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September 30, 1974

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report on the 1974 Article VIII Consultation

Attached for consideration by the Executive Directors is the staff report for the 1974 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 1974 Article VIII Consultation

Prepared by the Staff Representatives for the 1974 Consultation with Malaysia

Approved by Tun Thin

September 24, 1974

The 1974 Article VIII consultation discussions with Malaysia were held in Kuala Lumpur during August 5-16, 1974. The Malaysian representatives were led by Tan Sri Ismail bin Mohamed Ali, Governor, Bank Negara Malaysia, and Datuk Wong Yoke Meng, Deputy Secretary General to the Treasury, and included officials of Bank Negara Malaysia, and the Ministries of Finance, Trade and Industry, Labor, the Department of Statistics, the Economic Planning Unit, and other government agencies. The staff representatives were Messrs. Andreas Abadjis (ASD), E. Sakakibara (ETR), L. De Wulf (FAD), and J. Tillman (ASD).

I. Background to the Discussions

The quickening of the pace of economic activity in Malaysia that became evident in the second half of 1972, turned into a strong expansion in 1973 which continued during the first half of 1974. However, this expansion was accompanied by rapidly increasing prices, a development that represented a sharp departure from a long period of stability and became the major area of concern for the Malaysian authorities. The impetus to the expansion came from the strongly rising external and domestic demand which was supported by a large credit increase. Exports rose by 59 per cent in 1973, mainly because of higher prices; higher prices also contributed to the 30 per cent increase in imports. Gross official international reserves increased by SDR 199 million in 1973, and by SDR 135 million during the first five months of 1974. Malaysia became a marginal net exporter of crude oil and oil products in 1973. The consultation discussions focussed on policy measures for curbing inflationary pressures, while maintaining the momentum of economic growth.

II. Report on Discussions

1. Economic growth, development and employment

Following a year of moderate growth, gross national product at constant prices increased by 10 per cent during 1973 in response to substantially higher exports and the expansion of domestic demand. The latter stemmed mainly from the private sector, whereas in the two preceding years it had come mainly from the public sector. In 1973, private sector fixed investment increased by about 5 per cent in real terms, in contrast to a decline of about 7 per cent over the previous two years; private consumption expenditures were 7 per cent higher, compared with increases of 2 per cent in 1972, and 4 per cent in 1971. The Malaysian representatives stated that gross national product in real terms is estimated to increase by about 7 per cent in 1974. Private investment is expected to remain strong, and exports are expected to show a substantial increase, although the rate of growth would be considerably lower lower than in 1973.

The Mid-Term Review of the Second Malaysia Plan, 1971-75 was published in November 1973. During the period 1971-73, real output grew at an average annual rate of 6.9 per cent, as compared with the Plan target of 6.8 per cent. The average annual rate of growth of production in the agricultural sector (7.5 per cent) was lower than the Plan target, largely because of the decline in commodity prices during 1971-72. However, value added in the manufacturing sector grew by an average of 15.4 per cent per year in real terms, exceeding the Plan target of 12.5 per cent.

The Malaysian representatives stated that preparatory work was under way for the Third Malaysia Plan 1976-80. The Plan will focus on programs to reduce both rural and urban poverty and to move people to areas which provide better employment opportunities. In agriculture, the Plan would aim at developing at least one million acres of new land. In urban areas emphasis will be placed on providing housing, health, and other facilities. The Plan will include measures to increase the effectiveness of the family planning program which in the past was given a low priority relative to other government programs.

Unemployment is estimated to have declined from 7.5 per cent in 1970 to 7.3 per cent in 1973, and indications are that the downtrend has continued in 1974. The prospects for employment growth in the remainder of the plan period are considered promising; the target for the annual rate of job creation during the period 1971-75 has been revised upward to 3.4 per cent from the original Plan target of 3.2 per cent. During the remaining two years of the Plan, agriculture will account for 28.2 per cent of new employment and manufacturing for 24.2 per cent. The land development program continues to be the most important means for expanding agricultural employment. In manufacturing, emphasis is placed on the establishment and expansion of labor intensive industries such as textiles, electronics, wood, and rubber products, as well as the dispersal of industry to less developed areas. The authorities believe that underemployment has declined in recent years as a result of the employment opportunities created by the Second Malaysia Plan and the creation of new industries in the private sector.

2. Production

In response to strong overseas demand, production of major agricultural commodities increased by 15 per cent in 1973, compared with an increase of 7 per cent in 1972. Output of rubber increased by 18 per cent, in contrast to an annual average increase of 2 per cent in 1970-72. The bulk of the increase came from smallholdings whose output increased by 36 per cent; output from the estates, which is much less price responsive in the short run, rose by only 3 per cent. During the 13-month period to January 1974, rubber prices (monthly average) increased by 135 per cent; however, during the subsequent seven months they declined by more than one-third. In an effort to stabilize prices, the Government advised in July rubber estates and exporters to increase their stocks by 10 per cent, and in the latter part of August the Government purchased directly rubber in the market. The Malaysian representatives indicated that producers were able to make satisfactory profits at the current price of about M$1.60 per kilo, and that at that price natural rubber was competitive with synthetic rubber in view of the recent large increase in the costs of synthetic rubber.

During 1968-72, output of palm oil had increased at an average annual rate of 27 per cent, but in 1973 it increased by only 11 per cent owing to a drought that reduced output in the latter part of 1973. However, output is expected to increase by 16 per cent in 1974 and by 31 per cent in 1975. Malaysia is the world's largest producer and exporter of palm oil. The authorities continue to pursue vigorously their program of increasing the area under oil palm by clearing and developing new land. Facilities for processing crude palm oil into refined oil and hydrogenated products are being expanded.

Production of timber, which had expanded substantially in 1972, continued to increase at a rapid rate in 1973; the rise in timber prices made timber the second largest export earner, accounting for 21 per cent of exports. Output of timber in 1974 may be close to the 1973 level, but in 1975 it is expected to increase considerably. To ensure the long-term development of the forestry industry, the National Forestry Council has decided to establish permanent forest reserves in which harvesting will be based on the principle of sustained yield management. The Government encourages the growth of integrated timber based industries as part of its policy of promoting industries using local raw materials.

Production of rice increased by 8 per cent in 1973 and is expected to rise by 10 per cent in 1974. The acreage planted has been expanded and yields have risen owing to the wider use of fertilizers and improved seeds. In view of the recent worldwide food shortages, the Government has raised the self-sufficiency target for rice from 90 per cent to 100 per cent; this target is expected to be met for West Malaysia by 1976, and for Malaysia as a whole by 1980. It is planned to increase the area under double cropping and to develop new areas for rice cultivation. In 1973, rice output met 82 per cent of domestic consumption. Since November 1973, the Rice Authority has raised in several steps its buying price of paddy from farmers from M$16 per picul 1/ to a range of M$29 to M$31 per picul in August 1974.

Malaysia became self-sufficient in oil in 1972 and is at present producing about 95,000 barrels per day of low sulphur crude. In 1975 production is expected to rise to about 135,000 barrels per day, and by 1979 it may reach 500,000 barrels per day. A national petroleum company (Petronas) is being

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1/ 1 picul = 133.33 lbs.

established, in which the ownership of petroleum reserves in Malaysia will be vested. The existing exploration and exploitation agreements will be turned into production sharing arrangements. Natural gas reserves have been found offshore in West Malaysia and Sarawak. There are plans to construct a pipeline to distribute natural gas throughout West Malaysia, and construction of a large LNG plan in Sarawak is expected to commence in 1975.

Production of tin-in-concentrates is expected to decline by 3 per cent in 1974. However, in 1975 production may increase by 2 per cent because it is expected that two new dredges will commence operation and, because of the higher prices, certain marginal gravel pump mines will go into production.

Manufacturing output in West Malaysia increased by 20 per cent in 1973, compared with a rise of 12 per cent in 1972. Production increases were recorded in practically all industries. During 1974 manufacturing output is expected to rise by 15 per cent. The Malaysian representatives stated that industrial development policy accorded priority to the following types of industries: (a) export-oriented; (b) labor-intensive; (c) industries based on local resources; and (d) industries that upgrade local skills and introduce new technology.

3. Prices and wages

During 1973, the consumer price index increased by 18 per cent, compared with a rise of 4 per cent in 1972. Over the first six months of 1974, the index increased by 7 per cent, and in June 1974 it was 18 per cent higher than a year earlier. During the 12-month period to June 1974, the food component, which carries a weight of 47 per cent, recorded the largest increase of 29 per cent. The substantial rise in prices was attributable to external factors, and also to the strong growth of domestic demand which was supported by the large credit expansion.

The Malaysian representatives stated that inflation had become a major economic problem, and the authorities were concerned about the impact of a prolonged rise on the public's price expectations. Measures to moderate price increases were introduced during 1973 and in early 1974. These included steps to tighten bank liquidity and increase interest rates, encourage imports by removing quotas and reducing tariffs, a campaign to curb profiteering and hoarding of essential commodities, imposition of a land speculation tax, controls on exports of certain commodities, and measures to increase domestic production of goods in short supply. In April 1974, a package of fiscal and credit measures was introduced which included more progressive taxes on exports and a ceiling on total credit. The staff team remarked that both the credit ceiling and the export taxes were appropriate measures, but since the export boom had commenced toward the end of 1972, and credit and monetary expansion had accelerated since the second half of 1972, the effectiveness of these measures would have been enhanced had they been taken earlier.

The Malaysian representatives pointed out that there were signs that demand pressures were moderating, and the increase in prices had decelerated in recent months; the consumer price index increased by 18 per cent in the

12-month period to June 1974, whereas in the 12-month period to March 1974 it had increased by 24 per cent. However, the sharp increase (20 per cent) in import prices during the first four months of this year was a matter of concern. If the increase in import prices slowed down, the Malaysian authorities expected that the consumer price index would show a smaller rise during the second half, so that during the full year 1974 the consumer price index would show an increase of about 11 per cent. Although the Government subsidizes only one commodity, rice, 1/ a number of essential commodities are subject to price control; the staff team felt that pressures for substantial price increases for some of these commodities might develop in the near future. The progress made in liberalizing imports was commendable, and the staff team hoped that the study in progress on the effective rate of protection of domestic industries would guide the authorities as to what further liberalization measures should be taken.

Malaysia does not compile an index on wages, but available information indicates that wage increases during the past year have not been an an autonomous inflationary factor; they have, generally, compensated for the price inflation that had already taken place. The Malaysian representatives said that in October 1973, the Government had introduced special allowances for lower paid workers and these served as a guideline for similar increases in the private industry. In Malaysia, only about 10 per cent of the workers are organized, but wage increases in the unorganized sector usually follow those of the organized sector. However, the loss of man-days because of strikes has increased this year, and pressure for larger wage awards may build up in the near future.

4. Fiscal policies

The Malaysian representatives indicated that during the past few years the federal budget had been used both as a means of implementing the Second Malaysia Plan and as an anticyclical instrument. They pointed out that in 1972, a year of slackening of domestic economic activity, the overall federal budget deficit increased by 29 per cent, reaching 30 per cent of total expenditures, while in 1973, when demand pressures in the economy had started to build up, the federal deficit had been reduced by 17 per cent to 23 per cent of total expenditures. The staff representatives noted that the original 1974 budget, which had been prepared at a time of accelerating inflationary pressures, provided for a deficit of M$1.4 billion,2/ or about M$300 million more than in 1973; they inquired whether this reflected a change in the Government's policy regarding the role of the budget in demand management. The Malaysian representatives stated that the 1974 budget had been drawn up during a period of great uncertainty with regard to the prospective state of the economy and that, owing to higher prices and the need to meet the targets set by the Development Plan, certain increases in total expenditure were unavoidable. Moreover, when the budget was formulated the demand pressures emanating from the domestic economy were not clearly recognized, and the prevailing view was

1/ Imported rice is sold at a subsidized price by a government agency.
2/ On September 18, 1974, the exchange rate was M$2.8698 = SDR 1, and M$2.4148 = US$1.

that imported inflation was the principal contributing factor to the price increases. They indicated that the Government had not changed its stance regarding the use of the budget as an instrument of anticyclical policy, and referred to the measures taken in April 1974, which increased the progressivity of export taxes and curtailed less urgent expenditures. It was estimated that these measures would reduce the federal budget deficit for 1974 by about M$170 million.

Discussing the estimated expansion of development expenditures in 1974 (52 per cent), the Malaysian representatives remarked that their growth in 1973 (10 per cent) had been limited by the inability of contractors to complete their work on schedule owing to supply shortages and increased prices, and by administrative shortcomings. They stated that, although measures had been taken, these problems had not been completely overcome, and there would probably be delays in the implementation of certain projects in 1974.

Turning to the 1975 budget, the Malaysian representatives stated that its preparation was still at a preliminary stage. Current expenditures were expected to be set at a level about 15 per cent higher than those in 1974, but price increases might require an upward revision of this target. The development budget estimates would take account of the requirements of the Second Malaysia Plan and would allow for continuing inflation. The staff team stated that since strong demand pressures were likely to prevail during the period ahead, a policy of restraint should be observed in preparing the 1975 budget. For this purpose tax revenues should be substantially increased, especially in view of the growing requirements for current and development expenditures. The staff team remarked favorably on the Government's intention to introduce procedures for collecting income taxes on a current basis and stated that this would not only enhance the anticyclical impact of the budget, but would also increase tax revenue during the first year of its introduction. The staff team also discussed ways of improving the assessment and collection of taxes on partnership income. However, in view of the uncertainties surrounding the world economic outlook and the volatility of the prices of Malaysian primary exports, the staff team stressed the need for flexibility in fiscal policy during 1975. For this purpose, it would be useful to formulate in advance alternative expenditure programs which could be implemented promptly if it became necessary to stimulate economic activity.

The Malaysian representatives indicated that import duties and quotas on some goods produced locally had been reduced or eliminated during the past year. However, they recognized the need for a systematic cost-benefit appraisal of the whole range of policy instruments--investment incentives, export incentives, import duty exemptions for raw materials, and tariff protection and quotas--that are intended to encourage industrial investment. They stated that such an appraisal, focussing on the level of effective protection granted, resource allocation and revenue foregone, is presently under way, and that the authorities were waiting for the results of this study before taking action.

Turning to the financing of the federal government's deficit, the staff representatives noted the increased reliance on financing by captive institutions, particularly the Employees Provident Fund (EPF). The Malaysian representatives stated that they were aware of this dependency, and that in light of the relatively low interest rates available to holders of government securities this practice depressed the return available to the EPF contributors. The staff representatives suggested that the Malaysian authorities should investigate the possibility of widening the market for government securities and stressed the importance of making them attractive in terms of maturity structure, and interest rates. It would also be desirable if public corporations, that depend largely on the budget for their capital requirements, would issue debentures that could be sold to the EPF and the market.

5. Monetary developments and policies

The 10-year period to 1971 was characterized by relative price stability and moderate growth in the money supply: consumer prices had increased, on the average, by 1 per cent, and money supply by 4 per cent. However, in the second half of 1972 a new trend became discernible as monetary expansion and price increases began to accelerate; this uptrend gained momentum in 1973.

During 1973, money supply increased by 38 per cent, and total liquidity (money plus quasi-money) by 31 per cent. Bank credit to the private sector was the main expansionary factor; it rose by M$1,571 million (52 per cent) reflecting the upsurge in economic activity. At the same time net foreign assets of the banking system increased by M$317 million. Net lending to the public sector increased by only M$129 million, compared with M$287 million in 1972. It should be noted that following the credit measures announced on December 17, 1973, there were abnormally large drawings on unutilized overdrafts during the last week of December which artificially inflated the expansion of credit and liquidity during that year.

The Malaysian representatives referred to the measures taken since mid-1973 to restrain monetary expansion, which included: (a) an increase in the minimum liquidity ratio of commercial banks from 20.0 per cent to 25.0 per cent; (b) an increase in the statutory reserves of commercial banks from 8.5 per cent to 10.0 per cent of total deposits; (c) an increase in the statutory reserves of borrowing companies (consumer finance companies) from 2.5 per cent to 7.0 per cent of total deposits; and (d) increases in the banks' prime lending rate from 8.0 per cent to 10.0 per, cent and in the 3-month to 12-month rates on fixed deposits to a range of 6.5 per cent to 9.0 per cent. Moreover, in April 1974, the authorities directed commercial banks to limit credit expansion during the full year 1974 to 20 per cent of the December 1973 level. In July, certain loans, including small loans under the Credit Guarantee Scheme and loans of government institutions approved by the Central Bank, were exempted from the ceiling; these exemptions could add about 5 percentage points to the targeted credit expansion. The Malaysian representatives stated that the above measures had contributed to the deceleration of monetary expansion during the first half of 1974. During the full year, money was expected to increase by 15-20 per cent and total liquidity by 20-25 per cent. They felt that credit and monetary expansion had been brought under control, but the authorities were concerned about the continued rise in import prices.

The Malaysian representatives said that the credit ceiling introduced in April 1974 had operated effectively, although the overdraft system had created some difficulties because unutilized overdraft facilities had been relatively large; the Central Bank continued to favor shifting to terms loans, and over the past year the portion of term loans to total loans had reached 17 per cent. The Central Bank was studying the possibility of engaging in open market operations, probably by issuing its own securities for this purpose. The staff team said that such a step would strengthen the Bank's ability to control credit and make possible a more flexible intervention in the expanding money market. In this context, they pointed out the desirability of narrowing the wide fluctuations in interbank rates that had occurred in recent months.

The Malaysian representatives stated that interest rates on savings and time deposits had been increased during the past year in order to encourage savings. The Central Bank favored a gradual shift to market-determined interest rates; in 1973, the ceilings on interest rates paid by commercial banks on fixed deposits with a maturity of two years or more, as well as all ceilings on interest rates paid by borrowing companies on fixed deposits, were lifted. Also, the tap system of issuing Treasury bills was replaced by weekly tenders. Although both deposit and lending rates in Malaysia have increased during the past 18 months, they remain lower than in many other countries.

The Malaysian representatives referred to the division of the stock exchange of Malaysia and Singapore and the establishment of a separate Malaysian stock exchange in May 1973. This step was taken in order to develop a strong national capital market which could serve the country's development objectives and provide long-term investment funds. In April 1974, two new merchant banks were incorporated, bringing the total number to seven. These banks provide corporate financing, management services, financial investment advice, and act as underwriters. The Malaysian representatives added that the Kuala Lumpur foreign exchange market, both for spot and forward transactions, had developed quite satisfactorily since May 1973, when the arrangement for the free interchangeability of the Malaysian and Singapore currencies at par was terminated.

6. External position and policies

In 1973, Malaysia's balance of payments was characterized by a substantial increase in the trade surplus which more than offset the larger net payments on services and transfers; consequently, the current account showed a surplus of SDR 117 million in contrast to a deficit of SDR 257 million in 1972 (Table 1). Exports increased by 59 per cent in 1973 because of substantially higher prices for the major export commodities and an expansion in the export volume. Imports rose by 30 per cent owing to higher prices and strong domestic demand. Despite the smaller net inflow of capital and the large negative entry in "errors and omissions," the balance of payments recorded an overall surplus (as measured by monetary movements) of SDR 98 million--the sixth consecutive balance of payments surplus. In 1973, Malaysia was a net exporter of crude oil and products in the amount of SDR 4.3 million.

Table 1. Malaysia: Summary of Balance of Payments, 1970-74

(In millions of SDRs)

	1970	1971	1972	1973	1974 Projection
Exports	1,668	1,618	1,567	2,493	3,210
Imports	1,352	1,386	1,474	1,917	2,805
Trade balance	316	232	93	576	405
Net services and transfers	-347	-337	-350	-459	-560
Current account	-31	-105	-257	117	-155
Net nonmonetary capital	97	212	247	146	86
Errors and omissions	-47	-67	40	-165	34
Allocations of SDRs	21	20	20	--	--
Total	40	60	50	98	-34
Monetary movements (increase -)	-40	-60	-50	-98	34

Source: Central Bank of Malaysia.

Regarding balance of payments developments during 1974, the Malaysian representatives indicated that they expected a deceleration in the rate of growth of exports, because of the slowdown in economic activity in the major industrial countries. The export price of rubber had declined substantially from its peak in January, and in early August 1974 it was lower than a year earlier; during the remaining months of 1974, prices of logs, sawn timber, and palm oil were expected to decline considerably. Thus for 1974 as a whole, exports were estimated at SDR 3,210 million, or about 29 per cent higher than in 1973. The Malaysian representatives said that in the present uncertain world situation it was difficult to make good export projections; they agreed with the staff team that, in view of the sharp increase in exports during the first half of 1974, the export estimates for the full year might prove to be on the low side. Imports were expected to increase by 46 per cent, compared with an increase of 30 per cent in 1973, mainly because of the acceleration of price inflation in Malaysia's supplier countries. Net payments on services and transfers would also rise, principally because of higher freight rates. The net inflow of non-monetary capital may be lower, but, partly as a result of the inflow of export proceeds whose repatriation had lagged in 1973, the item "errors and omissions" would have a positive sign. Hence, it is expected that the balance of payments would show an overall deficit of SDR 34 million in 1974.

Regarding problems facing Malaysia's exports, the Malaysian representatives stated that the expansion of exports of textiles and canned pineapple and juice was limited by import restrictions imposed by developed countries. According to the Multifiber Textile Arrangement, which came into force in January of this year, participating countries would increase their imports of textiles, generally, by 6 per cent. However, for Malaysia whose textile industry is expanding at a rate above 20 per cent, the 6 per cent ceiling is too low. Exports of canned pineapple and juice to Japan face quota restrictions.

In 1973, gross official international reserves increased by SDR 199 million to SDR 1,157 million; this was equivalent to 60 per cent (about seven months) of imports at the 1973 level. At the end of 1972, reserves were equal to 65 per cent of imports in that year. During the first five months of 1974, gross official international reserves increased further by SDR 135 million to SDR 1,292 million.

Since June 1973, when Malaysia announced that it had suspended the lower intervention point for the U.S. dollar (M$2.4805 per US$1), the Malaysian dollar has appreciated by 3.5 per cent vis-a-vis the U.S. dollar, while the trade-weighted effective exchange rate has also appreciated by 8.2 per cent; since May 1971, Malaysia's effective exchange rate has appreciated by 16.8 per cent. The Malaysian representatives said that during the first half of 1974, when official international reserves had recorded an increase, Central Bank intervention policy aimed at moderating day-to-day fluctuations in the exchange rate vis-a-vis the U.S. dollar. At the same time sharp deviations from the effective exchange rate were also not allowed; actually, over that period the effective exchange rate had appreciated by 1.3 per cent. The Malaysian representatives added that the large accumulation of exchange reserves in 1973 and the first half of 1974 was due to unusually high export prices, and that the level of reserves was not excessive. During the second half of 1974, when international reserves were expected to decline, the authorities intended to continue to maintain the effective exchange rate relatively stable, since they did not consider the existing rate inappropriate. The Malaysian representatives explained, that the Central Bank intervened to moderate movements in the effective exchange rate from month-to-month and quarter-to-quarter if it believed that temporary factors were present.

With regard to a medium-term norm for the exchange rate, the Malaysian representatives stated that the sharp fluctuations in the prices of their principal export commodities, viz., palm oil, rubber, tin, and timber, made almost impossible reasonably accurate balance of payments projections for two or three years and, therefore, the authorities were not in a position to establish a medium-term norm or target zone for their effective exchange rate. The present near-term uncertainties in the world monetary and economic situation compounded this problem. Forecasting capital movements also presented great difficulties. In view of the foregoing the Malaysian authorities did not have a broad objective for the development of their international reserves over the medium term.

Considerable progress has recently been made in liberalizing imports: on August 16, 1973, 61 import items, including textiles, electrical goods, and domestic utensils, were removed from the list of goods subject to quotas. In addition, during the past year, import duties on a large number of items, including paints, certain steel products, automobile parts, fertilizers, and foodstuffs, were reduced or eliminated in order to moderate domestic price increases.

III. Staff Appraisal

The Malaysian economy recorded substantial growth during 1973 and the first half of 1974 under the impetus of strong external and domestic demand. However, this expansion was accompanied by rapidly increasing prices, which was in contrast to the price stability that Malaysia had enjoyed in previous years and became the principal area of concern for the Malaysian authorities.

Although rising import prices contributed to the price inflation during 1973, the sharp increase in bank credit was also an important factor. The policy response to the problem of inflation was gradual during 1973 and the beginning of 1974; in the monetary field, it consisted mainly of moderate increases in required reserves and in bank interest rates. However, in April 1974 stronger measures were announced, which consisted principally of a ceiling on total credit expansion over the full year 1974. The ceiling has operated effectively, and the staff believes that its introduction was a step in the right direction, especially in view of the difficulties in controlling the expansion of bank liquidity emanating from the external sector. The monetary authorities are studying a further strengthening of their ability to control credit by engaging in open market operations. Since the financial sector of Malaysia has expanded by the establishment of merchant banks and discount houses, the staff believes that the addition of open market operations to the present array of credit control instruments would be timely and would impart greater flexibility to the Central Bank's control of banking operations.

The Malaysian authorities have taken measures to develop the country's capital market in order to increase the availability of long-term investment funds. The staff suggested that in order to broaden the market, consideration should be given to making government securities more attractive in terms of interest rates and maturity structure, and to require public corporations that depend largely on the budget for their capital requirements to issue debentures that could be sold to the market and also to the

Employees Provident Fund. A diversification of the latter's portfolio, 90-95 per cent of which consists of government securities, would not only provide support and flexibility to the capital market, but would also increase the return to the Fund's contributors.

In addition to the monetary measures, the authorities also introduced fiscal measures in April 1974 in order to reduce the budget deficit. Since export incomes increased further in the first half of this year and investment activity continues to be buoyant, demand pressures are likely to remain strong in the period ahead, and in the staff's opinion a policy of restraint should be observed in preparing the 1975 budget. For this purpose tax revenues should be substantially increased, especially in view of the growing requirements for current and development expenditures. The Government's intention to introduce procedures for collecting income taxes on a current basis will enhance the anticyclical impact of the budget and will also increase tax revenues in the first year of its introduction. Methods for improving the assessment and collection of taxes on partnership income were suggested by the staff. However, in view of the uncertainties surrounding the world economic outlook and the recent decline in the prices of Malaysian primary exports, there is need for flexibility in fiscal policy during 1975. For this purpose it would be useful to formulate in advance expenditure programs which could be implemented promptly if it became necessary to stimulate economic activity.

The measures taken to liberalize imports and reduce tariffs are commendable. The staff welcomes the decision of the authorities to undertake a systematic appraisal of the full range of incentives granted to promote industrial investment, with a view to reducing benefits that may be excessive in relation to the Government's investment objectives.

Owing principally to the sharp increases in export prices, Malaysia's balance of payments recorded an overall surplus in 1973, and international reserves continued to increase during the first half of this year. However, the prices of certain major export commodities have started declining, and the authorities expect that the downtrend will continue during the remainder of this year. At the same time, in view of the worldwide inflationary trend, import prices are expected to continue to rise, and for the second half of 1974 the balance of payments is expected to show an overall deficit. During the first half of 1974, the Central Bank's intervention policy aimed at moderating day-to-day fluctuations in the exchange rate vis-a-vis the U.S. dollar--the intervention currency. At the same time, sharp deviations in the effective exchange rate were not allowed. Actually, the effective exchange rate appreciated by 1.3 per cent over that period. The Malaysian authorities stated that during the second half of 1974 when international reserves were expected to decline, the authorities intended to continue to maintain the effective exchange rate relatively stable, since they did not consider the existing rate inappropriate. The staff believes that Malaysia's intervention policy takes account in a satisfactory way of recent developments and near-term prospects.

Fund Relations with Malaysia

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

Malaysia's quota is SDR 186 million. On August 10, 1971, Malaysia purchased SDR 7.29 million under the Fund's buffer stock scheme to pay its contributions under the Fourth International Tin Agreement. In October and November 1973, Malaysia repurchased SDR 7.29 million. Currently, the Fund's holdings of Malaysian dollars amount to 75 per cent of quota.

The initial par value of the Malayan dollar (Malaysian dollar since June 12, 1967) was established at 0.290299 gram of fine gold per Malayan dollar and M$3.06122 to the U.S. dollar, effective July 20, 1962, and since that date it has remained unchanged. On May 2, 1972, Malaysia notified the Fund that Malaysia wished to avail itself of wider margins under paragraph 1 of the Executive Board Decision No. 3463-(71/126) of December 18, 1971, and to the use of the pound sterling as the intervention currency with the parity rate for the pound sterling in terms of Malaysian dollars at pound stg. 1 = M$7.3469. Following the floating of the pound sterling, Malaysia informed the Fund on June 28, 1972, of its decision to use the U.S. dollar as the intervention currency with the parity rate at M$2.5373 = US$1. On June 21, 1973 the Malaysian authorities notified the Fund that as from that date they would not intervene in their markets to buy U.S. dollars at the lower margin of M$2.4805 per U.S. dollar and that the Malaysian dollar would be allowed to float upwards.

Malaysia is a participant in the Special Drawing Account and has received three allocations totaling SDR 60.6 million. Malaysia was designated in the first quarter of 1970 to receive SDR 2.3 million. It has been included in all subsequent designation plans but has not been designated. SDR 2.3 million net was used in repurchases from the General Account, and as of August 31, 1974 Malaysia's net holdings totaled SDR 60.6 million, or 100 per cent of the net cumulative allocation.

Malaysia accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement as from November 11, 1968. The 1973 Article VIII consultation discussions were held in Kuala Lumpur, May 21-June 1, 1973 (SM/73/180, 7/24/73, and SM/73/204, 8/20/73), and the Board discussion was held on August 31, 1973 (EBM/73/89).

The Fund has provided technical assistance to Malaysia through its Asian Department, Bureau of Statistics, Central Banking Service, and Fiscal Affairs Department.

MALAYSIA

Basic Data

Area:	128,308 square miles
Population (1973):	11.7 million
Rate of growth of population (1973):	2.2 per cent
Gross national product (1973):	SDR 5,606.6 million
Per capita gross national product (1973):	SDR 474.7

Selected Aggregates as Per Cent of GNP

	1970	1971	1972	197[illegible]
Manufacturing production	11.7	12.0	12.8	1[illegible]
Gross capital formation	17.7	18.8	20.5	[illegible]
Gross national savings	19.2	16.5	15.8	[illegible]
Money	17.5	17.2	20.6	[illegible]
Total liquidity	35.6	38.1	43.8	46.
Federal Government tax revenues	17.2	17.0	18.2	18.
Exports of goods and services	48.7	45.6	40.7	4[illegible]
Imports of goods and services	45.6	46.0	44.9	46.

Annual Percentage Changes in Selected Economic Indicators

	1970	1971	1972	197[illegible]
Gross national product (constant prices)	...	7.3	5.2	10.
Agricultural production	-3.0	-3.1	6.5	15.
Rice production	5.2	7.0	1.7	[illegible]
Industrial production	7.9	2.0	8.3	13
Federal Government receipts	14.5	5.5	20.8	17
Federal Government expenditures	13.8	24.7	23.7	5
Money	8.0	4.3	28.1	37
Total liquidity	10.9	13.2	23.5	31
Bank credit to Government (net)	1.4	503.4	292.1	1[illegible]
Bank credit to private sector	21.9	14.5	17.2	[illegible]
Total bank credit	11.5	17.0	20.3	38
Consumer price index	0.6	2.9	3.6	1[illegible]
Merchandise exports (millions of SDRs)	2.0	-3.0	-3.2	5[illegible]
Merchandise imports (millions of SDRs)	19.1	2.5	6.3	3[illegible]
Unit value of exports (based on annual figures)	-2.9	-8.0	-4.3	2[illegible]
Unit value of imports (based on annual figures)	0.0	7.0	4.7	1[illegible]
Trade weighted effective exchange rate	...	...	2.2 1/	[illegible]

1/ January to December.

Federal Government Budget

(In millions of Malaysian dollars)

	1970	1971	1972	1973
urrent revenue	2,292	2,418	2,920	3,418
urrent expenditure	2,182	2,519	3,189	3,260
oreign grants	17	39	66	28
evelopment expenditure	600	949	1,102	1,265
verall deficit (-) or surplus	-473	-1,011	-1,305	-1,079
eficit financing: Foreign (net)	23	343	403	70
Banking system	50	210	129	212
Other	400	458	773	797

External Transactions and Related Items

(In millions of SDRs)

	1970	1971	1972	1973
erchandise exports	1,668	1,618	1,567	2,493
erchandise imports	1,352	1,386	1,474	1,917
rade balance	316	232	93	576
verall balance	40	60	50	98
ross official international reserves (end of period)	824	910	947	1,189
ross official international reserves (as per cent of imports)	61	66	64	62

und Position (August 31, 1974)

uota	SDR 186 million
utstanding drawings	Nil
und holdings of currency	75 per cent
DR holdings as per cent of net cumulative allocation	100 per cent
change rate (floating); September 18,1974	US$1 = M$2.4148; SDR 1 = M$2.8698