are currently serving with the Central Bank of Malaysia; Mr. Klein (Germany) as Deputy Chief Economist (November 1969-November 1971) and Mr. J.F. Smith (United States) as Assistant to Governor for Bank Supervision (March 1968-June 1971). Mr. San Lin of the Central Banking Service visited Kuala Lumpur in July 1970 to assist in review of the Central Bank's regulating authority. The technical assistance activities of the Fiscal Affairs Department in Malaysia commenced with the assignment of a staff member (Mr. P.D. Ojha) for a year from May 1965 to assist with the preparation of a revenue program and the establishment of an economic analysis staff. Two staff members (Messrs. R.S. Latham and C.Y. Mansfield) visited both

East and West Malaysia during January-February 1969 to review the present and potential sources of federal and state revenues and a follow-up of their report was provided when two staff members (Messrs. L. Muten and C.Y. Mansfield) visited Malaysia in February-March 1970. An expert from the fiscal panel, Mr. F. Bishop (United Kingdom) has been assigned as Advisor of Customs and Excise to the Minister of Finance (June 1969-July 1971). Mr. Schultz of the Bureau of Statistics visited Kuala Lumpur in May 1970 to assist in the improvement of the coverage of the Central Bank Bulletin.