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August 25, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report for the 1989 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with Malaysia, which will now be brought to the agenda for discussion, after the Annual Meetings, on a date to be announced.

Mr. Neiss (ext. 7604) or Mr. Somogyi (ext. 7330) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 1989 Article IV Consultation

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Hubert Neiss and Hiroyuki Hino

August 24, 1989

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I. Introduction

The 1989 Article IV consultation discussions were held in Kuala Lumpur during June 1-16, 1989. The mission 1/ met with the Hon. Daim Zainuddin, Minister of Finance, and Tan Sri Dato' Jaffar bin Hussein, Governor of Bank Negara Malaysia (the Central Bank), and had discussions with Tan Sri Dato' Zain Azraai, Secretary-General to the Treasury, Ministry of Finance, Clifford F. Herbert, Secretary, Ministry of Finance, as well as other officials of the Ministry of Finance, the Central Bank, the Economic Planning Unit, the Ministry of Trade and Industry, and other government agencies and representatives of the Chamber of Commerce and the Trades Union Congress.

Malaysia has accepted the obligations of Article VIII, Sections 2, 3, and 4. It maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

The last Article IV consultations were held in May 1988. At that time, Executive Directors paid tribute to the authorities' financial policies which, together with favorable external conditions, had led to an impressive recovery. Directors supported efforts to achieve fiscal consolidation while preserving adequate levels of development expenditure and advised the authorities to proceed swiftly with a reform of the tax system and of the public enterprise sector. They welcomed the measures taken to improve conditions for private investment by liberalizing the regulatory framework. They were in agreement with the accommodating monetary policy that had provided sufficient scope for financing increased private investment and stressed the appropriateness of the authorities' flexible exchange rate policy, which Directors hoped would continue to allow market trends to exert themselves. In this context, most Directors agreed that, should the current account surplus significantly exceed projections, it would be appropriate to accept a modest reversal of the recent trend of exchange rate depreciation.

II. Overview: The 1980s in Perspective

Following a period of fairly steady and rapid growth in the 1970s, the 1980s witnessed sharp fluctuations in Malaysia's economic development. The economy went through an expansionary period during 1980-84, a severe recession in 1985-86, and a rapid recovery beginning in 1987 (Table 1, Chart 1).

1/ H. Neiss (head), T. Balino, J. Somogyi, P. Gotur, J-H. Lin, L. Nielsen, and F. Lee (all ASD); Miss Asiah Hashim, Assistant to the Executive Director for Malaysia, participated in the discussions as an observer.

Table 1. Malaysia: Economic Trends, 1980-89

(Period averages; changes in percent)

| | 1980-84 | 1985-86 | 1987-89 |
|---|---------|---------|---------|
| Real GDP | 7 | -- | 7 |
| Manufacturing | 8 | 2 | 15 |
| Construction | 11 | -11 | -- |
| Real domestic fixed investment | 12 | -14 | 11 |
| Private | 7 | -13 | 15 |
| Public | 20 | -16 | 5 |
| Overall budgetary balance (Percent of GDP) | -12 | -8 | -7 |
| Money supply (M3) | 17 | 9 | 7 |
| Consumer prices | 6 | 1 | 2 |
| Commodity prices <u>1/</u> | -1 | -21 | 15 |
| Terms of trade | 1 | -12 | -- |
| Exports (volume) | 8 | 9 | 13 |
| Export shares | | | |
| Commodities (non-oil) | 35 | 29 | 27 |
| Oil/LNG | 26 | 25 | 16 |
| Manufactures | 27 | 39 | 51 |
| Current account/GNP | -9 | -1 | 5 |
| External debt/GNP <u>2/</u> | 46 | 67 | 56 |
| Debt service ratio <u>3/</u> | 11 | 17 | 14 |

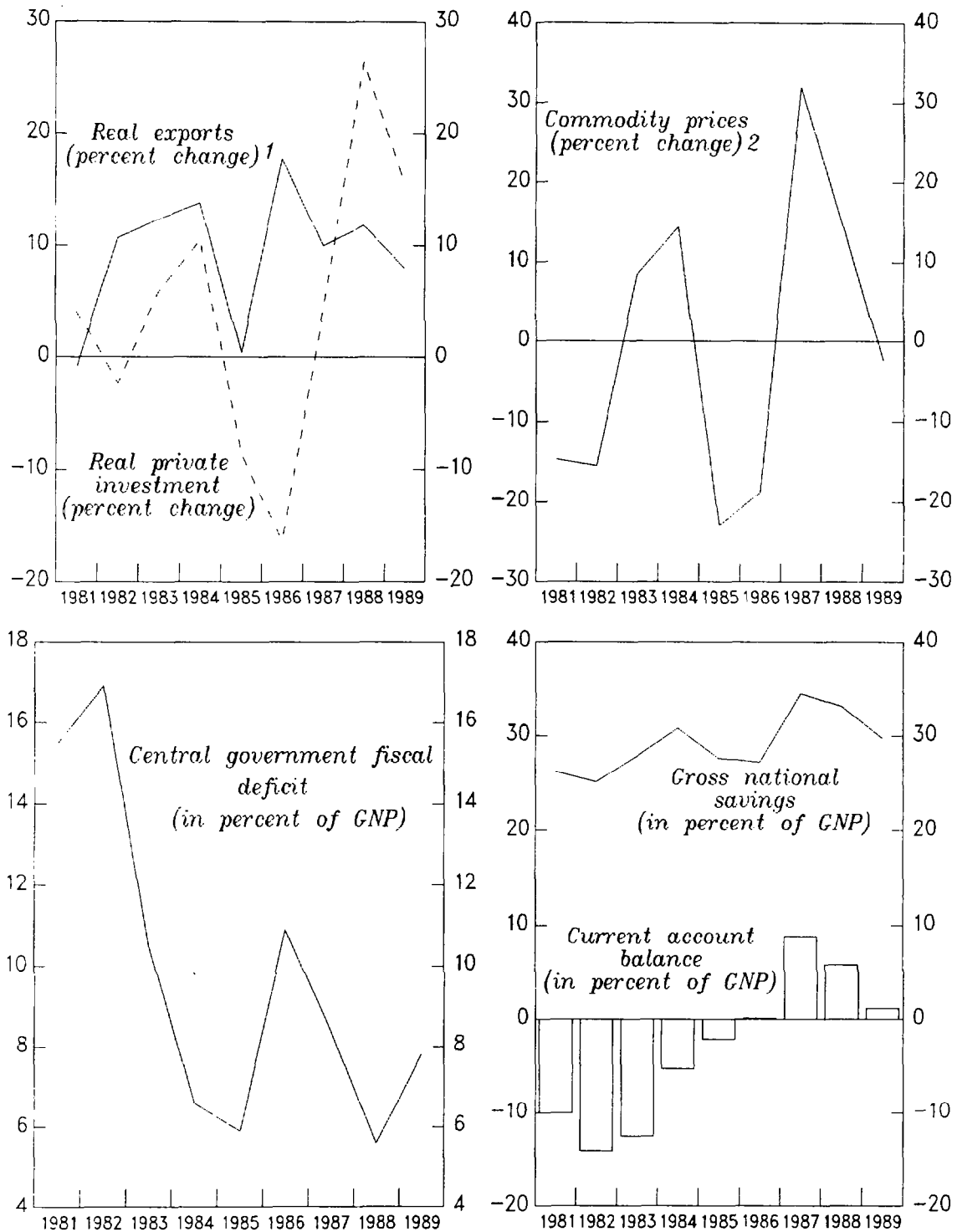
Sources: Data provided by the Malaysian authorities; and staff estimates and projections.

1/ Non-oil, export weighted.

2/ Medium- and long-term debt.

3/ Related to exports of goods and services.

CHART 1
MALAYSIA
SELECTED ECONOMIC INDICATORS, 1981-89



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

1. Exports of goods and nonfactor services

2. Nominal, export weighted.

During 1980-84, the economy achieved an average annual growth rate of close to 7 percent. However, growth in the initial period resulted mainly from the stimulus of public expenditures, undertaken to offset the impact of the global recession, and rising fiscal deficits led to a severe strain on the balance of payments and a sharp rise in external debt. By 1982, the federal government deficit had risen to 17 percent, and the external current account deficit to 14 percent of GNP. Adjustment measures were initiated in 1983, and through major expenditure cuts, the federal government deficit was reduced by almost two thirds within three years. At the same time, improved terms of trade and stronger export demand helped to reduce the external current account deficit while maintaining buoyant activity in manufacturing, construction, and the oil/LNG 1/ sector.

Growth came to an abrupt halt, however, with a sharp decline in the prices of Malaysia's major primary export commodities in 1985. Structural weaknesses already present in the early 1980s--inefficient allocation of investment resources, especially in the heavy industries and in construction, and overexpansion of nonfinancial public enterprises--came into the open and exacerbated the impact of the external shock. Also, a substantial loss in external competitiveness had occurred during 1981-84. The ensuing recession was severe. A sharp fall in private investor confidence led to a collapse of the property and stock markets, a fall in investment by over 25 percent, and insolvencies of financial institutions. Output growth ceased and unemployment rose sharply. Owing to the fall in commodity revenues and the recession, the fiscal deficit again widened, but the external current account deficit was eliminated as the decline in imports was larger than that in export receipts. Medium- and long-term debt reached close to US\$20 billion by end-1986, equivalent to 76 percent of GNP.

The recession highlighted the need for structural reforms, many of which were introduced in the Fifth Malaysia Plan (1986-90). The emphasis of policy shifted toward the promotion of private sector activity as the main engine for growth. Central to this strategy were the provision of tax incentives to investors, industrial deregulation, and the liberalization of foreign investment. Public investment was more closely circumscribed and monitored, and the restructuring of loss-making enterprises was started. To reduce Malaysia's vulnerability to external shocks, the expansion of manufactured exports was promoted through a number of special measures, including provision of export credits, and the restoration of external competitiveness through exchange rate depreciation. Banking legislation was adapted to strengthen the financial system and to enhance the effectiveness of Central Bank supervision.

1/ Liquefied natural gas.

The far-reaching adjustment measures effectively addressed the economic weaknesses and placed the economy in a position to take advantage of the improved international environment that took hold in late 1986. As a result, the economy started a remarkable recovery and private sector confidence turned around decisively. Thus, while the initial expansion in 1987 was primarily export-led, output growth in 1988 was based on a strong revival in private investment, alongside rising private consumption and a continuing good export performance. A significant part of the increase in private investment was centered in the manufacturing sector, which surpassed agriculture as the largest contributor to GDP in 1987 and accounted for more than half of total export earnings. Monetary policy supported the recovery. Inflation was kept low, although it started to rise gradually as the expansion gathered momentum. Fiscal consolidation was resumed in 1987 and the fiscal current account was close to balance in 1988. The external current account moved into surplus and the level of outstanding external debt was reduced through prepayments and restraint in new foreign borrowing. By end-1988, the debt service ratio had fallen to 13 percent from a peak of 19 percent only two years earlier. The recovery has maintained its momentum in 1989. Despite somewhat weaker international conditions, exports and the balance of payments remain strong, while domestic demand is buoyant.

Throughout the period, significant strides have been made in eradicating poverty with a reduction in the incidence of poverty from about 30 percent of the total population at the beginning of the decade to 17.3 percent in 1987. The strategy was set down in the New Economic Policy (NEP), initiated in 1970 for a 20-year period. The NEP includes direct measures to alleviate poverty and to reduce economic imbalances among ethnic groups through a restructuring of ownership. An extensive network of public programs has been established for the provision of various services, such as housing, education, health, and transportation, as well as for raising income levels by making available land and other resources. With the further reduction in poverty levels expected to have been achieved in 1988-89, the NEP target of reducing poverty to 17 percent by 1990 appears to be well within reach.

Economic policies are now being focused on a successful transition to a path of high and sustained growth, a reduction in unemployment, which has remained high despite the recovery, and further progress in eradicating poverty.

III. Recent Financial and Structural Adjustments

The impulse to the present recovery of the Malaysian economy came from a strong export expansion in response to the revival in world demand in late 1986 and a large real depreciation during the preceding period. However, the wide-ranging financial and structural adjustments implemented over recent years are an essential ingredient of the

recovery, accounting for its strength and duration. In this respect, Malaysia has followed the pattern of other successful economies in the region.

The measures that placed the economy in a position to launch a sustained recovery are reviewed briefly below. Of particular importance are fiscal consolidation, the rehabilitation of public enterprises, the creation of a favorable climate for private investment through deregulation and tax reform, and the strengthening of the financial system.

The authorities started the process of fiscal consolidation in 1983, by sharply reversing the expansion of development spending and also containing current expenditures. The overall deficit of the Federal Government was reduced from its peak of 17 percent of GNP in 1982 to about 6 percent of GNP in 1985 (Table 2, Chart 2). The process of fiscal consolidation was disrupted, however, by the recession and the worsening of the terms of trade in 1985. Deficit reduction was resumed in 1987, again relying mostly on expenditure cuts, and the deficit fell to 5.5 percent of GNP in 1988. There was also a marked improvement of the financial position of the public enterprise sector, which recorded a surplus in 1987, for the first time since 1981. As a result, the overall public sector deficit ^{1/} was reduced to about 5 percent of GNP in 1988. Since 1985, it was well exceeded by the surplus of the Employees Provident Fund (EPF), the bulk of which was allocated to the financing of the federal budget deficit.

Efforts were made to reduce the level and change the composition of public investment. It had amounted to 17 percent of GNP in 1981 and led to considerable inefficiencies as well as a crowding out of private investment. By 1987, central government investment had been reduced to its lowest level since 1973 and total public investment had been cut to 10 percent of GNP. The completion of major projects in the energy, communications, and transport sectors facilitated the initial drop in investment. Subsequently, investment in industry and commerce was scaled down, while the private sector was encouraged to take a leading role.

Nonfinancial public enterprises, which accounted for one fourth of GDP in 1986, had entered into areas (iron and steel, cars, petrochemicals) presenting little comparative advantage for public ownership and many enterprises encountered major operational and financial difficulties. The authorities initiated a rehabilitation and privatization program for public enterprises in 1985-86. They also refrained from the creation of new public enterprises and discouraged existing enterprises from diversifying into new lines of activity.

^{1/} Federal Government, statutory authorities, state and local governments, and nonfinancial public enterprises; the Employees Provident Fund (EPF) is excluded.

Table 2. Malaysia: Summary of Public Sector Developments, 1981-89

(In percent of GNP)

| | <u>1981-83</u> Average | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 <u>1/</u> |
|--|---------------------------|-------|------|-------|------|------|----------------|
| Federal Government | | | | | | | |
| Revenue | 28.2 | 27.8 | 29.1 | 29.2 | 23.9 | 23.4 | 23.3 |
| Expenditure | 42.5 | 34.5 | 35.0 | 40.0 | 32.3 | 29.0 | 31.1 |
| Current expenditure | 25.1 | 23.5 | 25.9 | 30.2 | 26.7 | 24.5 | 24.1 |
| Development expenditure | 17.4 | 10.8 | 9.3 | 10.3 | 5.3 | 4.5 | 7.0 |
| Current balance | 3.1 | 4.3 | 3.2 | -1.0 | -2.9 | -1.2 | -0.8 |
| Overall balance | -14.3 | -6.6 | -5.9 | -10.9 | -8.4 | -5.6 | -7.8 |
| Nonfinancial public enterprises | | | | | | | |
| Operating surplus | 5.4 | 6.7 | 8.0 | 4.5 | 5.0 | 4.2 | 3.9 |
| Overall balance | -4.4 | -7.2 | -0.6 | -1.3 | 1.1 | -0.1 | -0.7 |
| Consolidated public sector balance <u>2/</u> | -17.0 | -11.7 | -4.6 | -9.6 | -5.6 | -5.1 | -7.8 |
| Surplus of Employees Provident Fund | 5.0 <u>3/</u> | 5.4 | 6.3 | 7.6 | 7.4 | 6.7 | 6.4 |
| Of which: financing of budget deficit | 3.2 | 3.7 | 4.7 | 5.1 | 5.6 | 4.6 | 3.1 |

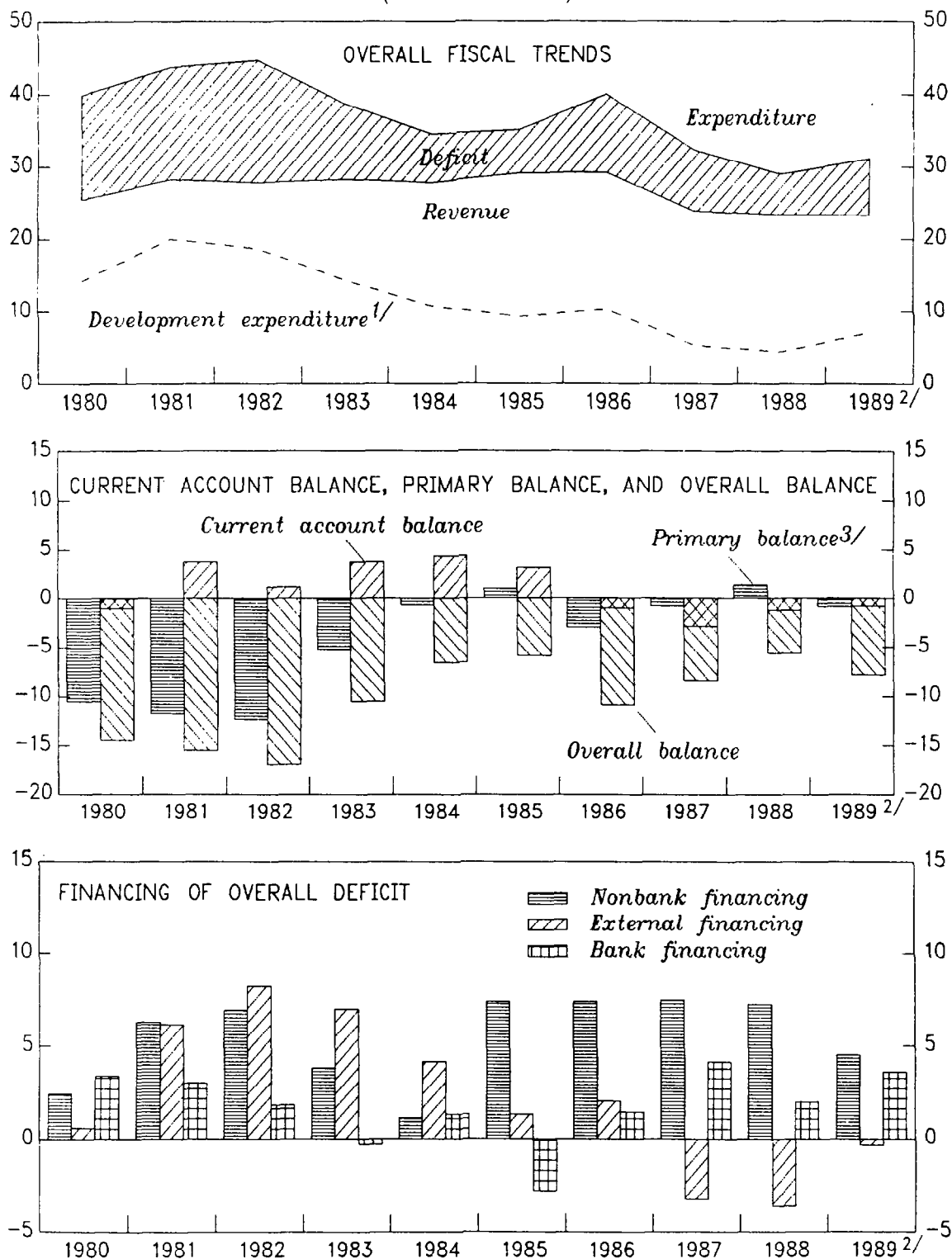
Sources: Data provided by the Malaysian authorities and staff estimates.

1/ Official estimates.

2/ Federal Government, statutory authorities, state and local governments, and nonfinancial public enterprises; the Employees Provident Fund (EPF) is excluded.

3/ Tentative estimate.

CHART 2
MALAYSIA
FEDERAL GOVERNMENT OPERATIONS, 1980-89
(Percent of GNP)



Source: Data provided by the Malaysian authorities.

1/ Includes net lending.

2/ Official estimates.

3/ Excludes interest payments.

The reorientation of investment toward the private sector was supported by a number of changes in industrial policy: simplification of administrative regulations; liberalization of controls; relaxation of ownership requirements; tax incentives; and provision of concessionary financing.

The administratively cumbersome Investment Incentives Act was replaced in 1986 by the Promotion of Investment Act, which also provided added tax incentives. The Industrial Coordination Act, under which larger firms 1/ are licensed for most changes in product lines or processes as well as for imports of capital equipment, was liberalized in 1985-86 through the provision of exemptions, and is being administered flexibly. To support the restructuring, an Industrial Adjustment Fund was established in 1987 to provide concessionary loans to firms undertaking rationalization and rehabilitation. Ownership rules for foreign investors were eased: they can now hold up to 100 percent of equity in manufacturing industries for the first five years if no local equity participation is available and if the company exports at least 20 percent of its production. This applies also to the expansion of existing projects, as well as to acquisitions on a case-by-case basis. A Coordination Center on Investment was established in 1988 to streamline procedures for project approval at the federal level, combining functions previously undertaken by three ministries and the Immigration Department.

Investments have also benefited from recent measures: the excess profit tax of 3 percent was abolished effective from 1988; the corporate tax rate has been reduced from 40 percent to 35 percent effective from 1989; 2/ and the 5 percent development tax will be phased out during 1990-94. With these cuts, the corporate tax rate is moving closer to those prevailing in other member countries of the Association of South East Asian Nations (ASEAN).

The financial system has been strengthened over the past years. The slump in corporate profits and a large number of business failures during the 1985-86 recession led to a severe deterioration in the quality of assets of banks and other financial institutions. The Central Bank took an active role in restructuring four medium-sized banks, which had incurred substantial losses. It assumed control of those banks and participated in their recapitalization. The Central Bank also encouraged the consolidation of finance companies that were undercapitalized. Twenty-four ailing deposit-taking cooperatives were taken over by finance companies, with direct or indirect support of the Central Bank. These operations safeguarded the stability of the

1/ Firms with more than M\$2.5 million in equity or employing more than 75 workers.

2/ Excluding petroleum companies operating under the Petroleum Income Tax Act of 1967. However, these companies have been granted other tax relief.

financial system. As the affected institutions have been regaining viability, the Central Bank has been withdrawing its financial support, recovering its credits, and selling its shares in those institutions. The Central Bank has also tightened capital requirements and reviewed bank supervision standards. In addition, it has been given responsibility for supervising insurance companies.

IV. The Ongoing Recovery in 1988-89

Economic performance in 1988, the second year of the recovery, was impressive: a sharp upturn in private investment, high growth and low inflation, a lower fiscal deficit, and a comfortable external position.

Exports benefited from the strong economic growth in partner countries (almost 7 percent), higher prices for Malaysia's commodity exports (rubber, saw logs and timber, palm oil, petroleum and LNG, and tin), and the depreciation of the real effective exchange rate, which amounted to 29 percent between end-1984 and end-1987. The rapid growth in exports (18 percent) made it possible to achieve a current account surplus equivalent to 6 percent of GNP (9 percent in 1987), despite the large increase in imports (29 percent) induced by the recovery. A substantial part of the surplus was used to prepay foreign debt. Because of this and interest rate sensitive short-term capital outflows, gross reserves fell from the equivalent of 7.9 months of imports at end-1987 to 5.3 months at end-1988.

While export growth remained strong, the main cyclical force in 1988 was the rise in domestic demand. Particularly remarkable--and unexpected a year ago--was the sharp increase in private fixed investment of more than 26 percent, reflecting strong foreign as well as domestic investment. While foreign investment had already started to rise in 1987, the sluggishness of domestic investment had been a source of concern during the 1988 Article IV consultation. The authorities gave two reasons for the turnaround: first, the recovery in economic activity, together with the lackluster investment record of the recent past, had led to a high degree of capacity utilization in several sectors; and second, the improved domestic political climate during 1988 had increased the confidence of local investors. The authorities also pointed out that Malaysia remains an attractive location for foreign investors because of well developed infrastructure, a well educated labor force, and competitive incentives.

Real GDP grew close to 9 percent, the highest rate so far in this decade. The main contribution came from manufacturing, which rose by 18 percent. The improved performance was well balanced across industries, with semiconductors, other electronic and electrical products, rubber products, and petroleum refining recording large increases. High growth in 1987 and 1988, however, failed to make a significant dent in unemployment, which remained at the high level of about 8 percent.

The prospect for 1989 is for growth to continue at a slightly more moderate rate of about 7-8 percent. Exports will decelerate from their record growth last year (Chart 3) because of lower demand from partner countries. Domestic demand will remain strong. While private investment is not expected to grow as rapidly as in 1988, there is likely to be a large increase in public investment.

With high import growth to sustain domestic demand, the current account surplus is expected to fall to about 1 percent of GNP. This weakening has its counterpart in the anticipated larger budget deficit and the likely drop in the private savings ratio from its record level in 1987-88. Smaller debt prepayments, together with continued high foreign direct investment, ^{1/} will result in a small net capital inflow, leaving gross reserves at the equivalent of five months of imports.

The authorities expect inflation to rise from 2.5 percent in 1988 to 3.5-4 percent in 1989. They shared the staff's concern that the potential for inflationary pressures had increased: the higher commodity prices and the increase in the producer price index last year have not yet been fully reflected in the general price level; the further depreciation in 1988 will also impact on prices; monetary conditions are relatively easy; and the rapid recovery has brought several sectors close to full capacity utilization.

V. Short-Term Policies

Fiscal policy in 1988 continued to aim at further budget consolidation while contributing to the economic recovery. Higher economic activity and commodity prices, as well as decisions by the authorities to narrow exemptions under the sales tax and to improve tax administration, boosted budget revenues in 1988, although their share in GNP remained below the level of the preceding years. The authorities continued to restrain current expenditures through a further postponement of a general salary adjustment in the civil service and the more effective monitoring of current spending adopted under the consolidation process. At the same time, external interest payments fell, reflecting, in part, the prepayment and refinancing of foreign loans. As a result, the current deficit in the federal government budget was lowered to about 1 percent of GNP, already close to the objective of balance in the current budget by 1989 (Appendix Table 3). Development expenditures, which had fallen to a low level by 1987, were planned to rebound, but owing to constraints affecting the start and implementation of projects, actual disbursements fell significantly short of budget allocations. Overall, the federal government deficit, which had been budgeted to rise to some 9 percent of GNP, continued to decline, to 5.5 percent of GNP,

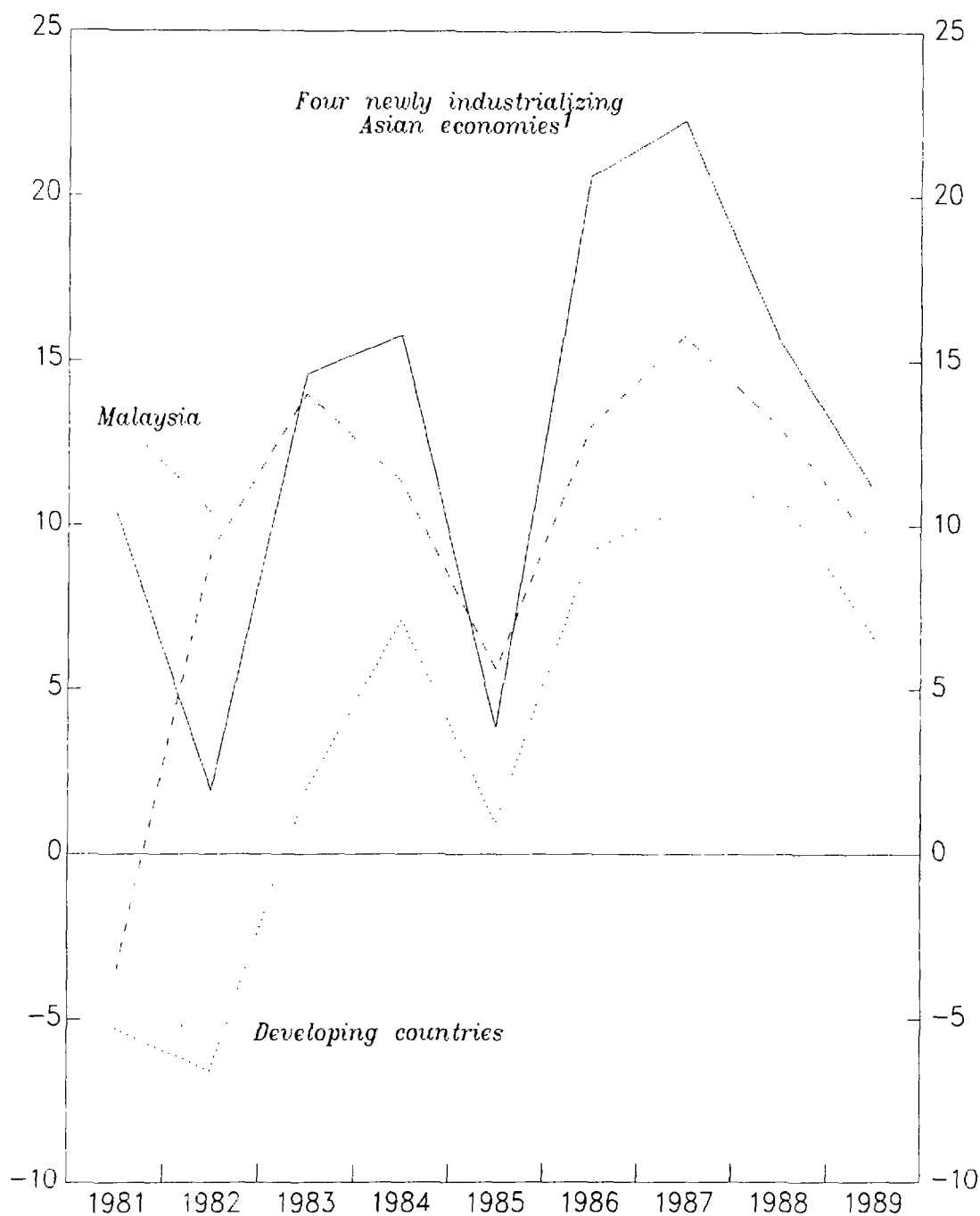
^{1/} The areas attracting mainly export-oriented foreign investment are: electrical and electronic products, petroleum and coal products, and fabricated metal products.

in 1988. Despite a recovery in the development expenditures of non-financial public enterprises, the overall deficit of the consolidated public sector also narrowed further.

The authorities emphasized that strict fiscal discipline remained the guiding principle of the budget strategy for 1989, while increased emphasis was placed on public investment in order to expand and improve the infrastructure. The authorities also decided to implement a moderate adjustment in civil service salaries, which could no longer be postponed: the last general increase had been granted in 1980 despite a commitment to a review of public sector remuneration every five years. Federal government employment was slightly increased to fill vacancies in essential public services and in revenue collection. The tax system was rationalized through cuts equivalent to 0.5 percent of GNP in direct taxes on corporations and import duties on items that had enjoyed extended tariff protection; about one half of the revenue loss was offset by a tightening of tax exemptions and a further broadening of the sales tax base. No deterioration of the current account balance is foreseen but, because of the planned expansion of development spending, the overall deficit of the Federal Government was budgeted to rise to 9 percent of GNP. Because revenues are likely to exceed budget estimates, the authorities now expect a deficit of about 8 percent of GNP. The staff pointed out that the deficit could be even lower as revenues are boosted by better prospects for economic activity and commodity prices than envisaged earlier. The authorities, however, noted that there will be pressure to use additional revenue for higher current spending. Operating expenditures had been severely restrained in the years of budget consolidation, and there are already requests for additional appropriations to meet deferred maintenance needs. In the staff's view, a deficit of about 8 percent of GNP in 1989, as expected by the authorities, was still consistent with macroeconomic objectives, given the progress already achieved in improving the financial position of public enterprises and other public authorities, and the large surplus of the EPF. However, the potential for increased inflationary pressures in 1989 called for prudence. Possible additional revenue increases should, therefore, largely be used to further lower the deficit, while any additional expenditure approvals should be limited to areas of highest priority. In any case, there was a need for further fiscal consolidation over the medium term.

The authorities' monetary policy objectives remain to support the recovery by ensuring adequate bank credit at reasonable cost, and to keep inflation low. In 1988, the growth in total liquidity (M3)

CHART 3
MALAYSIA
EXPORT VOLUME - DEVELOPING COUNTRIES, 1981-89



Sources: IMF, *World Economic Outlook* (April 1989); and staff estimates and projections.
1. Korea, Singapore, Hong Kong, and Taiwan Province of China. It should be noted that the term "country" used in this report does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

accelerated to 8 percent. ^{1/} This increase was, however, below the projected increase of 10 percent. The reduced recourse of the Federal Government to the banking system and substantial prepayments of external loans reduced total liquidity growth (Appendix Table 4). As a result, the recovery of private investment could be adequately accommodated through credit expansion, with credit to the private sector rising by 11 percent. In implementing this policy, the Central Bank expanded its domestic assets, and reserve money grew by almost 12 percent.

The income velocity for M3 continued on the upward trend observed since 1987, albeit at a slower pace (Chart 4), partly because of a shift from quasi-money deposits to higher-yielding assets such as Repurchase Agreements (Repos) ^{2/} and foreign assets.

The Central Bank also tried to help the recovery by keeping interest rates low, mainly through its authority over changes in the basic lending rate (BLR). Banks and finance companies must keep their rates within an established range centered on the BLR. Both the BLR for commercial banks and the average lending rate fell, the former from 7.5 percent to 7 percent and the latter from 9.7 percent to 9 percent--its lowest level since 1972. Deposit rates also eased. As a result, the interest rate differential between instruments denominated in ringgit and those denominated in foreign exchange widened, and this encouraged an outflow of short-term capital. In the latter part of the year, bank liquidity tightened somewhat and short-term rates edged upward. Interbank rates on overnight money increased from 3.2 percent in December 1987 to 4.2 percent by February 1989, and this spilled over into a firming of 1- to 12-month deposit rates.

Monetary expansion in 1989 is projected to be in the range of 8-10 percent. The staff suggested that the authorities should aim at the lower end of this range, given the higher inflationary pressures this year. Also, the rising trend in velocity since 1987 had not shown any signs of being reversed. As interest rate differentials continue to be in favor of non-ringgit denominated assets, and short-term capital flows have not reversed, a moderate increase in interest rates as a result of a somewhat tighter monetary stance should be allowed. While it would be unlikely to dampen investment activity, it would be consistent with the authorities' policy of maintaining a strengthened ringgit and of achieving a repatriation of short-term funds held overseas. It

^{1/} This rate of growth corresponds to the definition used by the Malaysian authorities, which excludes balances held by nonbank financial institutions. According to the IFS definition used in Appendix Table 4, the rate of growth in M3 would equal 7 percent.

^{2/} Repurchase Agreements are agreements under which a financial institution sells a security to the public with a commitment to purchase it back at the end of a certain period. Since the price of the sale and the repurchase are agreed upon at the time of concluding the agreement, the yield of the operation is similar to an interest rate.

would also be supportive of maintaining a high private savings rate. The authorities responded that they would adjust the rate of monetary expansion in the light of evolving conditions. However, they also indicated that they were still concerned about banks' large margins between deposit and lending rates, which raised the cost of funds to borrowers, and they would, therefore, like to see lower lending rates. The staff appreciated the authorities' concern to keep the costs of funds to the private sector reasonable, but suggested that the issue of margins should be dealt with separately, and that the formulation of interest rate policy should be made on the basis of macroeconomic considerations.

The authorities reiterated their policy of allowing the exchange rate to be determined by underlying market trends, with their interventions limited to moderating erratic fluctuations in the rate and maintaining international reserves at a comfortable level. ^{1/} The staff pointed out that, with the large real depreciation since 1984 (Chart 5), Malaysia's competitiveness has substantially improved vis-a-vis most of its competitors in the region. The authorities concurred that the degree of competitiveness achieved was about adequate and the balance of payments position did not call for a further depreciation in the real effective exchange rate.

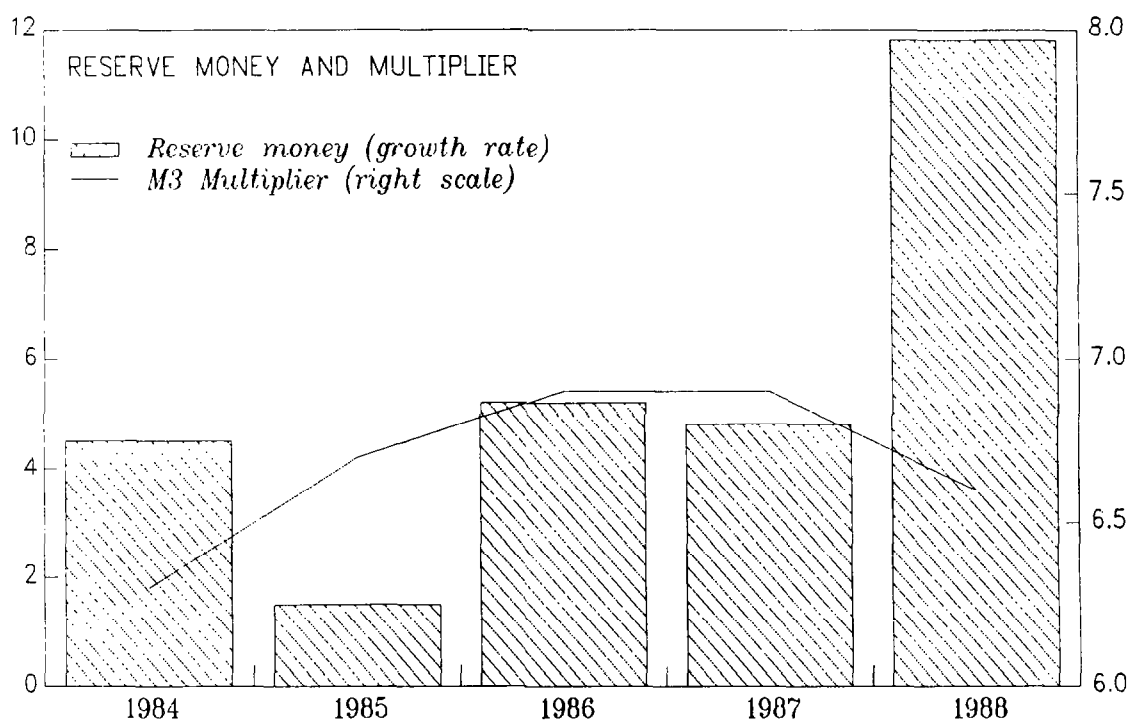
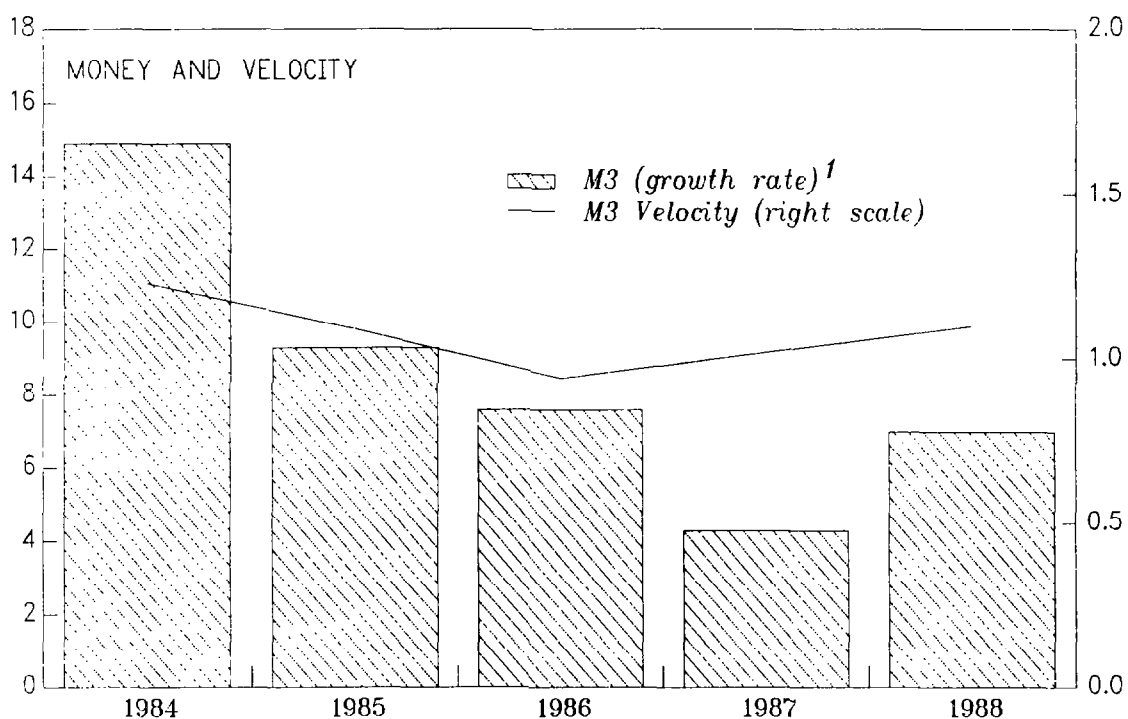
In contrast to the continuing depreciation during the second half of 1988, the ringgit has strengthened in 1989 as conditions in the money market have become somewhat tighter. This is consistent with the strength of the balance of payments. The staff encouraged the authorities to support the firmer exchange rate by allowing domestic interest rates to rise.

While the stock of external debt in U.S. dollar terms had risen sizably since 1985 owing to valuation changes, ^{2/} it actually declined--to US\$19.3 billion--in 1988 as a result of prepayment and refinancing of the more expensive loans, as well as restraint in new borrowing. The debt service ratio was reduced to 13.4 percent from a peak of 18.7 percent in 1986. The authorities' external debt policy is to safeguard the significant improvement achieved in debt and debt service levels over the past few years. Their strategy includes increased substitution of domestic for foreign funds, a more comprehensive management of debt so as to reduce exposure to exchange rate and interest rate risks, and better monitoring of public enterprise borrowing.

^{1/} The ringgit is pegged to a basket of currencies.

^{2/} About 60 percent of Malaysia's external debt is denominated in currencies other than the U.S. dollar.

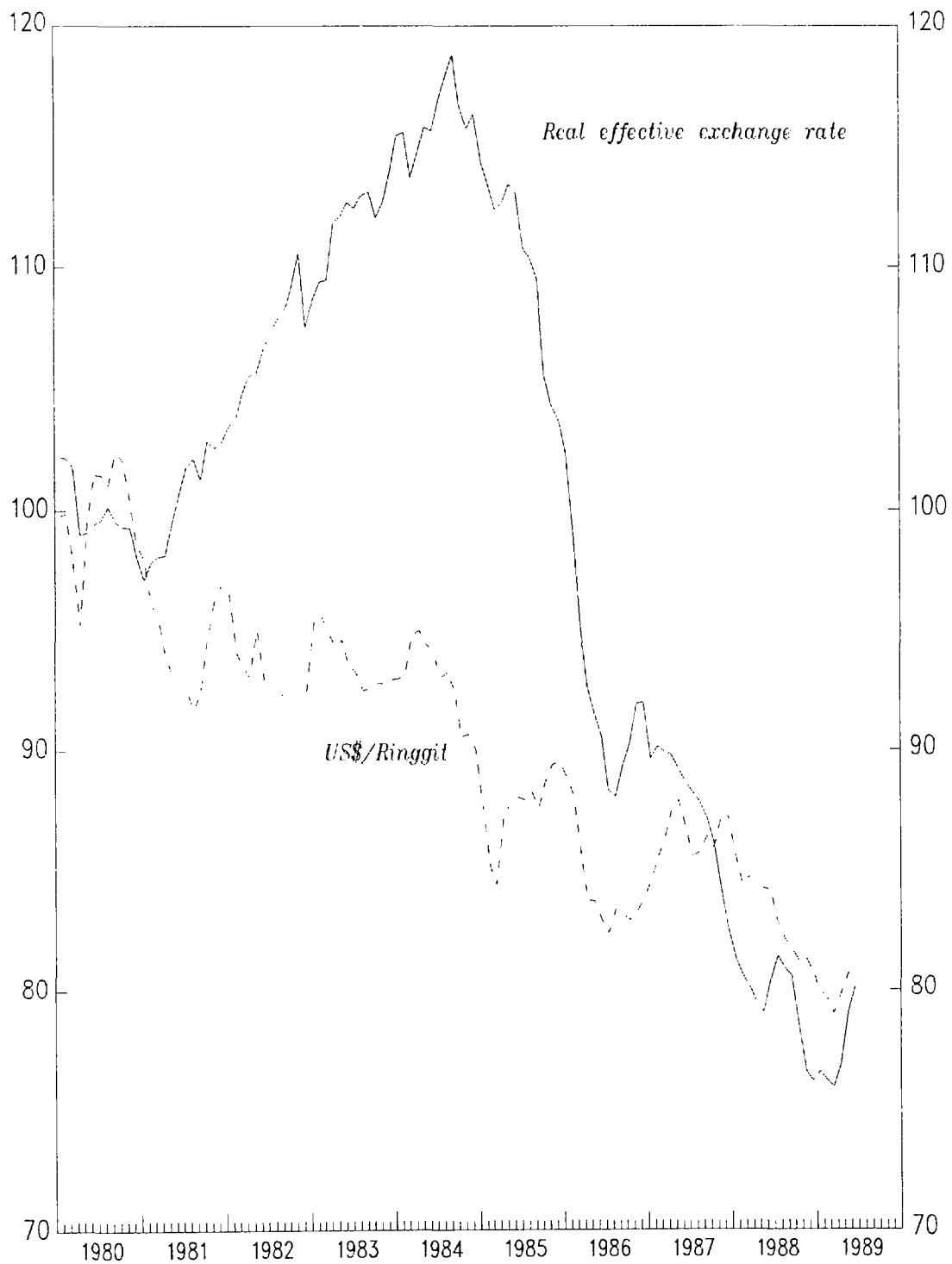
CHART 4
MALAYSIA
SELECTED MONETARY INDICATORS, 1984-88



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

1. Includes currency outside banks; demand, fixed, and savings deposits; and negotiable certificates of deposit

CHART 5
MALAYSIA
EXCHANGE RATE DEVELOPMENTS, 1980-89
(1980=100)



Source: IMF, Information Notice System.

VI. Medium-Term Scenario

The staff has prepared a scenario for 1990-94 ^{1/} to illustrate a possible transition of the economy from the current cyclical upswing to sustainable high growth. The main variables are presented in Table 3. The scenario starts from targets for economic growth (6.5 percent per annum) and inflation (3.5 percent per annum) which are in line with the authorities' views. Exports would grow at more modest rates than in 1987-89, and foreign direct investment would remain strong. With fairly rapid import growth to sustain the GDP growth trend, the current account would register smaller surpluses; the level of international reserves would rise somewhat, close to the equivalent of six months of imports. The consolidated public sector deficit is assumed to rise in 1990 to allow higher investment in infrastructure, after the cutback in fiscal spending in the recent past, but then to fall steadily to close to below 6 percent of GNP by the end of the period. A high investment ratio would be maintained, with a larger role for private investment and improved efficiency of investment.

This scenario would be a desirable outcome for Malaysia. First, it allows a high rate of growth, which is a prerequisite for the attainment of Malaysia's socioeconomic objectives, including a fall in unemployment. Second, it implies a shift from public to private investment, which is an important element in raising investment efficiency; third, it implies further export diversification, ^{2/} which is crucial to reduce the economy's vulnerability to large swings in the terms of trade. Fourth, it provides for further fiscal consolidation while accommodating somewhat higher fiscal expenditures in infrastructure which are needed to sustain growth. Fifth, it strikes a balance between using export earnings to increase domestic consumption and investment, and providing for some increase in the reserve cushion; and sixth, it implies restraint in inflation.

The key conditions for this scenario to become feasible are that (1) investment efficiency is significantly higher than during the 1980s; (2) a high level of domestic savings is sustained; and (3) international competitiveness is maintained. A further condition is that commodity prices, international interest rates, and rates of growth and inflation in Malaysia's partner countries develop in line with the latest World Economic Outlook (WEO) projections. The feasibility of the scenario requires, therefore, the conduct of effective domestic policies and a supportive international environment. In most areas, domestic policies have already been set in the required direction and must continue or be strengthened.

^{1/} The framework is outlined in Annex I.

^{2/} The share of manufactures in total exports would rise from 54 percent in 1989 to 67 percent in 1994.

Table 3. Malaysia: Medium-Term Scenario--Selected Macroeconomic Indicators, 1984-94

(Annual percentage changes; unless otherwise specified)

| | 1984-88 Average | 1989 Proj. | 1990 | 1991 | 1992 | 1993 | 1994 | 1990-94 Average |
|---|--------------------|---------------|----------------------|------|------|------|------|--------------------|
| | | | Scenario Projections | | | | | |
| Domestic sector | | | | | | | | |
| Real GDP growth | 4.3 | 7.3 | 6.5 | 6.5 | 6.5 | 6.5 | 6.5 | 6.5 |
| Consumer prices | 1.6 | 4.0 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Investment/GNP (in percent) | 29.2 | 28.6 | 29.0 | 29.0 | 29.0 | 29.0 | 29.0 | 29.0 |
| ICOR (value) | 5.5 | 4.0 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| National savings/GNP | 30.5 | 29.7 | 30.3 | 30.3 | 30.2 | 30.8 | 31.1 | 30.5 |
| Consolidated public sector deficit/GNP (in percent) | 7.2 | 7.8 | 8.3 | 7.6 | 7.0 | 6.3 | 5.7 | 7.0 |
| External sector | | | | | | | | |
| Export volume growth | 12.0 | 9.5 | 10.7 | 9.6 | 8.4 | 5.8 | 6.1 | 8.1 |
| Import volume growth | 6.7 | 15.4 | 12.6 | 12.1 | 9.6 | 7.0 | 6.8 | 9.6 |
| Terms of trade | -0.7 | -3.0 | -- | 0.1 | -0.1 | -0.1 | -- | -- |
| Current account surplus/GNP (in percent) | 1.5 | 1.1 | 1.3 | 1.3 | 1.2 | 1.8 | 2.1 | 1.5 |
| Reserves (months of imports) | 5.6 | 5.2 | 5.5 | 5.5 | 5.5 | 5.7 | 5.8 | 5.6 |
| External debt/GNP <u>1/</u> (in percent) | 61.2 | 45.3 | 40.7 | 37.5 | 34.8 | 32.3 | 30.0 | 35.1 |
| Debt service/current receipts <u>1/</u> (in percent) | 15.1 | 12.2 | 9.2 | 9.4 | 9.6 | 8.9 | 8.5 | 9.1 |
| External assumptions | | | | | | | | |
| Commodity prices <u>2/</u> | ... | -4.1 | 1.3 | 5.7 | 6.5 | 6.5 | 6.0 | 5.2 |
| Oil and LNG prices | ... | 11.7 | 3.0 | 4.1 | 4.4 | 4.4 | 4.4 | 4.1 |
| GDP growth in trading partner countries | 4.8 | 5.0 | 4.5 | 4.5 | 4.4 | 4.4 | 4.4 | 4.4 |
| International interest rates | 8.4 | 9.9 | 9.2 | 8.8 | 8.8 | 8.8 | 8.8 | 8.9 |

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

1/ Medium- and long-term debt.

2/ Weighted average: 1988 export weights.

To test the sensitivity of the scenario, the impact of plausible changes in external and domestic assumptions was estimated (Table 4). First, the target rate of growth is raised from 6.5 to 7.5 percent through expansionary demand policies. Because of higher import demand requirements, the current account turns into deficit, rising to 3 percent of GNP by the end of the period. Reserves would, consequently, fall to below three months of imports, a significantly lower level than the authorities consider prudent. Second, the following external assumptions were made: (1) the export prices of Malaysia's major non-energy commodities (palm oil, rubber, saw logs and timber, and tin) fall by 20 percent in 1990; (2) prices of petroleum and LNG experience a 20 percent fall in 1990; (3) growth in Malaysia's trading partners during 1990-94 is half of the 4.4 percent assumed in the scenario; and (4) international interest rates are 1 percentage point higher than assumed. The first three changes also convert the projected current account surpluses into deficits, and would reduce reserve levels below those which the authorities consider comfortable. The rise in international interest rates, on the other hand, could be accommodated without changing the scenario significantly, because Malaysia's debt was reduced substantially in 1987-88, and about half of the remaining debt is at fixed rates. Third, the effect on output growth of lower investment efficiency or of reduced private investment was considered. The ICOR assumptions are particularly uncertain. If the ICOR is 5.5, which is about the average in the 1980s, instead of 4.5 as in the more recent years, the growth trend would fall by 1 percentage point. If private investment were assumed to fall from 18.3 percent to 14.4 percent of GNP, its level in 1987, growth would be lower by at least 1/2 of 1 percent. (The concomitant drop in efficiency would cause a further decrease in growth.)

These sensitivity estimates indicate that the current account balance will remain quite vulnerable to changes in external factors, but that the changes envisaged would not lead to a critical situation during the projection period. They also indicate the crucial importance of investment efficiency and strong private investment.

VII. Medium-Term Issues

Malaysia's investment ratios have been higher than in several neighboring countries, but investment efficiency has been lower. Several factors account for the latter: the low efficiency of investment carried out by nonfinancial public enterprises in the early 1980s; the high cost of inputs produced by public enterprises; the licensing requirements imposed by the Industrial Coordination Act; the lack of sufficient investable funds for small and medium-sized firms; and the restrictions on equity ownership and other constraints on the freedom of enterprises. As already mentioned, raising investment efficiency will be critical to Malaysia's growth strategy. The Government has addressed this problem mainly by encouraging a shift of investment from the public to the private sector. This requires persevering with the policy of

Table 4. Malaysia: Sensitivity Analysis of Medium-Term Projections, 1990-94

| | End Projection Period (1994) | Period Average |
|---|---------------------------------|-------------------|
| Impact of selected shocks on external sector variables | | |
| On the current account balance/GNP (in percent) | | |
| Scenario assumptions | 2.1 | 1.5 |
| Shock | | |
| Higher growth of GDP | -3.0 | -2.2 |
| Fall in commodity prices | -1.5 | -1.7 |
| Fall in oil and LNG prices | -0.4 | -0.8 |
| Lower rate of growth in partner countries | -0.7 | -1.4 |
| Higher international interest rates | 1.5 | 0.9 |
| On international reserves (in months of imports) | | |
| Scenario assumptions | 5.8 | 5.6 |
| Shock | | |
| Higher growth of GDP | 2.7 | 3.7 |
| Fall in commodity prices | 3.4 | 4.0 |
| Fall in oil and LNG prices | 4.1 | 4.4 |
| Lower rate of growth in partner countries | 4.3 | 5.0 |
| Higher international interest rates | 5.4 | 5.3 |
| Impact of shocks to investment on economic growth | | |
| Rate of growth of GDP (in percent) | | |
| Scenario assumptions | 6.5 | 6.5 |
| Shock | | |
| Lower investment efficiency | 5.5 | 5.4 |
| Lower private investment | 5.7 | 6.0 |

Source: Staff projections.

removing state enterprises from activities where the private sector is more efficient, further streamlining the remaining public enterprises, and reducing the Government's role in regulating private investment. Also, allowing lending rates to reflect market conditions will increase the efficiency of the allocation of private savings.

In spite of the strong cyclical upturn, the rate of unemployment has hardly inched downward from its recent historic high of 8.3 percent in 1986, which was almost double the rate in 1982. Various explanations of high unemployment in Malaysia are debated, and no firm conclusions have been reached. It seems that the high rate of unemployment is mainly the result of a lower growth trend in the 1980s--5 1/2 percent compared with 7 1/2 percent in the 1970s. It lowered the growth of the demand for labor to 3 percent annually from 3 1/2 percent in the 1970s, while the labor force continued to increase at close to 3 1/2 percent. Faster labor absorption was discouraged by rigidities in the labor market. The wage-setting and arbitration systems are overly cumbersome, leading to high negotiation costs and inflexibility in wage determination. Retrenchment costs are very high, making firms cautious in the hiring of new workers. These rigidities have been aggravated by biases in the tax system in favor of capital-intensive modes of production. Concurrent with the high rate of unemployment, labor shortages exist in the plantation sectors and certain branches of manufacturing. The educational sector has expanded rapidly, and an increasingly higher proportion of new entrants into the labor force come with aspirations that are not met in the labor market. At the same time, unfilled jobs have led to production losses in plantations and in construction.

The Government has introduced a series of measures to address the unemployment issue. A National Clearing House for Graduates and Skilled Employment has been established to disseminate information; private firms are encouraged to equip graduates with training in business; loan schemes have been introduced to encourage self-employment; and labor laws have been revised to decrease fringe benefits and to ensure faster and smoother arbitration processes. The phasing out of accelerated depreciation has removed one of the system's biases in favor of capital-intensive production methods. Further necessary measures include a simplification of the bargaining process and a lowering of retrenchment costs. The authorities are moving in this direction, but emphasized that this is a politically sensitive area where progress could be attained only gradually. They will also review the educational and training system and explore ways to make it better suited to meet the requirements of the labor market.

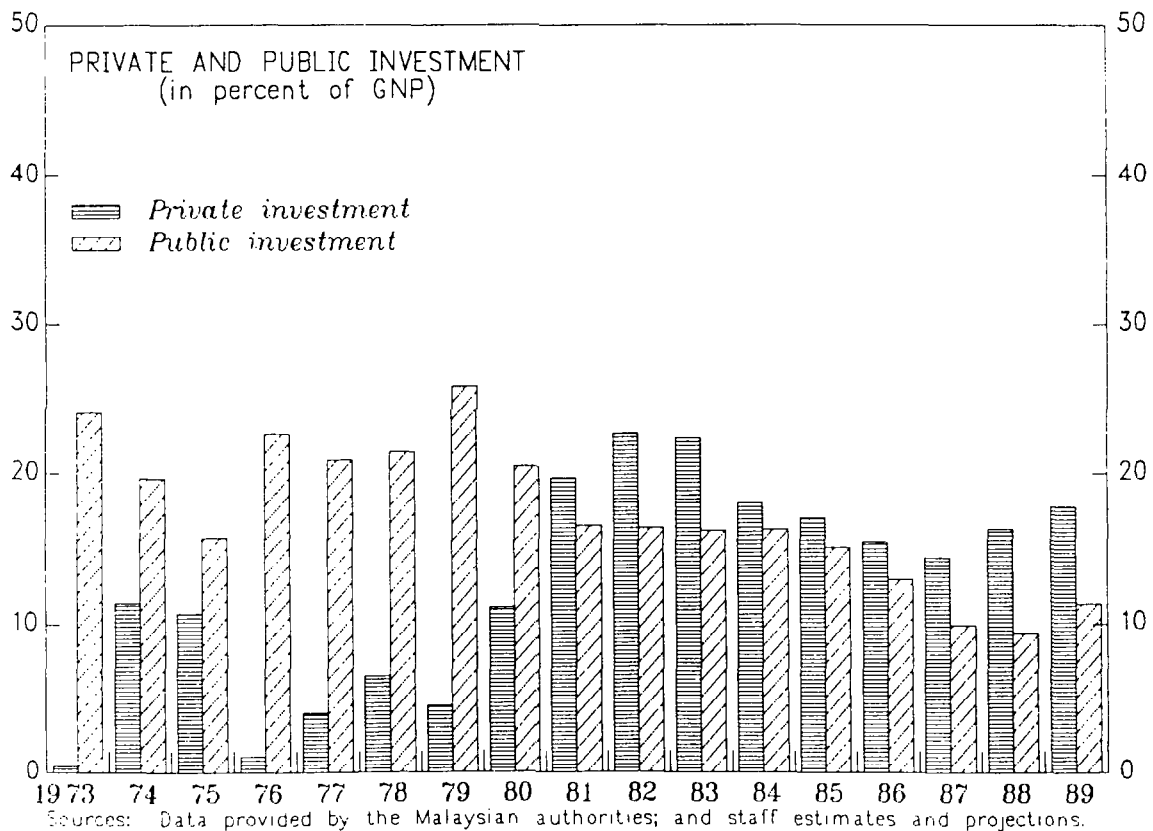
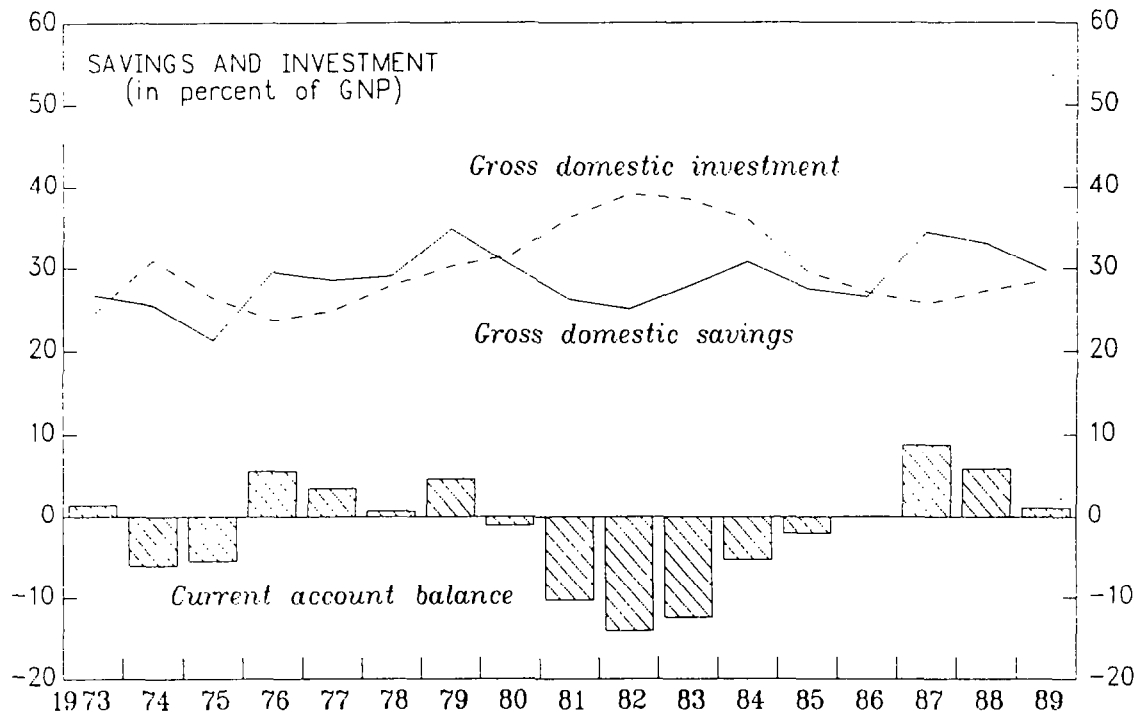
Further fiscal consolidation over the medium term will be consistent with the intended reduction of the role of the Government in the economy and the enhancement of the scope of the private sector. It will also be required to ensure a sufficiently high level of domestic

savings and to reduce the reliance of budget financing on EPF surpluses. The staff's scenario assumes a strong savings performance of about 31 percent of GNP, a level somewhat above the historical trend (Chart 6). The authorities concurred that further fiscal consolidation was desirable. While they saw limited scope for a lowering of the federal budget deficit during 1989-90, a reduction, to about 5 percent of GNP, for the period of the Sixth Malaysia Plan (1991-95) was tentatively envisaged. The resumption of fiscal consolidation will require a restructuring of public expenditures, a reform of the tax system, and the further rehabilitation and privatization of public enterprises. The authorities also intend to lessen the dependence of other public agencies and enterprises on federal budgetary allocations. Statutory bodies are encouraged to charge user fees for their services, and entities whose original objectives have been achieved are to be closed. The expansion of investment is to be concentrated on the development of the physical and social infrastructure and of a skilled labor force to support the growth of private sector activities.

Recent tax reform efforts were aimed at extending the base of the sales tax in order to reduce its sensitivity to changes in commodity prices and at lowering direct tax rates with a view to stimulating growth. The authorities pointed out that, after the recent elimination of the excess profit tax, the lowering of the corporate tax, and the planned phasing out of the development tax, further cuts in direct tax rates would be contingent on additional revenue from indirect taxes. While a further widening of the revenue base of the sales tax would be an alternative, the staff team reiterated the earlier Fund recommendation for the adoption of a comprehensive value-added tax (VAT), which has been actively debated in Malaysia. A strengthening of tax revenue through a VAT would avoid distorting consumption and production choices, as well as the penalization of vertical integration, and allow greater efficiency in tax administration and revenue collection through the integration of a diversity of sales, service, and excise taxes. The authorities expected that a political decision regarding the endorsement of the VAT would be taken soon.

In the nonfinancial public enterprise sector, the sizable overall operating surplus reflected a strong performance of the petroleum industry (Petronas), but masked the operational and financial difficulties faced by a number of other enterprises, notably in gas, steel, and cement. While the authorities' restructuring program has had positive results, some of the enterprises continue to require federal budget allocations to cover operating expenses, especially debt servicing. A new package of measures aimed at the rehabilitation of the ten largest public enterprises encompasses a restructuring of capital, improvements in production structure, cost efficiency, marketing, and internal controls, and the revamping of management through the involvement of private sector and foreign expertise. Further steps, involving closure, have been initiated with respect to a large group of ailing small public enterprises upon recommendations by private consultants.

CHART 6
MALAYSIA
SAVINGS AND INVESTMENT, 1973-89



The authorities are preparing a comprehensive Privatization Master Plan that identifies companies to be privatized and establishes priorities, procedures, and institutional conditions for the implementation of the program.

There remains scope to enhance the allocative efficiency of the financial system, in particular, the need to make interest rates more responsive to market forces. A first step would be to change the system of establishing a basic lending rate. The authorities expressed their willingness to explore this possibility and indicated their interest in Fund technical assistance.

Alternative external outcomes have important implications for external debt and reserve management. In discussing policy options, the authorities gave emphasis to their prudent external borrowing policy. Under less favorable external conditions, they would not finance higher current account deficits through higher foreign borrowing in order to maintain the target growth rate. Instead, they would tighten financial policies and accept a lower growth rate in order to keep external debt at prudent levels. If external conditions were more favorable, they would further strengthen the reserve position--which they perceived as being somewhat low--but also pursue more expansionary policies aimed at achieving a higher growth rate. At the same time, they would be prepared to see a further strengthening of the exchange rate which would reduce price pressures. They reiterated the importance of maintaining a strong reserve position in light of the highly volatile nature of Malaysia's commodity exports and capital flows. Also, as experience had shown, with an open capital market, Malaysia could incur severe foreign exchange losses during periods of speculative activity originating in factors unconnected to economic fundamentals. Even a limited drop in reserves could affect Malaysia's external creditworthiness and raise the costs of foreign borrowing.

The staff concurred with the authorities on their foreign borrowing policy and also on the need for a conservative approach to reserve management. Indeed, the fluctuations in Malaysia's terms of trade were much wider than those experienced by other developing countries (Chart 7). However, if external conditions turn out significantly better than presently projected, the concern for strengthening the reserve position would have to be balanced against the desirability of achieving a higher growth rate. It would thus be advisable to pursue moderately expansionary financial policies--to the extent that the real constraints to the absorptive capacity of the economy make this feasible--and to accept an appreciation of the exchange rate.

VIII. Staff Appraisal

The Malaysian economy has shown extraordinary vigor during the present recovery. Growth, private investment, and the balance of

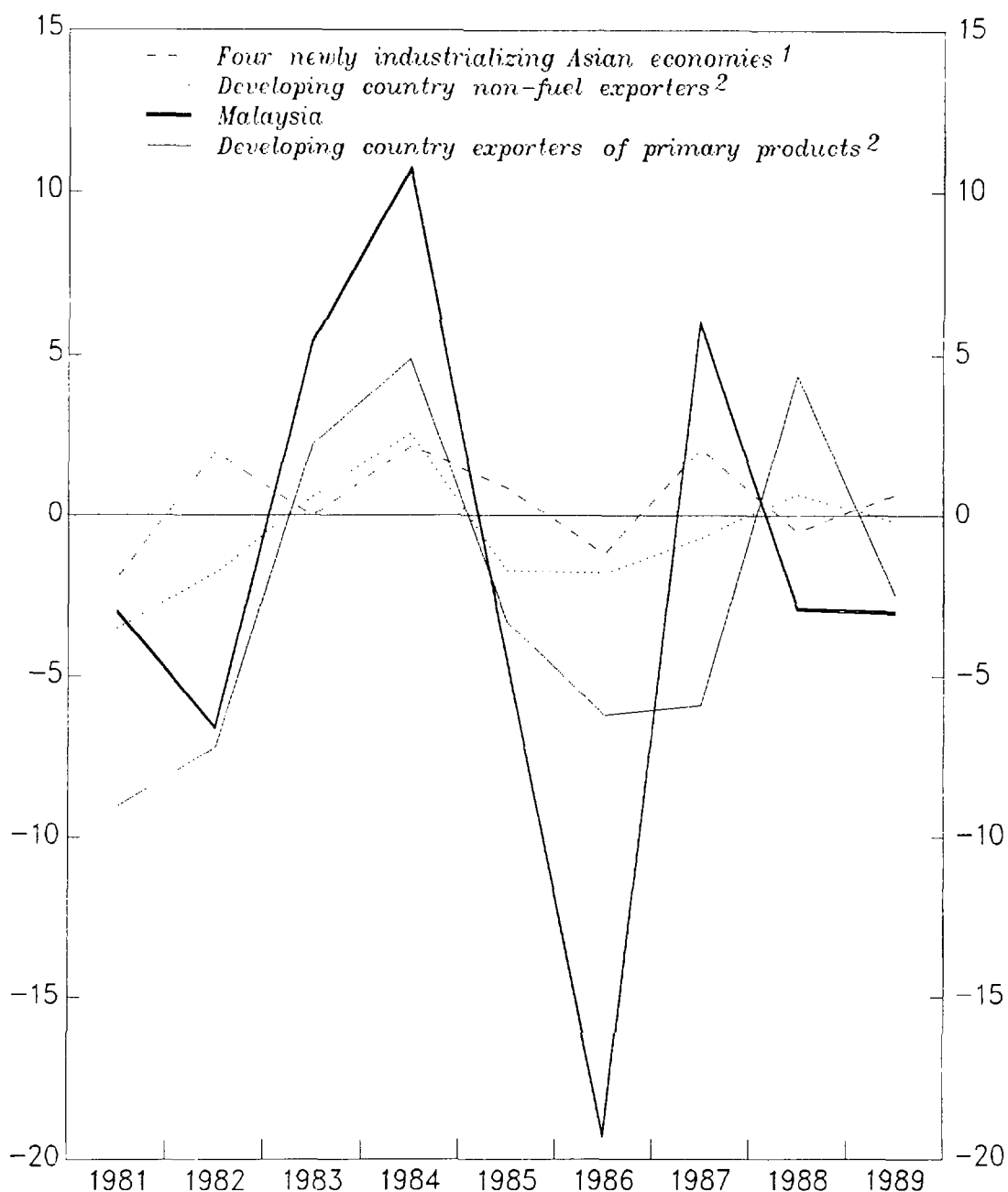
payments strengthened in 1988 beyond expectations while inflation was kept low. Whereas favorable international conditions, in particular strong demand for industrial goods and high commodity prices, played an important role, the main credit goes to effective economic management: far-reaching adjustment measures undertaken during the preceding years, as well as an exchange rate depreciation, created the conditions for the recovery; once recovery was under way, further structural reforms and appropriate financial policies provided the necessary support.

The outlook is for continued strong growth, with somewhat weaker international conditions being offset by buoyant domestic demand. While the current account surplus is likely to be smaller, the balance of payments position remains comfortable. Price developments, however, warrant increased attention. There may be a lagged impact of last year's depreciation as well as the increase in commodity prices; monetary conditions are still relatively easy; and capacity constraints in some areas may well emerge as the economy moves through the third year of recovery.

Fiscal policy has achieved a significant success in consolidation, with the budget on current account last year and this year being close to balance. Because of higher infrastructure investment, the overall deficit is budgeted to increase in 1989. The increase can be moderated, however, since both oil and non-oil revenues are likely to exceed the budget forecast. Given the need for greater vigilance on the price front, the authorities should resist pressures for expenditure increases above budgeted levels and should use additional revenue to reduce the deficit. The likely budgetary outcome for 1989 is consistent with the macroeconomic targets. There is, nevertheless, a need for further fiscal consolidation over the medium term. This should ensure the achievement of a sufficiently high savings rate and also allow a greater role of the private sector in development, which the authorities envisage. There are also important microeconomic aspects of public expenditure allocation and control. The need continues for careful monitoring of expenditure, eliminating low-priority expenditures, reducing budgetary support to public enterprises and statutory bodies, and improvements in project implementation.

Although monetary expansion was lower in 1988 than planned at the outset, it was possible to expand credit to the private sector considerably more than foreseen because of the reduced recourse of the Government to the banking system. The authorities have set a range of 8-10 percent for monetary expansion (M3) in 1989. As the rising trend in velocity since 1987 has shown no sign of being reversed, and given the potential for rising inflationary pressures, it would be appropriate to regard the lower end of the range as an orientation for monetary policy. Some tightening of monetary policy now might obviate the need for a more pronounced change at a later stage. A consequent firming of short-term interest rates would be consistent with the authorities'

CHART 7
MALAYSIA
TERMS OF TRADE, 1981-89
(Percent change)



Source: IMF, *World Economic Outlook* (April 1989).

1. Korea, Singapore, Hong Kong, and Taiwan Province of China. It should be noted that the term "country" used in this report does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

2. As defined in *World Economic Outlook* (April 1989).

objectives of maintaining a strengthened ringgit and achieving a reflow of short-term capital.

The authorities have reconfirmed their policy to allow the market to determine the trend of the exchange rate. The recent change in the trend of the ringgit rate from depreciation to appreciation is consistent with the underlying balance of payments position, which is expected to remain strong. As the competitiveness of Malaysian exports is now about appropriate, there is no immediate need for a substantial change in the exchange rate.

As a result of past policies, the Malaysian economy is in a much stronger position than at the beginning of the decade. Sustained high growth now appears feasible, together with a reasonably comfortable external position. The realization of high growth over the medium term takes on a sense of urgency, given the need to absorb a rapidly growing labor force--in addition to the existing high number of unemployed--and to generate the resources needed to implement the Government's long-standing policies to alleviate poverty and improve social conditions. Continued policy efforts are required to achieve rapid development, in particular in removing remaining impediments to private investment, strengthening public sector management, and improving the functioning of the labor market.

While the buoyant private investment has relegated some of last year's concerns into the background, impediments to private investment could become a source of concern again, once the cyclical investment boom gives way to a more normal pace of expansion. Deregulation, a simplification of procedures, and a relaxation of licensing conditions, particularly at the state and local levels, should therefore be continued, as well as the rationalization of taxation. Equally, privatization and government withdrawal from areas of private production remain important.

The need for higher public investment in infrastructure is recognized. A strengthening of the tax base is necessary to ensure that the desired public investment expansion is accomplished within a framework of further fiscal consolidation. The introduction of a VAT was proposed during last year's consultation, and it is hoped that the Government will come to a final decision soon. Besides tax reform, the authorities' plans for enforcing financial discipline in the statutory bodies and for further reform of public enterprises are important to ease the burden on the budget.

The concern about high unemployment, already expressed during last year's consultation, has heightened as the unemployment rate has hardly reacted to the cyclical upswing. While the reasons are complex, there is evidence that the problem is partly a result of labor market rigidities. Recent changes in the labor laws have been a first step in easing these rigidities, but further steps are required to effectively address

the problem. It must be recognized, however, that this is a politically sensitive issue, and its resolution will take time. The planned review of the education and training system with a view to achieving a better match of labor supply and demand should also help.

According to the staff's medium-term scenario, external developments would allow some further reserve buildup, which the authorities regard as desirable. Considering the large variability in the terms of trade for Malaysia, the comparatively high degree of openness of the Malaysian economy, and the past experience of vulnerability to foreign exchange speculation, there is a case for a modest buildup of Malaysia's reserve position. However, should the balance of payments be significantly stronger than currently projected, the potential for further reserve accumulation would have to be balanced against the possibility of higher growth, and the authorities should give preference to this latter option.

The Malaysian economy is going through a period of rapid change, which will not only prove decisive to the country's future but will be observed with great interest by the international community. It is recommended that the next Article IV consultation with Malaysia be held on the standard 12-month cycle.

Table 1. Malaysia: Selected Economic and Financial Indicators, 1984-89

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 Proj. 1/ |
|---|--------|---------|---------|---------|--------|------------------|
| (Annual percentage changes; unless otherwise specified) | | | | | | |
| Production, prices, and employment | | | | | | |
| Real GDP | 7.8 | -1.0 | 1.2 | 5.2 | 8.7 | 7.3 |
| Real domestic demand | 4.1 | -6.8 | -10.2 | 3.6 | 15.7 | 10.1 |
| Total consumption | 3.4 | 0.2 | -7.3 | 2.3 | 14.7 | 9.6 |
| Total investment | 5.5 | -19.7 | -16.9 | 7.0 | 18.1 | 11.4 |
| Of which: Private fixed investment | (10.5) | (-8.6) | (-16.3) | (4.1) | (26.4) | (15.5) |
| Public fixed investment | (-4.3) | (-10.4) | (-20.7) | (-14.6) | (5.7) | (28.4) |
| Net exports 2/ | 3.4 | 5.9 | 11.1 | 2.1 | -4.6 | -1.8 |
| Consumer prices (period average) | 3.9 | 0.3 | 0.7 | 0.8 | 2.5 | 4.0 |
| Unemployment rate 3/ | 6.3 | 6.9 | 8.3 | 8.2 | 8.1 | 7.9 |
| Federal government budget | | | | | | |
| Revenue | 11.6 | 1.6 | -7.6 | -7.2 | 13.0 | 10.1 |
| Expenditure 4/ | 0.7 | -1.2 | 5.3 | -8.5 | 3.7 | 18.5 |
| Operating expenditure | 8.4 | 7.4 | 7.1 | 0.5 | 6.0 | 8.3 |
| Development expenditure | -14.5 | -16.5 | 2.2 | -41.6 | -3.4 | 75.3 |
| Monetary aggregates and interest rates | | | | | | |
| Total liquidity (M3) | 14.9 | 9.2 | 7.7 | 4.3 | 7.0 | 8.0 5/ |
| Domestic credit | 20.1 | 8.6 | 6.8 | 3.6 | 7.8 | 10.3 5/ |
| Credit to Government, net | 14.2 | -27.3 | 12.4 | 34.3 | -14.5 | 17.6 5/ |
| Private sector | 21.2 | 14.6 | 6.2 | 0.1 | 11.2 | 9.4 5/ |
| Money velocity (M3) | 1.23 | 1.09 | 0.94 | 1.02 | 1.10 | 1.13 5/ |
| Interest rates 6/ | | | | | | |
| Deposits (one-year) 6/ | 10.8 | 7.5 | 7.0 | 4.3 | 4.3 | 5.3 7/ |
| Average lending rate 6/ | 13.1 | 12.1 | 12.0 | 9.8 | 9.0 | 9.0 7/ |
| External sector | | | | | | |
| Exports, f.o.b. (US\$) | 19.9 | -7.8 | -9.5 | 29.2 | 18.0 | 10.0 |
| Imports, f.o.b. (US\$) | 1.3 | -13.9 | -10.9 | 15.7 | 29.1 | 20.6 |
| Export volume | 11.2 | 5.6 | 13.1 | 15.8 | 13.0 | 9.5 |
| Import volume | 11.6 | -5.4 | -10.7 | 10.6 | 22.3 | 15.4 |
| Terms of trade | 10.7 | -4.5 | -19.3 | 6.1 | -2.9 | -3.0 |
| Real effective exchange rate (depreciation -) | 2.2 | -10.7 | -11.4 | -10.3 | -7.6 | -0.4 8/ |

Table 1. Malaysia: Selected Economic and Financial Indicators, 1984-89 (concluded)

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 Proj. ^{1/} |
|---|--------|--------|--------|--------|--------|-----------------------------|
| (In billions of U.S. dollars) | | | | | | |
| Balance of payments | | | | | | |
| Current account balance | -1.7 | -0.6 | -- | 2.6 | 1.9 | 0.4 |
| Overall balance | 0.3 | 1.2 | 1.1 | 1.5 | -1.0 | 1.3 |
| Gross official reserves | 4.3 | 5.4 | 6.4 | 7.9 | 6.8 | 8.0 |
| (In months of imports) | (3.9) | (5.6) | (7.5) | (7.9) | (5.3) | (5.2) |
| External debt | 17.9 | 20.1 | 21.8 | 22.2 | 19.3 | 18.5 |
| Debt service | 2.5 | 3.1 | 3.3 | 3.5 | 3.4 | 3.4 |
| Of which: Interest payments | (1.5) | (1.6) | (1.5) | (1.6) | (1.4) | (1.3) |
| (In percent of GNP) | | | | | | |
| Federal government budget | | | | | | |
| Revenue | 27.8 | 29.1 | 29.2 | 23.9 | 23.4 | 23.3 |
| Total expenditure | 34.5 | 35.0 | 40.0 | 32.3 | 29.0 | 31.1 |
| Current expenditure | 23.5 | 25.9 | 30.2 | 26.7 | 24.5 | 24.1 |
| Development expenditure | 10.8 | 9.3 | 10.3 | 5.3 | 4.5 | 7.0 |
| Overall balance | -6.6 | -5.9 | -10.9 | -8.4 | -5.6 | -7.8 |
| Gross national savings | 30.7 | 27.6 | 27.2 | 34.5 | 33.1 | 29.7 |
| Private savings (residual) | (18.0) | (14.2) | (20.7) | (29.6) | (28.3) | (24.9) |
| Public savings | (12.7) | (13.4) | (6.5) | (4.9) | (4.8) | (4.8) |
| Gross investment | 36.0 | 29.7 | 27.1 | 25.7 | 27.3 | 28.6 |
| Of which: Private fixed investment | (18.0) | (17.0) | (15.5) | (14.4) | (16.3) | (17.7) |
| Public fixed investment | (16.2) | (15.1) | (13.0) | (9.9) | (9.4) | (11.3) |
| External current account | -5.3 | -2.1 | 0.1 | 8.8 | 5.8 | 1.1 |
| External debt | 58.4 | 67.6 | 85.4 | 73.6 | 60.4 | 52.4 |
| Debt service ratio ^{9/} ^{10/} | 11.8 | 15.8 | 18.7 | 16.0 | 13.4 | 12.2 |

Sources: Ministry of Finance, Economic Report, 1988/89; Bank Negara Malaysia, Annual Report, 1988; data provided by the Malaysian authorities; IMF, International Financial Statistics; and staff estimates and projections.

^{1/} Official and staff projections.

^{2/} Contribution to percent change in real GDP.

^{3/} Average, in percent of labor force.

^{4/} Includes adjustments for accounts payable.

^{5/} Projections consistent with lower limit of the authorities' 8-10 percent target zone for growth of total liquidity (M3).

^{6/} End of period.

^{7/} February 1989 data.

^{8/} IMF, Information Notice System (1980=100); end-period. Percentage change over the 12-month period to June 1989.

^{9/} Medium- and long-term debt.

^{10/} As a ratio of exports of goods and services.

Table 2. Malaysia: Social and Demographic Indicators

| | 1975 | Most Recent Estimate |
|---|-------|----------------------|
| Population characteristics | | |
| Population (millions) | 12.3 | 17.6 |
| Population density (per sq. km.) | 37.3 | 53.3 |
| Population growth (percent) | 2.6 | 2.4 |
| Crude birth rate (per 1,000) | 32 | 31 |
| Crude death rate (per 1,000) | 9 | 6 |
| Infant mortality rate (per 1,000) | 37 | 14 |
| Life expectancy at birth | 64 | 70 |
| Access to safe water (percent of population) | 34 | 71 |
| Access to electricity (percent of dwellings) | 43 | 64 |
| Nutrition | | |
| Per capita supply of energy (calories per day) | 2,543 | 2,730 |
| Per capita supply of protein (grams per day) | 55 | 46 |
| Health | | |
| Population per physician (thousand persons) | 4.3 | 1.9 |
| Population per hospital bed (thousand persons) | 0.3 | 0.4 |
| Education | | |
| Primary school enrollment (percent) | 91 | 101 |
| Secondary school enrollment (percent) | 42 | 53 |
| Primary school pupil/teacher ratio | 32 | 24 |
| Secondary school pupil/teacher ratio | 27 | 22 |
| GNP per capita (US\$) | 820 | 2,010 |
| Absolute poverty income level per capita (US\$) | | |
| Urban | 124 | 314 |
| Rural | 112 | 289 |
| Poverty incidence (percent) | | |
| Urban | 21 | 13 |
| Rural | 59 | 38 |

Sources: World Bank, Social Indicators of Development, 1988 and World Development Report, 1989; and Ministry of Finance, Economic Report, 1988/89.

Table 3. Malaysia: Budgetary Developments, 1984-89

| | 1984 | 1985 | 1986 | 1987 | 1988 Prelim. | 1989 Budget Official Est. | |
|--|--------|--------|--------|--------|-----------------|---------------------------------|--------|
| (In millions of ringgit) | | | | | | | |
| Total revenue and grants | 20,647 | 20,970 | 19,368 | 17,974 | 20,316 | 21,364 | 22,366 |
| Tax revenue | 17,208 | 17,499 | 15,459 | 13,245 | 15,518 | 15,674 | 16,639 |
| Non-petroleum tax revenue | 12,185 | 11,773 | 10,017 | 9,299 | 10,696 | 11,387 | 12,040 |
| Taxes on net income and profits | 5,412 | 5,681 | 5,218 | 4,597 | 4,972 | 5,304 | 5,506 |
| Sales tax and excises | 3,459 | 3,319 | 2,857 | 2,859 | 3,398 | 3,467 | 3,725 |
| Taxes on international trade | 2,819 | 2,298 | 1,554 | 1,476 | 1,965 | 2,180 | 2,368 |
| Petroleum tax revenue | 5,023 | 5,726 | 5,442 | 3,946 | 4,822 | 4,287 | 4,599 |
| Oil production companies | 2,570 | 3,130 | 3,072 | 1,533 | 2,208 | 1,623 | 1,988 |
| Excises and duties | 2,453 | 2,596 | 2,370 | 2,413 | 2,614 | 2,664 | 2,611 |
| Nontax revenue | 3,380 | 3,469 | 3,909 | 4,729 | 4,798 | 5,690 | 5,727 |
| Petroleum | 1,561 | 1,549 | 1,549 | 2,410 | 2,499 | 2,797 | 2,834 |
| Other | 1,819 | 1,920 | 2,360 | 2,319 | 2,299 | 2,893 | 2,893 |
| Total expenditure and net lending | 25,556 | 25,242 | 26,569 | 24,304 | 25,208 | 29,088 | 29,884 |
| Current expenditure | 17,414 | 18,696 | 20,028 | 20,134 | 21,352 | 22,329 | 23,125 |
| Wages and salaries | 6,698 | 6,953 | 7,476 | 7,562 | 7,801 | 8,500 | 8,568 |
| Other expenditures on goods and services | 2,438 | 2,514 | 2,585 | 2,395 | 2,445 | 2,833 | 2,833 |
| Subsidies and transfers | 3,858 | 4,197 | 4,735 | 4,418 | 4,937 | 4,998 | 5,004 |
| Interest | 4,420 | 5,032 | 5,232 | 5,759 | 6,169 | 5,998 | 6,720 |
| Development expenditure | 8,013 | 6,690 | 6,837 | 3,992 | 3,856 | 6,759 | 6,759 |
| Direct expenditure | 4,279 | 3,836 | 4,342 | 3,163 | 3,286 | 5,444 | 5,444 |
| Net lending | 3,734 | 2,854 | 2,495 | 829 | 570 | 1,315 | 1,315 |
| Overall balance | -4,909 | -4,272 | -7,201 | -6,330 | -4,892 | -7,724 | -7,518 |
| Current balance | 3,233 | 2,274 | -660 | -2,160 | -1,036 | -965 | -759 |
| Primary balance ^{1/} | -489 | 760 | -1,969 | -571 | 1,277 | -1,726 | -798 |
| Overall financing (net) | 2,901 | 6,682 | 8,113 | 5,073 | 3,342 | 7,723 | 8,566 |
| External (net) | 3,093 | 956 | 1,348 | -2,438 | -3,137 | -815 | -321 |
| Domestic (net) | -192 | 5,726 | 6,765 | 7,511 | 6,479 | 8,538 | 8,886 |
| Banking System ^{2/} | -1,030 | 402 | 1,866 | 1,886 | 192 | 2,808 | 4,536 |
| Central Bank ^{3/} | -714 | -28 | 555 | -1,347 | -6 | 678 | 2,148 |
| Commercial banks | 686 | -299 | -153 | 2,911 | 310 | 120 | -56 |
| Change in Govt. cash balances | -1,002 | 729 | 1,464 | 322 | -112 | 974 | 2,444 |
| Nonbanks | 838 | 5,324 | 4,899 | 5,625 | 6,287 | 5,730 | 4,350 |
| Employees Provident Fund | 2,773 | 3,403 | 3,395 | 4,246 | 3,987 | 4,230 | 3,000 |
| Petronas | -2,034 | 1,402 | 1,070 | 783 | 1,000 | 1,000 | 1,000 |
| Other | 99 | 519 | 434 | 596 | 1,300 | 500 | 350 |
| (In percent of GNP) | | | | | | | |
| Memorandum items: | | | | | | | |
| Overall balance | -6.6 | -5.9 | -10.9 | -8.4 | -5.6 | -9.0 | -7.8 |
| Current balance | 4.4 | 3.2 | -1.0 | -2.9 | -1.2 | -1.1 | -0.8 |
| Primary balance | -0.7 | 1.1 | -3.0 | -0.8 | 1.5 | -2.0 | -0.8 |

Source: Data provided by the Malaysian authorities.

^{1/} Excludes interest payments.^{2/} Includes float and timing differences in recording between the Treasury and Bank Negara Malaysia as well as unallocable sources.^{3/} Includes share sales of M\$994 million to Bank Negara Malaysia in 1988 and 1989.

Table 4. Malaysia: Monetary Survey, 1984-89 1/

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 Feb. |
|---|----------|--------|--------|--------|--------|--------------|
| | December | | | | | |
| (In millions of ringgit; end of period) | | | | | | |
| Foreign assets, net | 5,806 | 9,124 | 14,252 | 19,426 | 20,772 | 20,684 |
| Domestic credit | 66,913 | 72,646 | 77,593 | 80,406 | 86,705 | 91,584 |
| Claims on Government, net | 9,698 | 7,050 | 7,923 | 10,644 | 9,113 | 12,041 |
| Claims on private sector | 57,215 | 65,596 | 69,670 | 69,762 | 77,592 | 79,543 |
| Total liquidity (M3) <u>2/</u> | 60,076 | 65,628 | 70,701 | 73,771 | 78,937 | 80,838 |
| Other items (net) | 12,643 | 16,142 | 21,144 | 26,061 | 28,540 | 31,430 |
| Memorandum items: | | | | | | |
| Narrow money (M1) | 13,999 | 14,356 | 14,803 | 16,708 | 19,130 | 20,077 |
| Broad money (M2) | 49,074 | 51,842 | 57,233 | 60,352 | 63,929 | 65,005 |
| (12-month rate of change) | | | | | | |
| Foreign assets (net) | -22.2 | 57.1 | 56.2 | 36.3 | 6.9 | 14.9 |
| Domestic credit | 20.1 | 8.6 | 6.8 | 3.6 | 7.7 | 10.7 |
| Government (net) | 14.2 | -27.3 | 12.4 | 34.6 | -14.5 | -2.0 |
| Private sector | 21.2 | 14.6 | 6.2 | 0.1 | 11.1 | 12.9 |
| Total liquidity (M3) | 14.9 | 9.2 | 7.7 | 4.3 | 7.0 | 7.9 |
| Narrow money (M1) | -0.3 | 2.6 | 3.1 | 12.9 | 14.5 | 14.3 |
| Broad money (M2) | 11.8 | 5.6 | 10.4 | 5.4 | 5.9 | 6.3 |

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

1/ Consolidation of the accounts of the monetary authorities, commercial banks, finance companies, merchant banks, and discount houses.

2/ Includes currency outside banks; demand, fixed, and savings deposits; and negotiable certificates of deposit (NCDs), but excludes NCDs held by financial institutions.

Table 5. Malaysia: Balance of Payments, External Debt, and International Reserves, 1984-89

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 Proj. <u>1/</u> |
|--|--------------|-------|-------|-------|-------|-------------------------|
| (In billions of U.S. dollars) | | | | | | |
| Balance of payments | | | | | | |
| Current account | -1.7 | -0.6 | -- | 2.6 | 1.9 | 0.4 |
| Trade balance (f.o.b.) | 3.0 | 3.6 | 3.4 | 5.8 | 5.5 | 4.4 |
| Exports | 16.4 | 15.1 | 13.7 | 17.7 | 20.9 | 23.0 |
| Imports | -13.4 | -11.6 | -10.3 | -11.9 | -15.4 | -18.6 |
| Services and transfers (net) | -4.7 | -4.2 | -3.4 | -3.2 | -3.6 | -4.0 |
| Capital account (net) | 2.7 | 2.1 | 1.3 | -1.6 | -2.2 | 1.3 |
| Official <u>2/</u> | 2.0 | 1.0 | 0.8 | -1.0 | -1.9 | -- |
| Private <u>2/</u> | 0.8 | 0.7 | 0.5 | 0.4 | 0.6 | 0.7 |
| Direct investment, net | 0.7 | 0.6 | 0.7 | 1.0 | 1.1 | 1.1 |
| Short-term, net | -0.1 | 0.4 | -- | -1.0 | -0.9 | 0.6 |
| Errors and omissions <u>3/</u> | -0.7 | -0.2 | -0.2 | 0.4 | -0.8 | -0.4 |
| Overall balance | 0.3 | 1.2 | 1.1 | 1.5 | -1.0 | 1.3 |
| Outstanding external debt <u>4/</u> | 17.9 | 20.1 | 21.8 | 22.2 | 19.3 | 18.5 |
| Medium- and long-term | 15.3 | 17.4 | 19.3 | 20.2 | 17.4 | 16.0 |
| Public sector <u>5/</u> | 12.6 | 14.4 | 16.5 | 17.8 | 15.5 | 14.7 |
| Private sector | 2.8 | 3.0 | 2.9 | 2.4 | 1.9 | 1.3 |
| Short-term | 2.5 | 2.7 | 2.4 | 2.0 | 1.9 | 2.5 |
| Debt service | 2.5 | 3.1 | 3.3 | 3.5 | 3.4 | 3.4 |
| Amortization | 1.0 | 1.4 | 1.6 | 1.8 | 2.0 | 2.1 |
| Interest payments | 1.5 | 1.6 | 1.5 | 1.6 | 1.4 | 1.3 |
| Total prepayments | 0.2 | 2.2 | 0.2 | 1.2 | 1.5 | 0.6 |
| Of which: Federal Government | 0.2 | 2.2 | 0.2 | 1.0 | 1.3 | 0.3 |
| Gross official reserves | 4.3 | 5.4 | 6.4 | 7.9 | 6.8 | 8.0 |
| (In months of imports) | (3.9) | (5.6) | (7.5) | (7.9) | (5.3) | (5.2) |
| Memorandum items: | (In percent) | | | | | |
| Current account/GNP | -5.3 | -2.1 | 0.1 | 8.8 | 5.8 | 1.1 |
| External debt/GNP <u>2/</u> | 50.1 | 58.6 | 75.9 | 66.9 | 54.4 | 45.3 |
| Debt service payments/ current receipts <u>2/</u> | 11.8 | 15.8 | 18.7 | 16.0 | 13.4 | 12.2 |
| Short-term debt/total debt | 14.2 | 13.4 | 11.1 | 9.1 | 9.9 | 13.1 |

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

1/ Official and staff projections.

2/ Medium- and long-term.

3/ Includes valuation adjustments for exchange rate changes.

4/ End of period.

5/ Includes loans to public sector entities not guaranteed by the Federal Government.

Malaysia

Medium-Term Scenario--Technical Aspects

This annex provides additional details on the framework used to obtain the staff projections for the medium-term scenario. This framework has two main series of projections, those for the balance of payments and those for macroeconomic flows, both of which are derived in a consistent fashion.

1. Balance of payments projections

Given the importance of commodities in Malaysia's exports, projecting the volume and prices of commodity exports was the first step in the balance of payments projections. Capacity constraints and technical factors--such as the cycle of rubber-tree production--were the basic elements in projecting production volumes, together with information on government policy provided by the Malaysian authorities. Commodity prices were assumed to move over 1990-94 as projected by the WEO exercise. Thus, existing price differentials (such as the quality premium paid on Malaysian oil) were built into the projections.

Manufactured exports were assumed to be a function of economic growth in Malaysia's trading partners. The elasticity of these exports with respect to income in trading partners was projected to fall gradually over time, as Malaysia's market share in foreign markets stabilizes.

Malaysia's imports were disaggregated into imports of consumption goods, investment goods, intermediate goods, goods for re-export, and other. The projections of imports of consumer goods took into account both the pent-up demand for such goods during the recession years and import substitution effects by gradually lowering the income elasticity of the import volumes. However, it was also assumed that the unit value of those imports will rise over time, as demand moves to higher-quality products and domestic supply substitutes for lower-end imports.

The import volume of investment goods was projected to move in line with total investment; the unit value of these goods was projected to change at the same rate as the unit value of consumption goods imports. The volume of intermediate goods imports in Malaysia is largely a derived demand function of manufactured exports: therefore, it was projected to grow at the same rate as those exports. The unit value was assumed to be a constant share of the unit value of manufactured exports. 1/ Imports for re-export were projected to grow in

1/ Manufactured exports have a high import content.

line with the volume and unit value of the re-exported products (rubber and tin).

For the services, separate projections were made for profits, interest receipts, interest payments, and nonfinancial services. Profits were projected assuming a marginal rate of profit on new direct investment of 6.5 percent, 1/ which was assumed to fall gradually, stabilizing at 4.5 percent as of 1992. Interest receipts were projected assuming that Malaysia's foreign exchange reserves would be remunerated at the LIBOR. Interest payments were based on the Central Bank's projections, adjusted to reflect the fact that roughly one half of Malaysia's outstanding public debt, carries a fixed interest rate. Private debt (long- and short-term), as well as new public debt was assumed to carry LIBOR. Nonfinancial services (in which freight and insurance have the largest share) were assumed to move in line with total trade, minus an adjustment factor to take account of the growing importance of domestic shipping and insurance.

Capital flows were projected as follows: the projected amortization of outstanding medium- and long-term debt 2/ was based on a schedule provided to the mission by the Central Bank; new debt was assumed to carry a three-year grace period and a five-year amortization schedule. Projected drawings of the public sector were also based on projections made by the Central Bank and discussions held with the Ministry of Finance.

For the private sector, 1990 drawings of medium- and long-term debt were assumed to cover 70 percent of the amortization of outstanding debt falling due that year. For the rest of the projection period, drawings were projected to exceed such amortization by small but growing amounts. Modest short-term capital inflows were projected after 1991, as the inflow of funds currently being repatriated by the banking system was expected to be completed in 1990. Direct investment was assumed to stabilize at a somewhat lower level than the 1989 record amount.

2. Macroeconomic flows

The second part of the framework presents projections of the main macroeconomic flows. Domestic investment was projected using an incremental capital-output ratio (ICOR) of 4.5 and no change in stocks. The ICOR figure was projected on the basis of discussions held with the Malaysian authorities. The figures for public investment and savings were based on the medium-term fiscal objectives explained to the mission by the Malaysian authorities. Both private investment and private savings are derived residually, after incorporating the current account balance projections.

1/ This is the average profitability ratio for 1985 reported in the 1988 IBRD Country Economic Memorandum for Malaysia (it is also close to the 1981-85 average).

2/ Includes debt outstanding as of end-1988 only.

Malaysia--Fund Relations
(As of July 31, 1989)

I. Membership status

- (a) Date of membership: March 7, 1958
(b) Status: Article VIII

A. Financial Relations

II. General Department

- (a) Quota: SDR 550.6 million
(b) Fund holdings of ringgit: SDR 380.6 million
(69.1 percent of quota)
(c) Fund credit: None
(d) Reserve tranche position: SDR 170.1 million
(e) Current operational budget
(maximum use):
Transfers SDR 8.8 million
Receipts SDR 8.4 million
(f) Lending to the Fund: None

III. Stand-by or extended arrangements and special facilities

- (a) Current stand-by or
extended arrangements: None
(b) Special facilities:

| <u>Type</u> | <u>Date of Approval</u> | <u>Amount</u> (SDR mn.) |
|---------------|-------------------------|----------------------------|
| CFF | 9/16/81 | 189.8 |
| BSFF (tin) | 6/23/82 | 58.5 |
| BSFF (rubber) | 3/11/83 | 67.8 |
| BSFF (tin) | 3/11/83 | 45.2 |

IV. SDR Department

- (a) Net cumulative allocation: SDR 139.05 million
(b) Holdings: SDR 123.1 million (88.5 per-
cent of net cumulative
allocation)
(c) Designation Plan: Included but the calculated
amount was zero

V. Administered Accounts

(see EBS/89/127; June 26, 1989)

Malaysia--Fund Relations (continued)

| | Overdue Financial Obligations | <u>Principal and interest due</u> | | | |
|---------------------------------------|-------------------------------------|-----------------------------------|------|------|------|
| | | 1989 Aug.-Dec. | 1990 | 1991 | 1992 |
| <hr/> | | | | | |
| | | <u>(In millions of SDRs)</u> | | | |
| Principal Repurchases | -- | -- | -- | -- | -- |
| Charges and interest (Provisional) | -- | 0.6 | 1.2 | 1.2 | 1.2 |
| Total | -- | 1.6 | 1.2 | 1.2 | 1.2 |

VI. Use of Fund resources to date

Yes.

B. Nonfinancial Relations

VII. Exchange rate arrangement

Exchange rates are determined on the basis of supply and demand conditions in the foreign exchange market. The Central Bank of Malaysia intervenes in order to maintain orderly market conditions and to avoid excessive fluctuations in the value of the ringgit vis-a-vis an undisclosed basket of currencies of Malaysia's major trading partners, which has weights reflecting the importance of these currencies in trade and settlements. The representative exchange rate of the ringgit under Rule 0-2 is the midpoint between the buying and selling rates for the U.S. dollar, which is the intervention currency, quoted at noon on the Kuala Lumpur foreign exchange market; the midpoint on July 31, 1989 was M\$2.632 per US\$1. Malaysia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Payments and transfers for current international transactions are free of restrictions. Capital transactions above certain limits require prior approval; approvals are freely given except for investments in Israel and South Africa by Malaysian residents.

VIII. Last Article IV consultation

Staff discussions were held during May 3-16, 1988 (SM/88/139; SM/88/147), and the Executive Board discussed the staff report on July 27, 1988.

Malaysia--Fund Relations (concluded)

IX. Technical assistance (from 1985 to date)

(a) Central Banking Department: An advisor for economic research and econometric modeling (from February 1985, for two years). Two advisors for bank examination and for updating of a bank inspection manual (both for six months from July and November 1986, respectively). Studies on the government securities market and on the construction of cost-of-funds indicators (September 1986). An advisor on general economic statistics (from December 1987, for three months). Second phase of the study on government securities market (January-February 1988). An advisor on bank supervision to complete a manual for Bank Negara Malaysia (from March 1989, for one year).

(b) Bureau of Computing Services: Review of electronic data processing needs (February 1989).

(c) Bureau of Statistics: Public enterprise statistics (May-June 1985); financial statistics (November 1985); public enterprise statistics (July 1986); general economic statistics (May 1987); and local government finance statistics (November 1987).

X. Resident Representative/Advisor:

None.

Malaysia--Relations with the World Bank Group

The Bank has maintained an active dialogue with the Malaysian authorities on a range of macroeconomic and sectoral issues. It has continued to support the authorities' efforts to contain the public sector deficit and reorient priorities, giving more emphasis to considerations of economic efficiency. In the recent past, the Bank undertook a number of sectoral studies on development banks, the power, transport, housing, and rice sectors, and on municipal finances and liability management. Its last economic memorandum was issued in October 1988. The Bank staff is continuing to discuss with the authorities proposals for industrial restructuring, privatization of nonfinancial public enterprises, and poverty alleviation.

IBRD Lending (as of June 30, 1989):

(In millions of U.S. dollars)

| | |
|---------------------------------|----------|
| Total loans approved <u>1/</u> | 2,301.52 |
| Repaid: | 738.03 |
| Total commitments in FY 1988: | 130.3 |
| Total disbursements in FY 1988: | 162.6 |

(In percent)

| | | |
|---|-------------|------------|
| Total commitments (FY 1981-88): <u>1/</u> | | |
| Agriculture and rural development | 415.1 | 31.2 |
| Power | 276.3 | 20.8 |
| Education | 401.9 | 30.3 |
| Transportation | 80.8 | 6.1 |
| Industry | 92.0 | 6.9 |
| Water supply | <u>62.0</u> | <u>4.7</u> |
| Total | 1,328.1 | 100.0 |

| | |
|--------------------------------------|--|
| Technical assistance: | The IBRD provides technical assistance to Malaysia through its standard lending operations for projects. |
| Recent economic and sector missions: | "Liability Management Study" (November-December 1988); "Education Sector Study" (April 1989). |

1/ Less cancellations.

Malaysia--Relations with the Asian Development Bank

The Asian Development Bank (AsDB) has been active in lending to Malaysia for projects in agriculture, energy, transport and communications, education, water supply, urban development, and health. Sixty-four loans totaling US\$1.4 billion have been approved since 1968 and have come mostly from the AsDB's ordinary resources. As of June 1989, cumulative disbursements amounted to US\$656.2 million or 64 percent of the amount available for withdrawal. The AsDB has also provided project-related technical assistance totaling US\$12.0 million. Advisory technical assistance has also increased in the last few years in line with the Government's efforts to upgrade institutional capabilities to enhance absorptive capacity.

Loan Approvals, 1968-88

(In millions of U.S. dollars)

| | |
|---------|-------------------|
| 1988 | 29.5 |
| 1987 | 82.3 |
| 1968-88 | 1,394.4 <u>1/</u> |

1 Of which US\$3.3 million is from the Asian Development Fund.

Malaysia--Statistical Issues

1. Outstanding Statistical Issues

a. Real Sector

The existing trade indices are inadequate for analysis as they suffer from problems of coverage, weighting, and classification. A technical assistance mission conducted by the Bureau in 1987 concluded that there was insufficient information available to make a recommendation on the advisability of compiling foreign trade price indices based on survey or customs data, and suggested that the authorities first compile a register of exporters and importers and convert the trade statistics to the Harmonized System. Based on this information, it would be possible to recommend whether direct pricing or unit value data should be used, the choice of the weighting base, the determination of weights, and the selection of representative prices.

The Department of Statistics has now completed the conversion of trade statistics to the Harmonized System, and is in the process of reweighting the foreign trade unit value and volume indices with a 1983 weighting base. The resulting indices are still under review and are not yet available.

b. Government finance

The 1989 GFS questionnaire, with revised data for 1986-88, and preliminary data for 1989 has been recently received. This information is being reconciled with RED data. However, no data regarding the extrabudgetary central government agencies have been provided for publication.

The Malaysian authorities are presently undertaking a significant effort to improve data on local government finance.

c. Monetary accounts

Malaysia's monetary statistics have been substantially revised in recent years as a result of technical assistance. The Asian Department has been receiving the revised data directly from the Central Bank and has requested the Bureau of Statistics to maintain the data base. The Bureau will shortly propose to the authorities the publishing of data based on this system in IFS.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Malaysia in the July 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank which, during the past year, have been provided on a timely basis.

Status of IFS Data (concluded)

| | | <u>Latest Data in July 1989 IFS</u> |
|--------------------|------------------------------|---|
| Real Sector | - National Accounts | 1988 |
| | - Prices: CPI | March 1989 |
| | - Production | March 1989 |
| | - Employment | n.a. |
| | - Earnings | n.a. |
| Government Finance | - Deficit/Surplus | Q4 1988 |
| | - Financing | Q3 1988 |
| | - Debt | Q4 1988 |
| Monetary Accounts | - Monetary Authorities | February 1989 |
| | - Deposit Money Banks | February 1989 |
| | - Other Banking Institutions | August 1988 |
| Interest Rates | - Discount Rate | November 1988 |
| | - Bank Lending/Deposit Rates | April 1989/ December 1988 |
| | - Bond Yields | n.a. |
| External Sector | - Merchandise Trade | |
| | Values | February 1989 |
| | Prices | |
| | All exports (unit value) | January 1989 |
| | Imports (unit value) | Q4 1987 |
| | - Balance of Payments | 1988 |
| | - International Reserves | April 1989 |
| | - Exchange Rates | June 1989 |

