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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/117

3:00 p.m., July 27, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. G. A. Faria, Temporary
	C. Enoch
Dai Q.	
	C. S. Warner
J. de Groote	J. Prader
	M. Hepp, Temporary
	F. El Fiky, Temporary
	R. Wenzel, Temporary
J. E. Ismael	
	L. M. Piantini, Temporary
	C. L. Haynes, Temporary
	C. V. Santos
	I. A. Al-Assaf
	C. Noriega, Temporary
	S. Guribye, Temporary
	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
	A. A. Agah, Temporary
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
S. Zecchini	

J. W. Lang, Jr., Acting Secretary
S. B. Woolls, Assistant

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Also Present

Asian Department: B. B. Aghevli, M. S. Kumar, J. Schulz, W. M. Tilakaratna. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; A. Basu, H. J. G. Trines. Fiscal Affairs Department: A. Cheasty. Legal Department: R. H. Munzberg, Deputy General Counsel; P. L. Francotte. Research Department: R. D. Haas. Treasurer's Department: D. Williams, Deputy Treasurer; J. C. Corr, S. J. Fennell, B. B. Zavoico. Advisors to Executive Directors: W. N. Engert, Khong K. N., D. C. Templeman. Assistants to Executive Directors: N. Adachi, H. S. Binay, R. Comotto, B. Fuleihan, C. Y. Legg, D. V. Nhien, S. Rebecchini, Yang J.

1. MALAYSIA - 1988 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/88/116, 7/27/88) their discussion of the staff report for the 1988 Article IV consultation with Malaysia (SM/88/139, 6/30/88; and Sup. 1, 7/25/88). They also had before them a background paper on recent economic developments in Malaysia (SM/88/147, 7/13/88).

Mr. Al-Assaf made the following statement:

> The Malaysian authorities' appropriate policy stance, coupled with an improvement in the country's terms of trade, led to an impressive economic recovery in 1987. Output rebounded with the help of strong export growth, the external position markedly improved, and prices remained stable. The authorities deserve strong commendation for their sound economic management. As I am in broad agreement with the general thrust of the staff report, I will limit my comments to the following areas.
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> First, with respect to fiscal policy, I am encouraged by the authorities' commitment to fiscal discipline. Indeed, I endorse their fiscal policy for 1988, as it reconciles the need for fiscal consolidation with the need for appropriate support for domestic demand. Moreover, I strongly agree with the authorities that public investment should be limited to those areas where private investment is not feasible.
>
> In this context, a closer examination of the parastatal sector is warranted. While I recognize that the overall position of this sector is in balance, this is mainly due to the strong performance of PETRONAS. Hence, it is crucial that further efforts to privatize and restructure unprofitable parastatals be exerted. This will help reduce the drain on government resources and thereby facilitate the gradual reduction of the fiscal deficit over the medium term. Therefore, I welcome the authorities' decision not to establish new parastatals or to diversify existing ones, as well as their efforts in the heavy industry sector. Progress in this area, especially with respect to the privileges extended to these parastatals, would contribute to the reduction of the Government's role in the economy and would enhance private sector participation.
>
> Second, with respect to the low level of private investment, while I recognize that business confidence will not emerge overnight, the authorities can play a supporting role by further liberalizing controls on investment and eliminating unnecessary regulations. I am not minimizing the authorities' efforts and the steps undertaken in this direction, in particular, the measures taken to liberalize foreign investment. However, it would be helpful if the authorities would set out a clear liberalized framework for private investment for the period

after 1990. In addition, the strong and decisive actions taken to restore confidence in the financial system should contribute to a favorable overall investment environment. These steps, along with the reduction in labor market distortions, will go a long way in helping to reduce the rather high unemployment rate.

Despite these difficulties, the authorities have exhibited skill and foresight in managing the economy. They have correctly emphasized the role of the private sector in promoting growth and employment. Therefore, I am confident that they will implement the needed measures to enhance private investment and restore business confidence in the economy.

Mr. Fernando said that the authorities should be strongly commended for their skillful management of the economy. The authorities' policy stance had been characterized by a blend of pragmatism and judicious caution. The practice of fiscal restraint in the face of adverse exogenous developments was particularly commendable. As a consequence of that restraint, the authorities had been able to safeguard external balance and internal price stability to a remarkable extent.

As Mr. Khong's detailed opening statement and the staff report had noted, the authorities had accepted, as a matter of policy, that a strong and dynamic private sector was vital to sustaining economic growth, maintaining balance of payments viability, and solving the unemployment problem, Mr. Fernando observed. The authorities' clear commitment to halt the growth of--and eventually roll back--the role of the public sector was welcome. Such actions, together with the removal of special privileges to public enterprises and further liberalization of the regulatory framework that affected private enterprise should strengthen business confidence and promote efficiency through more equitable competition.

He concurred with the basic thrust of the authorities' strategy of domestic, demand-driven growth, Mr. Fernando commented. Structural measures to facilitate investment, as had been outlined by the authorities, would be strengthened through federal budget actions that would seek a return to a balanced current account status in 1989. He underscored the supportive role that monetary policy should play. In that respect, the staff report had advocated a reduction of the yield on government securities, which could trigger a reduction in the cost of credit for business investment through changes in banks' portfolios. Although he agreed with that suggestion, he wondered whether the scope for reductions in the average lending rates of banks--considering that nonperforming debts were reported to amount to about 20 percent of the lending portfolio--could be a severe obstacle. One dimension of that problem, namely, interest accruals, had been mentioned by Mr. Enoch. Staff comment on the progress that had been made in addressing the larger problem would be welcome.

The authorities should be encouraged to act to stimulate domestic demand, partly on the grounds that it would help in achieving sustainability in the balance of payments, Mr. Fernando considered. In case the structural surplus in the current account remained persistent along with reserve accumulation, the staff had suggested that the authorities should be prepared to allow a modest deterioration in export competitiveness. Such an eventuality would be unfortunate. The export effort of Malaysia was a strong response to its external vulnerability, which had arisen both from the narrow base of exports and from the primary commodity concentration of the export structure. As the staff report had pointed out, the instability of Malaysia's export earnings was the highest among Asian countries. The momentum of Malaysia's export growth, as part of an outward-looking policy should be protected. Thus, the challenge facing policymakers was translating a larger share of the benefits of growth to broadly improving living standards in Malaysia.

Mr. Lim said that the staff report and Mr. Khong's opening statement had presented a particularly encouraging picture of recent developments in the Malaysian economy, and he fully concurred with the staff that the authorities should take much of the credit for the improvement.

Particularly noteworthy features of recent developments included the significant recovery in real GDP growth after the recession experienced in 1985-86 and the maintenance of strong export performance, Mr. Lim continued. There was clearly much to be said for the policy mix that had achieved those results with only a minor pickup in the rate of inflation. On the occasion of the 1987 Article IV consultation with Malaysia (EBM/87/111 and EBM/87/112, 7/29/87), a number of Directors had been concerned that the improvement experienced in the balance of payments had coincided with lower growth and a rise in unemployment, Mr. Lim recalled. Fears had been expressed that recovery in those areas could result in some reversal of the gains achieved in the external sector. It was interesting, therefore, that in the event, while external sector stability had been maintained along with the pickup in domestic activity, it was in the area of unemployment that performance had been disappointing. The figures in the staff report indicated that unemployment was expected to climb further in 1988 to 9.3 percent, from 8.7 percent in 1987. That trend was a matter for concern.

In part, the explanation for the decline in employment lay in the inadequate levels of investment of recent years, and both the authorities and the staff were correct to focus on investment in their policy considerations, Mr. Lim went on. Success in lifting the level of private investment would be crucial if the shift currently under way to an economy based more on domestic activity was to be sustainable. In that context, he agreed with the authorities that the objective of fiscal policy over the longer term should be to free up domestic savings for private use and generally reduce the role of the public sector. He commended the authorities' resolve in that regard, and strongly encouraged them to continue their efforts, including the introduction of the comprehensive value-added tax.

In view of the low level of inflation, there was clearly scope for continuing with a relatively accommodative monetary stance, Mr. Lim considered. The poor responsiveness of private credit growth to date, however, was perplexing. Part of the explanation may well lie in the persistently high average lending rates, as the authorities had suggested. Equally, however, it appeared that the low levels of private investment were as much--if not more so--the result of a general lack of investor confidence, particularly in domestically oriented activities. In addition, there could be some substance to the staff's concerns about the current approval process, although he noted Mr. Khong's comments on that process. Naturally, it was desirable to ensure that such administrative requirements were not unnecessarily costly or cumbersome, and Mr. Khong's indication that streamlining and reducing regulations would be pursued wherever possible, was welcome. Mr. Khong was right to emphasize the primary importance of appropriate fiscal and monetary policy settings, flexible prices, and a stable macroeconomic environment in restoring confidence, not only among potential investors, but also within the financial system. The forecast of 11.4 percent growth in private investment for 1988 represented a welcome improvement on recent performance, and he hoped that that growth could be achieved.

High and relatively inflexible labor costs, and a rigid wage settlement and arbitration system, were clearly part of the explanation for the persistently high level of unemployment, and the indications that the authorities were preparing to tackle those problems, was welcome, Mr. Lim stated.

Turning to the external sector, the success the authorities had achieved was clear testimony to the merit of a flexible, market-determined exchange rate policy, and he welcomed the indications that the authorities would continue to adhere to that approach, Mr. Lim commented. Despite some recent improvement, the external debt burden remained a serious constraint, and he commended the authorities' prudent approach to debt management by taking appropriate opportunities to reduce net external exposure.

In that connection, Malaysia's comfortable level of international reserves had incurred an opportunity cost to the extent that they could be used to redeem external debt, Mr. Lim observed. It was necessary, therefore, to find the right balance between that opportunity cost and the potential cost associated with sharp fluctuations in the external accounts. In view of Malaysia's continued reliance on commodity exports, and the expected narrowing of the external surplus over the medium term, there was merit in the authorities' cautious approach to the management of its international reserves. The authorities' actions to strengthen the financial sector, and their commitment to further rationalization and reform of the public enterprise sector, were commendable.

Mr. Agah made the following statement:

The terms of trade were the primary cause of both the 1985/86 recession and the remarkable recovery in Malaysia's economy in 1987. Indeed, the improved terms of trade in conjunction with a continued effective depreciation of the ringgit increased the level of exports by 16 percent in real terms, accounting for about half of GNP in 1987. Thus, in response to a revival of external demand for both manufactured goods and traditional export commodities, a strong export performance paved the way to a more than 5 percent increase in output and a record surplus in the external account. Meanwhile, domestic prices continued to remain virtually stable.

Like other Directors, I agree with the staff that much of the credit for these favorable developments should go to the authorities' appropriate policy stance and their skillful management of the economy. Despite the lagged effects of the 1985/86 recession, the Government successfully reduced the budget deficit to 8 1/2 percent of GNP in 1987, through an internal freeze on current expenditures and a sharp cut in development expenditures. It is expected that the Government's current account will be balanced by 1989, and that the overall budget deficit will be gradually reduced thereafter.

However, Malaysia's economy is facing some domestic problems, particularly the weakness in private investment and the high level of unemployment. In order to benefit from the recent gains in incomes and profits that would lend impetus to the cyclical upswing in the economy and bolster business confidence, these problems should be met, as the staff rightly suggested, with a judicious mix of financial and structural policies. Furthermore, as a means to revive business confidence and to aid the recovery of private investment, I support the staff's recommendation that the Industrial Coordination Act should be further relaxed and licensing requirements should be streamlined along with the authorities' recent effort to tighten controls on both the establishment of new public enterprises and the diversification of existing ones.

On monetary policy, in 1987, the lending rates were reduced to stimulate private investment. Furthermore, the central bank took determined actions to rescue ailing financial institutions and to restore confidence in the financial system. This action brought about a substantial improvement in the financial position of the banks that, according to the staff, played a critical role in enabling the system to withstand the impact of the October 1987 stock market crash.

In view of the staff's references to a category of financial institutions called "bank-like" institutions, I wonder what types of financial institutions were included in this category. According to some published accounts, Islamic banks have become quite active in Malaysia. Does this category include Islamic banks? If so, what effect does their overall intermediation role have on the economy?

Regarding external policies, given Malaysia's liberal trade and payments system, I note that a flexible stance will be maintained to allow the exchange rate to adjust in response to underlying market forces. Indeed, Malaysia's highly volatile commodity exports and capital flows call for a conservative approach to the management of international reserves and external debt. In this respect, since the pattern of Malaysia's economic growth in the medium term is highly sensitive to movements in the terms of trade, which is extremely volatile, particularly compared with other Asian countries, I support the authorities' approach of using conservative assumptions in assessing medium-term external prospects.

I wish the authorities success in preparing labor legislation intended to address the existing distortions in the labor market, which are caused mostly by the rigid wage settlement and arbitration system, a relatively high level and cumbersome structure of wages, and the high cost of retrenchment. In preparing such legislation, the authorities may find it useful to consider other more market-oriented alternatives, such as profit-related pay schemes, which have proven successful in other countries.

In conclusion, I support that the next Article IV consultation with Malaysia be held on the standard 12-month cycle.

Mr. Dai made the following statement:

After two years of recession, Malaysia's economy picked up rapidly in 1987. While prices remained stable, output increased vigorously, and the balance of payments position strengthened substantially as a result of the favorable terms of trade and a strong recovery in export growth. It is apparent that the economic development of Malaysia is to a large extent affected by changes in the international environment. However, the authorities have been successful in adjusting to the volatile external environment. It would appear that three main elements have contributed to the success of the authorities' management of the economy, namely, sound monetary policy and fiscal discipline; diversification of production and exports by means of industrialization; and a flexible exchange rate policy.

The cautious monetary policy pursued in the past few years has helped maintain a stable price level. In particular, it should be noted that this monetary policy has been supported by the authorities' restrictive fiscal discipline. Government borrowing from the banking system has been restricted, even during the period of fiscal expansion. The well-coordinated monetary and fiscal policies have made it possible for the authorities to contain domestic inflation and generate a balance of payments surplus, even when the terms of trade were unfavorable. On the fiscal side, despite a substantial shortfall in revenues, fiscal deficits were reduced to 10 percent of GNP in 1987, from almost 11 percent of GNP in 1986, and are expected to be reduced further in 1988.

As a result of the authorities' strategy of rapid industrialization, growth in the manufacturing sector has been remarkable in recent years. Export performance has been impressive, and, in particular, the share of manufactured goods in total exports has increased significantly. This indicates that the export industry is changing from a primary goods-oriented industry into one that is more diversified. This trend is encouraging in view of the fact that an export-led economy like that of Malaysia is highly vulnerable to the changing external environment.

The favorable macroeconomic trends and the easing of external constraints provides relief for policymakers, and enables them to concentrate on outstanding problems, such as the weakness of private investment and the high level of unemployment. In dealing with these problems, the authorities have taken a series of policy measures, including accommodating monetary policy with lower interest rates, speeding up the process of licensing procedures, relaxing the Industrial Coordination Act, limiting the establishment of new public enterprises, eliminating the excess profit tax, and liberalizing regulations on foreign investment. According to Mr. Khong's opening statement, recent developments have shown some initial achievements, particularly the rise in private investment. In the first quarter of 1988, the long-depressed mining and construction sectors turned around to show positive growth for the first time since 1984.

I note, however, that the high level of unemployment is of a structural nature, partly associated with technological progress in production, including the use of more capital-intensive techniques and less labor-intensive techniques, as well as some rigidities in the labor market, involving a lengthening of the job-search period by the better educated and trained younger labor force. Owing to the nature of the unemployment problem, it should be tackled through a good combination of macroeconomic and structural measures, such as a comprehensive industrial policy; a more liberal foreign investment policy, aimed at stimulating private investment and broadening the production base; and an improved labor and wage policy, aimed at alleviating the rigidities in the labor market.

With respect to the management of international reserves, I fully endorse the authorities' cautious approach, especially given the high volatility of commodity exports, the increasing demand for imports, and the higher cost of debt repayment over the longer term, mainly owing to changes in the exchange rates of the major currencies.

Finally, I highly commend the Malaysian authorities for their significant achievements in reducing the incidence of poverty in recent years. I note Mr. Khong's statement that the authorities will continue to stick to their twin objectives of the new economic policy in the years ahead--namely, the eradication of poverty and the restructuring of society. I hope that their good experiences could be useful for other developing countries, since we all share the same goal, to alleviate poverty and modernize our economies.

Mrs. Hepp made the following statement:

The authorities are to be commended for their successful experience in alleviating poverty. In fact, the most recent estimates show impressive improvements in the social and demographic indicators, compared with those prevailing in 1973. Furthermore, per capita GNP has grown more than three times between 1973 and 1987, which is particularly remarkable, considering the high rate of population growth in Malaysia.

This positive performance is a reflection of the strong development strategy adopted since 1971, which has resulted in high economic growth with low inflation and a strong external position. In 1987, the economy experienced a sharp recovery from the recession of previous years, and the prospects for 1988 show a continuation of the positive trend of high growth and stable conditions, with low inflation and a positive balance in the external sector. In this context, and as the staff report clearly points out, there remain only few aspects that could be cause for concern and therefore deserve special attention, namely, the relatively high unemployment rate and the weakness of private investment.

With respect to the unemployment rate, I note that the increase in the rate of unemployment has been concentrated in highly qualified young people. The actions undertaken so far by the authorities to alleviate the situation are welcome. However, some further efforts are needed to achieve a more flexible wage determination system to reverse the emphasis on capital-intensive activities that developed in the 1980s. In this respect, Mr. Khong's indication that Parliament is expected to look at proposals to remove rigidities in labor legislation before the end of 1988 is very welcome.

Turning now to private investment, we note the continued decline in the ratio of private investment to GNP between 1981 and 1987. The authorities have introduced measures to promote private investment and liberalize the existing regulations for the development of productive activities. In this connection, it is encouraging to note from Mr. Khong's opening statement, that private investment is responding to the efforts of the authorities since the last quarter of 1987, and appears to be buoyant in the first half of 1988.

As to the highly volatile and unstable external capital flows experienced by the Malaysian economy, the prudent and flexible approach of macroeconomic policies, and particularly the reserves and external debt management implemented by the authorities, have been commendable. Nevertheless--and despite reduced external borrowing and substantial repayments--outstanding external debt has continued to increase in recent years. In this connection, Mr. Khong mentioned in his statement that the country's losses, stemming from exchange rate movements of the major currencies, were equivalent to 10 percent of GNP over a period of three years. We would appreciate further comments on this issue, and on whether a different management of reserves could potentially have reduced this loss.

Economic performance in Malaysia has been outstanding, and we commend the authorities for their successful economic management as well as for their efforts in alleviating poverty and restructuring the society--the twin objectives of the New Economic Policy adopted in 1971.

Mr. Faria said that, as other Directors had commented, the authorities were to be commended on their ability to bring the economy out of a period of recession into a period of sustained and robust growth, and on the buildup in reserves. He agreed with the thrust of the staff appraisal.

Like Mr. Ortiz, he was intrigued by the suggestion in the staff appraisal that for Malaysia, which was not a money-centered economy, a modest deterioration in external competitiveness might be one way to manage the reserve situation, Mr. Faria commented. Implicit in that view was an assumption that the current account surplus could considerably exceed present reserve levels, and, therefore, steps would have to be taken to prevent that from happening. In a sense that suggestion also implied that there had been some overshooting of the real effective exchange rate.

Another way in which such a situation could be handled was through the promotion of domestic demand, Mr. Faria suggested. On page 8 of SM/88/139, the staff had made the point that there was an inherent tendency in the system to generate a surplus in the balance of payments. Therefore, he would have expected the staff appraisal to contain a little more emphasis on the need to foster a higher level of domestic demand, particularly with respect to the private sector and the need to reduce some of the rigidities that seemed to work against private sector investment outside the property market. Staff comments on that issue would be welcome.

The staff representative from the Asian Department said that, as Executive Directors had noted, the weakness in private investment was perhaps the most important issue currently facing the Malaysian authorities. There was no disagreement between the authorities and the staff concerning the basic causes of that weakness: both cyclical factors and rigidities in the regulatory environment had contributed to it. Mr. Khong had apportioned more blame to cyclical factors than the staff had, but he had agreed with the staff on the importance of streamlining licensing requirements and reducing regulations, as well as on the need to rationalize and privatize the public enterprises. In that connection, substantial progress had been made in liberalizing industrial regulations. It was clear that at the policymaking level there was a strong commitment to remove the obstacles to private investment, and the recent liberalization of regulations related to private investment had been a very important step in that direction. Nevertheless, at the implementation stage, particularly at the state government level, certain problems remained. It was clearly more effective to eliminate unnecessary regulations wherever possible, rather than to rely on more relaxed implementation. Of course, the staff was aware of the noneconomic factors involved in that process and the difficulties the authorities faced in that connection.

As to prospective developments, the most recent data signaled a recovery of private investment, although it was too early to reach any definite conclusions about the strength of that recovery, the staff representative went on. Public investment over the medium term was not expected to crowd out the private sector. The projected ratio of public investment to GNP of about 12 percent in 1993 was substantially below that of the early 1980s, when it had reached 20 percent, and was broadly in line with that of the 1970s. The staff agreed with the suggestion made by several Directors that future fiscal consolidation efforts should focus mainly on the current budget, given the recent sharp cutbacks in development expenditures. With respect to using higher public investment to compensate for weak private investment and to reduce the external current account surplus, it was clearly important that such considerations not lead to development projects with inadequate rates of return.

On the issue of interest rates and the large differential between lending rates and deposits rates, there were a number of factors involved that had to be taken into consideration. These included high administrative costs; large provisions for bad and doubtful debt; the slow decline of actual interest paid on longer-term deposits by banks; the high risk of lending associated with a weak domestic economy; the substantial cost of litigation; and the relatively high yield of government bonds, which had absorbed a substantial share of private savings, the staff representative pointed out. There was substantial resistance to reducing the yield on government bonds, because the authorities were concerned that such a reduction could lead to an excessive reflow of private savings to finance private investment, which was considered to be more risky. However, the staff considered that there was more room for reducing the rates of return on government bonds to be more in line with the movements in the market rates, which would, of course, contribute to a decline in interest rates. It should be noted that the real interest rates in Malaysia--at about 5 1/2 percent--were not that far out of line with those in other countries in the region. For instance, the real interest rate was about 4 1/2 percent in Singapore, and about 7 percent in Thailand. The relatively high real interest rates in those countries reflected the high rates of return for investments in private sector undertakings.

With respect to the future movements of interest rates and the supply of funds for investment, pressure on interest rates was on the downward side, the staff representative remarked. However, the impact of the ongoing recovery of the domestic economy had to be taken into account, and that would tend to push interest rates up. It was very difficult at the present time for the staff to project what was going to be the trend over the medium term, after accounting for the effects of the recovery, but it expected some moderate decline.

At the current stage, the staff could only highlight the broad areas of planned labor legislation, which was designed to remove various impediments in the labor market. Those impediments included a rigid wage bargaining system, which had often led to excessively large wage increases; an excessively broad definition of wage and overtime pay; and regulations applying to the retrenchment of workers, the staff representative continued. Those regulations and legal restrictions had been very costly. They had reduced the flexibility of enterprises by reducing the mobility of workers within enterprises and had complicated the operations of the industrial relations courts in the arbitration system.

The authorities were not planning to undertake any additional prepayments of external debt after 1990, the staff representative stated. However, the authorities had indicated that if the external position became stronger than expected, they would consider additional prepayments. In planning such prepayments, the authorities were taking into account currency as well as interest rate considerations. Recent prepayments had been mainly for non-dollar denominated debt. The authorities were managing their assets with a view to minimizing the risk of exchange rate realignments, but they did not operate in the forward market.

The role of Islamic banking had been increasing in recent years, the staff representative observed. The Bank of Islam in Malaysia was founded in 1983. It currently had 19 branches and was expanding. However, the portion of its assets in the overall banking system was still relatively small, at less than 1 percent. The staff would provide additional material on the Bank of Islam to Mr. Agah.

Mr. Khong said that Executive Directors had raised a lot of interesting issues, and that their comments had touched on the core of microeconomic management and on how to maintain growth with stability. He was in general agreement with those comments. However, the main focus of Directors' comments had been on the margin that could be built into the management of reserves and external debt. The authorities were trying to rebuild the room for maneuver in those areas to increase flexibility of management with respect to the external sector.

With respect to the fiscal deficit, it should be borne in mind that the financial and fiscal structure of Malaysia was not the same as in many other countries. In Malaysia, the fiscal system excluded the social security system. It had been designed so that the social security institutions acted separately from the Government, and the general philosophy was that the Government should manage its operational budget to generate a surplus that could contribute to investment. However, most of the expansion in investment would be funded by compulsory savings institutions, such as the Employers' Provident Fund.

Some Directors had referred to a return to the fiscal policies of the 1960s, Mr. Khong noted. In that connection, it should be emphasized that the fiscal policies of the 1960s had called for an annual budget deficit of about 5-6 percent of GNP, even at the best of times. Therefore, given the whole structure of the financial and the fiscal system, a federal deficit of 6-7 percent of GNP would be fairly normal. In fact, there would be a problem if the public sector mobilized too many resources without spending those resources.

As to the current account, as the staff had noted, the authorities and the staff were in agreement as to what should be done if the surplus of 1987 were to continue, Mr. Khong commented. The only difference between the staff and the authorities in that connection was on whether or not the current surplus was likely to persist in the future. The staff's expectation was for the current account surplus to decline gradually to about 3.7 percent of GNP in 1990, while the authorities currently expected that surplus to be only 1 1/2 percent of GNP in 1990. Certainly, there would be a future downturn in commodity prices associated with the slowdown in world trade and demand. Therefore, the authorities' expectation was for a much lower surplus than that of the staff; they expected the current account to be in a balanced position by 1990, if imports and private investment recovered more than currently expected.

On the lending rates and deposit rates, the staff had been correct in pointing out that there were a lot of factors that made up for the fairly large differential between those rates, Mr. Khong continued. The authorities were concerned about the gap and they wanted to reduce it as much as possible. However, it was important to note that the deposit rate cited both by the public in Malaysia and in the staff report was an unweighted rate, while the cited lending rate was a weighted average of all deposits. To that extent, the deposit rate, as presently measured, may have overstated the size of the gap as well as the cost of mediation. His authorities wanted to invite the staff to do further research aimed at establishing a reliable measure of the weighted average cost of deposit funds.

The unemployment problem mainly concerned recent graduates and highly skilled workers, Mr. Khong explained. At the same time, however, there were a lot of job opportunities in the agricultural sector, for example, on the rubber and palm oil estates and in the construction trade; many of those jobs were being filled with legal and illegal immigrants from neighboring countries. Mr. Templeman had been correct in stating that there should be greater mobility, both in terms of the jobs available and in the areas of work. However, it was also important to change the expectations of the labor force coming into working age. Owing to the expansion of the public sector in the past decade, many people were expecting to find white collar jobs that just did not exist.

The Acting Chairman made the following summing up:

Directors generally agreed with the views expressed in the staff report for the 1988 Article IV consultation with Malaysia. Directors were impressed by the strength of economic recovery in 1987: both output growth and the external current account surplus had exceeded expectations while prices had remained stable. These favorable developments owed much to the appropriate financial policies that had reinforced the impact of improved terms of trade. Directors were also encouraged by the more recent information indicating a further strengthening of economic performance in 1988. Nevertheless, they expressed concern about the underlying weakness of private investment as well as the high level of unemployment and supported the authorities' policy focus on overcoming these problems.

Directors were pleased to note that, according to updated information, the federal government deficit in 1987 was markedly lower than earlier estimates. They commended the authorities for their efforts toward fiscal consolidation, which had made an important contribution to the progressive strengthening of Malaysia's external position. Directors also supported the fiscal stance for 1988, but noted that there was further scope for reducing the overall budget deficit over the medium term in order to allow room for the expansion of productive private investment. The planned elimination of the deficit in the current account of the Federal Government by 1989, both through curtailing operating expenditure and raising revenue, would alleviate pressures on development expenditures, which were relatively low. Directors, therefore, encouraged the authorities to proceed rapidly with their planned tax reform, particularly with the introduction of a value-added tax.

Most Directors also noted the importance of strengthening the finances of the nonfinancial public enterprise sector through restructuring and rehabilitating loss-making enterprises. In addition, Directors supported the authorities' privatization program and their decision to refrain from establishing additional public enterprises.

A continuation of the accommodative stance of monetary policy seemed appropriate to most Directors, given the need to stimulate private investment and the absence of inflationary pressures. Directors, however, discouraged reliance on measures that would be aimed at directly reducing lending rates, because such measures could dampen the supply of credit. While progress had been made in reforming the financial sector, Directors observed that further measures were needed to reduce the cost of financial intermediation and to enhance competition among financial institutions. Directors welcomed the authorities' success to date in tackling the problems of ailing financial institutions and in restoring confidence in the financial system.

Directors also commended the authorities on their recent management of Malaysia's external debt and their policy of using favorable external circumstances to build Malaysia's reserves. They noted that the strong improvement in the balance of payments in 1987 and favorable outlook over the medium term afforded the authorities greater latitude for further alleviating the burden of external debt without curbing domestic demand. As international reserves were considered to be at a comfortable level, even after taking into account the external uncertainties that Malaysia faces, most Directors agreed that, should the current account surplus significantly exceed present projections, it would be appropriate to accept a modest reversal of the recent trends in the exchange rate. In this respect, Directors noted and supported the authorities' commitment to maintain a flexible stance vis-à-vis exchange rate policy and not resist underlying pressures in the foreign exchange market.

Directors urged the authorities to persevere in their efforts to further relax the regulatory framework and simplify administrative procedures for private investment. They encouraged the authorities to make an early announcement of the investment guidelines that would apply after the expiry of the

New Economic Policy in 1990 so as to bolster investor confidence. Most Directors also deemed the impending labor legislation an important vehicle for removing rigidities in the labor market and increasing employment opportunities.

Malaysia's contribution to the enhanced structural adjustment facility was welcomed.

It is expected that the next Article IV consultation with Malaysia will be held on the standard 12-month cycle.

2. ESAF TRUST - ESTABLISHMENT OF ADMINISTERED ACCOUNT; AND LOAN ACCOUNT - BORROWING AGREEMENT

The Executive Directors considered staff papers on the establishment of an administered account for a subsidy contribution to the ESAF Trust by the National Bank of Belgium (EBS/88/141, 7/18/88) and on a borrowing agreement with the Ufficio Italiano Dei Cambi for the Loan Account of the ESAF Trust (EBS/88/136, 7/12/88).

Mr. de Groote said that the envisaged arrangement with the National Bank of Belgium was similar to the arrangement that had been concluded with the Austrian National Bank (Decision No. 8895-(88/90) ESAF, adopted on June 8, 1988) so that Directors were familiar with that type of arrangement. It consisted simply of reserves, in the amount of SDR 100 million with the National Bank of Belgium, that were to be deposited in an administered account, the income from which was to be used for the subsidy contribution to the ESAF Trust.

His authorities were facing a number of budgetary and legal constraints, but they were satisfied with the formula that had been devised, particularly from the legal viewpoint, Mr. de Groote continued. He congratulated the Fund staff for its assistance in formulating the appropriate presentations. During the Managing Director's recent visit to Brussels, he had had an exchange of views with the Minister of Finance for Belgium on future arrangements, and the Belgian authorities would consider favorably the possibility of entering into similar arrangements in the future, in light of the general evolution of the budgetary situation in Belgium in coming years.

Mr. Zecchini stressed that the terms of the borrowing agreement with the Ufficio Italiano Dei Cambi were fully in line with the initial proposal put forward by the Italian authorities to lend the ESAF Trust Account SDR 370 million, fully subsidized up to the level of 0.5 percent interest. The only reason the Ufficio Italiano Dei Cambi had been mentioned in the agreement was that the Italian authorities were using international reserves to make the loans, and the Ufficio Italiano Dei Cambi was responsible for the management of the Italian international reserves.

The Executive Board then took the following decisions:

NATIONAL BANK OF BELGIUM -
ESTABLISHMENT OF ADMINISTERED ACCOUNT

1. Pursuant to Article V, Section 2(b), at the request of the National Bank of Belgium (the "Bank") as set forth in its letter dated July 6, 1988 (Annex II to EBS/88/141, 7/18/88), the Fund adopts the Instrument to establish an account for the administration by the Fund of deposits to be provided by the Bank on the terms and conditions set forth in the Instrument contained in Annex I to EBS/88/141.

2. The provisions of the Instrument may be amended only by a decision of the Fund and with the concurrence of the Bank.

3. Pursuant to Article V, Section 2(b), the Managing Director is authorized to accept the proposal by the Bank (Annex III to EBS/88/141) to make a deposit with the Administered Account in the total amount of SDR 100 million to be deposited in three parts in the amounts and on the value dates specified in the Bank's letter. The deposit shall be administered in accordance with the provisions of the Instrument adopted under paragraph 1 of this decision. The agreement between the Fund and the Bank on the deposit shall enter into effect on the date the Fund accepts the proposal by the Bank for deposits with an Administered Account.

Decision No. 8933-(88/117) ESAF, adopted
July 27, 1988

ESAF TRUST - UFFICIO ITALIANO DEI CAMBI -
LOAN ACCOUNT - BORROWING AGREEMENT

Pursuant to Section III, Paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Ufficio Italiano Dei Cambi in terms of the draft set out in the attachment to EBS/88/136, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8934-(88/117) ESAF, adopted
July 27, 1988

APPROVED: February 17, 1989

LEO VAN HOUTVEN
Secretary