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04 INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/138

10:00 a.m., August 27, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	L. Hubloue, Temporary
M. Finaish	M. Z. M. Qureshi, Temporary
	K. Murakami, Temporary
	B. Goos
	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	Jaafar A.
	J. R. N. Almeida, Temporary
	M. Foot
	S. King, Temporary
	S. Simonsen, Temporary
	O. S.-M. Bethel, Temporary
	A. Abdallah
	J. J. Dreizzen, Temporary
	L. P. Ebrill, Temporary
	J. de la Herrán, Temporary
H. Ploix	
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	R. Msadek, Temporary
	A. S. Jayawardena
S. Zecchini	

J. W. Lang, Jr., Acting Secretary
J. K. Bungay, Assistant

Also Present

IBRD: D. Dutt, East Asia and Pacific Regional Office. African Department: S. L. Rothman. Asian Department: P. R. Narvekar, Director; J. Schulz, D. A. Scott. European Department: L. A. Whittome, Counsellor and Director; P. M. Nagy, D. C. L. Nellor, T. M. Ter-Minassian, G. Tyler. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman, E. H. Brau. Fiscal Affairs Department: M. Shadman. IMF Institute: C. Y. Chang, Participant. Legal Department: P. L. Francotte, A. O. Liuksila. Research Department: M. S. Ho. Treasurer's Department: A. G. Chandavarkar. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, A. Ouanes, I. Puro. Assistants to Executive Directors: O. Debains, V. Govindarajan, A. R. Ismael, Z. b. Ismail, J. A. K. Munthali, M. Rasyid, C. A. Salinas, G. Seyler, L. Tornetta.

1. MALTA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Malta (SM/86/171, 7/15/86, and Cor. 1, 8/26/86; Sup. 1, 8/7/86, and Sup. 1, Cor. 1, 8/12/86; and Sup. 2, 8/26/86). They also had before them a report on recent economic developments in Malta (SM/86/195, 8/13/86).

Mr. Zecchini made the following statement:

At the outset, on behalf of my Maltese authorities, I wish to express appreciation for the staff report, which presents a more accurate and balanced assessment of Malta's recent economic developments and policies than that contained in the statement issued at the end of the 1986 consultation mission. Achievements in policy management and economic performance are correctly pointed out, together with the issues that the Maltese authorities have to face to ensure a stronger, long-lasting development of the economy. This is not to deny that differences of view still persist between my authorities and the staff on the appraisal of policies in the fiscal, monetary, and exchange rate areas.

In 1985, the expansion of the Maltese economy accelerated compared with the previous three years, leading to such an increase in employment level (1.3 percent) as to lower the unemployment rate. At the origin of the economic expansion, there was a rise in private consumption as well as an increase in public expenditure (6.7 percent in nominal terms), resulting in a higher deficit compared with 1984. It is also noteworthy that a positive contribution to growth derived from the recovery of fixed investment (2.1 percent) after its stagnation in 1984.

Economic expansion was successfully combined with a further decline in the overall price level. The price decline continued for the third consecutive year, showing the effectiveness of a policy mix that since 1983 has assigned a significant role to incomes policy in the strategy aimed at eradicating inflationary expectations and fostering real growth.

Important and positive though the 1985 results are in terms of growth and employment, the authorities did not consider them fully satisfactory in laying the foundation for a speedy reabsorption of the still disappointing unemployment level and in securing stable and strong economic growth in the years ahead. A more forceful economic policy approach is needed. In this light, the authorities drew up the Sixth Development Plan for the period 1986-88. The Plan calls for a strong stimulatory action on the economy by the public sector for the purpose of inducing a substantial increase in job opportunities in the context of a significant upgrading of Malta's productive structure as well as its economic and social infrastructure.

For the Plan period the new job requirement is estimated to be around 10,800, which would involve the need for additional investment on the order of Lm 60 million. Great attention is and will be paid by the authorities to the capacity of the country to absorb the impact of these economic stimuli without undesirable inflationary pressures or an erosion of external competitiveness. The choice of policy instruments and the extent of their use will be crucial to this effect.

Before turning to the individual economic policies, I should note that the main policy guidelines for the period 1986-88, like those for the year 1985, are consistent with the last Board recommendations. In 1985, for instance, Malta brought its external competitiveness to more appropriate levels, made its exchange rate peg more coherent with its balance of payments objectives, and eased several restrictions and regulations on external trade.

In 1985, fiscal policy played a major role in sustaining the growth of the economy and, as a result, the public deficit rose compared with the previous year. This development cannot be considered a policy slippage since it represents a deliberate and carefully planned policy reorientation that is consistent with a multiyear policy approach. In previous years, funds stemming from public budget surpluses were accumulated in the Posterity Fund and in the Consolidated Fund precisely for the purpose of financing valuable projects at a later time. This deficit increase cannot be considered a weakness, since this judgment depends on the specific use to which these resources are devoted. In 1985, while current expenditure hardly rose (0.7 percent), capital expenditure increased by 3.5 percent, namely, more than the rise in GDP. At the same time, total revenue remained stable, mainly because of a shortfall in nontax revenue.

In line with the new action program, the authorities intend to step up public capital expenditure by 24 percent in the current year and by 31 percent in 1987; this will be followed by a small decline (-3 percent) in 1988. Most of the expenditure will be directed toward infrastructural projects, manpower training, export infrastructure, and private investment promotion. In this respect, it has to be stressed that public investments are not designed to be a substitute for private initiative but a complement to it where it is already thriving, and as a supplement in the sectors where it is still lacking or inadequate. These expenditure programs are intended to foster the expansion of production and the enhancement of export competitiveness, thereby leading both to a reabsorption of the public deficit in the near future and to a durable improvement of the external accounts.

The financing of these programs will be provided mainly by the resources accumulated in special public funds in previous years. Efforts will also be made to mobilize a larger volume of private domestic savings in support of investment projects. To this end a more active financial strategy will be required. In contrast, no increase in taxation is envisaged, as this runs counter to the objective of stimulating production and fixed investment. The rise in income and economic activity that would result from the action program should provide a sufficient base for revenue expansion.

Traditionally, monetary policy has played the role of supporting the development priorities of the country while avoiding inflationary pressures. The main instruments have been selective credit controls and an interest rate policy that has promoted an increasing demand for quasi-money instruments. However, in both respects it is necessary to dispel some inaccurate impressions.

First, the Central Bank's controls on credit applications to commercial banks are not so extensive as might be inferred from the staff report. These controls are limited basically to requests for financing fixed investment in textile, tourist, and property development sectors with a view to restraining undesirable expansion of production capacity when it is already adequate. These credit requests represent a small share of total bank credit demand. Moreover, while these controls are still in place, the monetary authorities adopted a more flexible attitude in 1985, allowing more credit for upgrading plants in the textile and tourist sectors.

Second, the degree of liquidity in the economy is relatively high. However, this is not a cause for serious concern for several reasons. The relatively high propensity for liquid forms of savings represents a structural feature of the Maltese economy. The authorities have a large influence on the credit policy of banks, and in addition they are legally empowered to impose an additional reserve requirement equal to 20 percent of deposits. Furthermore, real interest rates have been maintained at relatively high levels.

Recently, there even seems to be less cause for concern about the development of the economy's liquidity. In 1985, for the first time in three decades, the stock of narrow money declined, leading also to a sharp, 3.7 percent, deceleration in the growth of broad money. In this context, and given the decline of interest rates abroad, the authorities reduced lending rates by 1/2 of 1 percentage point.

A more active monetary policy is called for by the Plan for the years 1986-88 with the aim of supporting the projected large investment effort. Specifically, a more flexible interest rate policy than in the past will be considered so as to channel more bank credit toward priority sectors. Moreover, with a view to broadening the financing base of state-controlled long-term credit institutions, the authorities will give consideration to the possibility of public issues of marketable paper, the placement of bonds, and the sharing of capital increases.

In 1985, external policies were geared mainly to reviving exports of goods and services, while gradually eliminating the few existing trade restrictions and bilateral payment arrangements. To this end, first, the authorities allowed the depreciation of the U.S. dollar, with its heavy weight in the pegged currency basket, to be reflected in a substantial depreciation of the effective rate for the Maltese lira. As a result, the real effective exchange rate was brought down to about the level of the 1980 base. It is too early to assess the impact of this exchange movement on export performance and in improving the overall external account. However, in light of the mentioned size of the depreciation, there is not enough evidence to support the staff's contention that "the lira has become noncompetitive" (see page 11 of the staff report). After the aforementioned depreciation, the currency basket was modified in December 1985 to better reflect the currency composition of trade and tourist transactions.

In the same period, the authorities took a series of measures to liberalize trade and external payments relationships. The import licensing scheme has also been applied with a more liberal attitude. Overall, it should be stressed that all the above measures are fully coherent with the recommendations of the Board on the occasion of the 1985 Article IV consultation.

For the years covered by the Plan, exchange rate policy will be guided by the need to enhance export competitiveness, taking into account the evolution of price and nonprice factors. In this context, relative stability of the external value of the lira will be pursued, in accordance with external circumstances and other domestic policy developments. Moreover, the pegged currency basket will be kept in line with the evolving pattern of trade flows and tourist receipts.

The staff representative from the European Department, recalling Mr. Zecchini's statement that "however, in light of the mentioned size of the depreciation, there is not enough evidence to support the staff's contention that 'the lira has become noncompetitive'...," said that given the importance of the exchange rate in the Maltese economy, the staff had carefully considered Mr. Zecchini's comment and agreed that there was not enough evidence at hand to say that the Maltese lira had become noncompetitive. In retrospect, he thought it would have been more appropriate to have indicated that the evidence suggested that the lira had become noncompetitive before the significant depreciation of the real effective exchange rate in 1985.

Mr. King remarked that 1985 seemed to have been a successful year for the Maltese economy, as growth had recovered from the depressed level of 1983 and 1984. The rate of inflation had remained moderate, while unemployment had eased somewhat. In addition, the authorities had made an encouraging start on liberalizing external transactions after the intensification of restrictions and payments that had been undertaken in recent years.

Overall, the situation seemed to be encouraging, although as the staff report had made clear, there were some signs that all was not as well as that broad picture might suggest, Mr. King continued. The authorities had previously had a commendable record of prudence, but the fiscal position had weakened in 1985, resulting in a consolidated public sector deficit exceeding 4 percent of GDP, which in turn, had helped bring about a further increase in the liquidity of the banking system. The current account had moved from a position of modest surplus in 1984 to a deficit of almost 2 percent of GDP. Furthermore, although recorded inflation had remained modest, the staff appeared to doubt whether that was an entirely accurate reflection of the underlying trends. Finally, and perhaps most fundamentally, the economy continued to be heavily influenced by controls and regulations, and it remained to be seen whether they would prove to be consistent with the objective of achieving strong growth over the medium term.

The deterioration in the public sector finances had been connected in part with the large infrastructural investments undertaken by the authorities, and in any case, it had been financed partly by the depletion of reserves accumulated previously at the Central Bank, Mr. King commented. The appropriateness of that easing of the fiscal position would depend partly, as Mr. Zecchini had pointed out, upon the rate of return earned on the additional projects. In the absence of a detailed analysis, it was difficult to assess the returns that the investments were likely to produce, although comments on page 9 of SM/86/171 (7/15/86) seemed to indicate that the staff had some doubts. More generally, a comparison of the likely fiscal position for the current year with that of 1984 indicated that the rise in the deficit during that period was only partly attributable to higher capital spending (Table 4, SM/86/171, 7/15/86). Over the same period, consolidated public expenditure was estimated to have risen by Lm 22.5 million, but almost exactly half of that increase was due to higher current, rather than capital, expenditure. The outlook for the fiscal position was also clouded by the most recent development plan, which appeared to propose a substantial increase in public expenditure. Any staff comments on the likely impact of such policy changes would be helpful.

Of course, the relaxation of the fiscal position that had already taken place had had implications for monetary policy, Mr. King added. The liquidity of the banking system had shown a further increase in the past year, although the potential impact of that buildup in liquidity on demand and on inflation seemed to have been suppressed by the continuing controls on prices, bank lending, and imports. While such administrative devices might damp down the symptoms of excess liquidity in the short run, they did so only at potentially high cost in terms of reduced efficiency.

The monetary situation had also been complicated by the shift between M1 and quasi-money, Mr. King went on. The authorities attributed that shift to the private sector's reduction of its cash holdings and increase in its deposits in savings and time accounts, prompted in part by the issue of new design bank notes. Such behavior also presumably reflected the more attractive terms currently available on those accounts as a result of the positive real interest rates. Otherwise, the private sector might have simply replaced new-style bank notes with old ones in their cash holdings. If the private sector was to continue to be willing to hold balances in those accounts, and thus if the buildup in broad liquidity was not to spill into demand, it would be important for the yields to remain attractive. That suggested that the authorities needed to consider following more active interest rate policies in the future.

The staff had noted that the current account deficit did not appear to be a source of concern in the short run because of the low external debt, Mr. King recalled. In any case, the depreciation of the lira during 1985 should have continuing positive effects on the external balance in 1986. The authorities' decision to change the currency basket to which the lira was pegged was a helpful development, as the competitiveness of the tourist industry in particular appeared to have declined in recent years. Gross foreign exchange earnings from tourism in 1985, for example, had been only about 60 percent of their 1980 level. While those trends reflected exogenous developments in part, they underlined the need to ensure that exchange rate policies maintained adequate competitiveness. The exchange between the staff and Mr. Zecchini had been helpful in clarifying the issue of the competitiveness of the exchange rate.

A wide range of various forms of administrative control remained in force in Malta, including administrative controls on imports, prices, and the controls over bank lending, Mr. King noted. Despite a recent welcome easing of external restrictions policy, the staff appeared to believe that the trend in bank credit policy was toward more official direction. That trend seemed to contradict the helpful objective in the development plan for 1986-88 of strengthening the role of the private sector. It was encouraging to learn from Mr. Zecchini that in some areas, at least, the authorities had adopted a more flexible attitude toward credit requests.

To strengthen the role of the private sector, appropriate supporting policies from the public sector would be needed, Mr. King considered. In addition, however, it appeared that the authorities could make a major contribution by reducing the administrative controls and restrictions that currently affected the private sector, such as the price freeze that had been in continuous operation since early 1983 and presumably imposed considerable distortions on relative prices.

Finally, he welcomed the inclusion of medium-term scenarios in the staff report, Mr. King stated. Despite their inevitable limitations, those scenarios were a helpful way of examining the possible consequences of current policies, and provided a way of judging their sustainability.

Mr. Templeman made the following statement:

We have some uneasy feelings about the current Maltese economic situation and outlook for two reasons. In the shorter run, it is clear that the economy is now at a turning point with regard to the fiscal and external position and, over the longer term, economic strategy continues to depend on a strongly dirigiste approach to economic management.

The sharp turnaround in the fiscal position from past surpluses or rough balance to very substantial deficits represents one major shift in Malta's economic situation. The emergence of a significant current account deficit in the balance of payments is the other major shift. Admittedly, past careful management of the economy, including the buildup of external reserves and public deposits, ensures a degree of cushion against any adverse fallout from these shifts in the external and fiscal positions, provided that the imbalances do not persist for an extended period.

Concerning the fiscal situation, the staff report says that the public sector deficit reached nearly 3 1/2 percent of GDP in 1985 and that it is expected to reach more than 5 1/2 percent in 1986. Furthermore, the new public investment program is expected to amount to about 4 percent of GDP in 1987 and 1988. Other things being equal, this suggests a further rise in the public sector deficit to about 9 1/2 percent of GDP. We would welcome comment by the staff or Mr. Zecchini as to whether this is a correct conclusion, or whether offsetting fiscal measures are envisaged. We recognize that there may be a justification for some additional public investment in infrastructure, especially if it is aimed at helping to strengthen the external accounts, but we also note that public consumption has been rising rapidly, about 5 1/2 percent in 1985, with a similar rate expected for 1986. We wonder what is driving this increase and if it, too, is expected to continue. Finally, we welcome the indication by Mr. Zecchini that consideration will be given to the sale of various forms of public securities. This would seem to be an attractive means of financing the expanded public investment program, tapping a higher level of private savings, and absorbing household liquidity. However, we wonder about the status of financial markets for private sector securities.

Concerning the external accounts, we are somewhat concerned at the emergence of an external current account deficit on the order of 2 percent of GDP in 1985 and 1986. Admittedly, the high level of foreign reserves and low level of foreign debt provide some assurance. We remain uncertain whether the exchange rate is overvalued, in the light of the recent depreciation and of the expected lags that may occur before Malta's market share in goods and tourism could be expected to respond. We see little justification for the continued tight control over imports and we view exchange rate flexibility as one means of helping to achieve some trade liberalization. Staff analysis suggests that it would take some time over the medium term for foreign debt to become a substantial problem, even in the worst-case scenario, although by 1991, the current account deficit and the debt/GDP ratio would become a matter for serious concern.

The question of whether there is excess liquidity in the economy and whether this should be considered to be a problem is an interesting one. The authorities seem to be saying that, first, there is no excess liquidity; second, if excess liquidity emerged, we can intervene to sterilize it and, in any case, we can suppress its effects on inflation and the balance of payments with price controls and import restrictions. This is not an appealing set of arguments. If one accepts a controlled approach to the economy, which this attitude reveals, there is a certain logic. However, if one believes that, in the end, direct price and import controls will create a misallocation of resources, then the argument is not very satisfactory.

We believe that such misallocation is likely to occur and that price controls must be creating a disincentive to foreign investment, which otherwise could be quite beneficial to Malta's longer-term growth and balance of payments prospects. Therefore, we are disappointed that the authorities have not seized the opportunity of low inflation and declining oil prices in 1986, at least to begin to relax the price freeze in effect since 1983.

In conclusion, we are confronted with something of a dilemma with regard to Malta. The past record of prudent economic management is reassuring and a financial cushion has been built up which, to some extent, can legitimately be used now. Nevertheless, the sharpness of the turnaround in the fiscal and current account balances is a considerable break with the recent past and raises some concerns about the future. It is incumbent on us, at a minimum, to convey a word of caution to the authorities about the direction of policy that they are now pursuing. We will be able to assess the results of this shift more clearly 18 months from now, at the next discussion of the Article IV consultation with Malta.

Mr. Finaish made the following statement:

Malta's economic performance since the last Article IV consultation has been good in many respects. The rate of growth picked up after two years of stagnation; inflation was kept at a low level; and although the fiscal and external balances moved into deficits, the magnitude of these deficits could not be considered particularly excessive in Malta's circumstances. Thus, from a short-term perspective, it appears that the authorities' strategy of relying on a price and wage freeze to preserve external competitiveness and on public sector spending to stimulate demand and growth has had, for the most part, its intended effects. What is important, however, is to recognize the short-term nature of such a strategy. A prolonged suppression of prices is bound to have some negative effects on resource allocation and investment decisions, which in turn would affect growth and employment unfavorably. However, despite the margin for maneuver provided by the relatively comfortable reserve position, even after the loss incurred in 1985, the stimulation of domestic demand without a concomitant rise in production and exports could lead to a gradual deterioration in the external position over the medium term. Thus, what is essential is to develop a medium-term strategy that aims at providing the kind of environment conducive to restoring and sustaining growth and employment rates such as those achieved in the past. Of course, demand management has an important role to play in support of such a strategy. Indeed, it would not be worrisome that, in the process, fiscal and balance of payments deficits will be incurred, particularly given the surpluses accumulated in the past. Clearly, however, the reliance on demand management alone to stimulate the economy could not be sustained indefinitely.

The information on the 1986-88 Development Plan provided in Supplement 1 to SM/86/171 gives a broad indication of the policy strategy to be followed over the next three years. Although a full assessment of the plan is not yet possible, a number of positive elements in the plan should be recognized, including its emphasis on stimulating investment and exports and on expanding the role of the private sector. While the Government's role and official direction may continue to be substantial, and may in fact increase, that in itself should not necessarily be judged as counterproductive, particularly in a small economy like that of Malta. It is nevertheless crucial that public sector support for private sector investment and exports be designed in such a way so as not to jeopardize but to foster the longer-term profitability and competitiveness of private enterprises receiving official support.

Another positive indication of medium-term policies is the recent lessening of trade restrictions. However, although price controls have helped keep the rate of inflation low over the last three years, the decline in the world inflation rate and the authorities' emphasis on stimulating output and investment seem to argue for a gradual phasing out of these controls.

We welcome the fact that the authorities and the staff mission were able to consolidate the budgetary and extrabudgetary figures of public sector operations. This should provide a more accurate picture of the status of, and changes in, fiscal policy.

As for monetary policy, the staff considers the current interest rates adequate, but seems to disagree with the authorities on whether excess liquidity exists in the system. It is admittedly difficult to ascertain the presence of excess liquidity when real interest rates are rising, as is the case in Malta. Mr. Zecchini has also pointed out why the liquidity issue is not a serious one. Nevertheless, it would be prudent for the authorities to avoid an excessive expansion of liquidity, whose effects may not be evident in the presence of price and import controls, but would inevitably be reflected in the rate of inflation and the balance of payments if and when those controls are phased out. As to the use of government bonds to finance the public sector deficit, the authorities are understandably reluctant, given the accumulated balances in the posterity fund. However, it should be recognized that the use of these cash balances is tantamount to central bank financing. In a sense, therefore, such financing is not without cost either, given its potential effect on prices and the balance of payments. We have noted in this regard the staff's reference to the possibility of tapping the liquid assets of the private sector in order to finance the public sector deficit in the context of the new Development Plan. Mr. Zecchini also refers to the mobilization of private domestic savings in support of investment projects; perhaps he or the staff could elaborate on how this will be achieved, and whether the authorities are more inclined now to engage in government bond sales to the private sector.

The depreciation in the effective exchange rate over the past year, and the adoption of a new currency basket, whose weights include both trade and tourism transactions, are welcome developments. It is hoped that this will be reflected in improved competitiveness and the restoration of lost market shares in the period ahead.

Mr. Bengs remarked that two issues merited consideration in the 1986 Article IV consultation with Malta. First, it was important to know the short- and medium-term implications of the previous year's shift in fiscal policies for the economy, with particular regard to the sustainability of that policy stance. Second, there was a question whether the authorities' policy stance--notably, the choice of policy instruments--was conducive to the achievement of their goals. The staff and the authorities held different views with regard to the appraisal of those policies. He tended to agree with the staff's position. He also agreed with the staff's conclusion that the implications of the authorities' recent policy shift for the fiscal and external accounts should not be of immediate concern, however, particularly if that policy stance was only temporary and if the public sector investment projects were apt to enhance the productivity and efficiency of the economy.

Nevertheless, it was quite clear that the continuation of current trends in the fiscal and external position would entail serious risks for the medium term, Mr. Bengs continued. Internal and external imbalances could well reach worrisome proportions. Scenario B of the staff's medium-term projections (Appendix IV, SM/86/171) clearly highlighted the potential dangers inherent in a policy stance that attempted to maintain a specific growth target of GDP by means of faster growth of domestic demand. Caution was therefore warranted to prevent internal and external balances from reaching unsustainable proportions.

With respect to the appropriateness of the authorities' chosen policy stance, he, like the staff, saw a number of risks, even in the short run, Mr. Bengs went on. The staff had rightly pointed out the underlying risks attached to the current trend in public sector finances with regard to the liquidity situation, as well as the consequences of an increasing absorption of domestic savings by the public sector. Moreover, there might be questions whether the continued emphasis given to controls and government intervention was appropriate. While some liberalization in the trade sector had indeed been undertaken along with the pursuit of a more realistic exchange rate policy, it was disappointing to note the authorities' continued reliance on price and wage controls. Such controls were not likely to encourage the best allocation of resources and might even discourage the inflow of foreign investment. In addition, the extent of official intervention in the economy would remain high or would even increase in some areas under the 1987-88 Development Plan.

In conclusion, while the implications of the recent shift in fiscal policy did not give rise to immediate major concerns, a word of caution might be appropriate, Mr. Bengs stated. Given the questions about the appropriateness of the authorities' policy stance, developments should be monitored carefully. The authorities should be cautious and ready to change or adapt their policy stance, particularly if it became evident that the financial imbalances risked becoming unsustainably large. Finally, he could support the proposed decision.

Mr. Romuáldez made the following statement:

> What the Maltese authorities have decided to do seems clear; the staff have certainly summed it up well in the staff appraisal (page 10, SM/85/171). As Mr. Zecchini has stated, moreover, they have embarked deliberately on their present course. They seem fully aware of the risks of inflation in particular and possible loss of external competitiveness that are associated with

their policy choices. The authorities seem confident nevertheless that the that the economy possesses a sufficient cushion in terms of international reserves and public sector finances to allow temporarily what, in the longer term, could be unsustainable fiscal and external deficits. The staff's unease or fears are fully justified in that these policies, which depend for the most part on the exercise of administrative controls over the exchange and trade system and on prices and wages, can be distortive and a disincentive to the private sector activity that the authorities are so keen to develop and will be far from easy to dismantle if maintained for very long.

As the staff reminds us, nevertheless, the authorities have in the past generally exhibited prudence in fiscal management. While we would like not to doubt that they still retain this prudent posture, we do share some of the staff's unease over what might be regarded as venturesome decisions made in the past two years. We would therefore encourage them to be cautious and monitor developments closely, to retain control over these possibly troublesome policy decisions. The authorities should be alert to the nuances of exchange and trade developments and of the liquidity situation of banks and the nonbank public, areas in which retrenchment cannot always be sufficiently rapid. Moreover, such retrenchment is not without pain.

We support approval of the proposed decision and hope that the authorities will succeed early in what they are trying to achieve so that they can return without delay to more patently traditional prudence.

The staff representative from the European Department remarked that the discussion had reflected the difficulties evident in the staff analysis of the present state of the Maltese economy. There were some features in recent developments that no one, including the authorities, would wish to continue.

There had been a large increase in the public sector deficits during the past year, after many years of surplus, the staff representative continued. The staff still believed that those deficits in themselves were not worrying, and indeed they could continue a while longer without posing undue danger. If those deficits continued for a longer time, however, that would be worrying.

With respect to the details of the budget for the 1986-88 Plan, data for the entire public sector were available only for 1986, the staff representative explained. It was not possible to indicate whether the public sector deficit might increase to 9 percent of GDP because the staff had only fragmentary data about the budget itself, and not about other parts of the public sector. Based on past evidence, at least, a deficit of 9 percent of GDP would be quite large, and would almost certainly cause the authorities some concern. It was not known whether the authorities intended to take any additional measures to reduce the extra called-upon resources that were identified clearly in the Three-Year Plan. However, there had been an indication that the authorities were not currently envisioning any increases in direct taxes.

The financing of the public sector deficit in the second two years of the Three-Year Plan could be achieved in two ways, the staff representative commented. The continued running down of public sector deposits with the Central Bank would cover a significant part of the deficit in prospect. The authorities might also consider issuing public sector securities to the commercial banks and to the private sector.

At present, there was no financial market for private sector securities, the staff representative from the European Department indicated. Most of the public sector bonds that had been issued many years previously, and had been rolled over, were held by the commercial banks. It was possible that the private sector could issue securities to other parts of the private sector, but the securities market was not such that one could expect a large amount of resources to be obtained in that manner. Any references to the utilization of private sector savings were in terms of the sale of public sector securities.

Mr. Zecchini remarked that the authorities were in the process of reorienting their economic policies and their development strategy, and that the occasion for the reorientation had been offered by the issuance of the Sixth Development Plan, which covered the period 1986-88. The Plan had three main objectives. The objective of export promotion represented a major step forward, compared with the past strategy that had emphasized import substitution over export promotion. The shift in strategy gave rise to several implications in terms of policy choices. A second objective of the Plan was a strong push toward fixed capital expenditure, both from the public side and the private side. The data in the Development Plan, which he had quoted earlier, gave a clear picture of the degree and rhythm of expected fixed capital formation over the next three years--namely, very rapid growth. The third objective of the Plan involved more flexibility and active use of policy instruments by the authorities, not only in the domain of fiscal policy but also in monetary policy.

The authorities had stated that they planned to draw inter alia on the balances accumulated in previous years to help finance the deficit spending, Mr. Zecchini reported. Many Executive Directors had expressed concerns about the inflationary implications of drawing on those balances, but it was not clear to him what kind of inflation model they had in mind. An analysis of that kind of financing had to be considered in the light of an expansion of the supply side of the economy, of the production capacity of the economy, and of the ability of the economy to provide goods and services. Any monetary financing could lead to inflation--on the assumption of a certain set-up of market conditions, which were not similar to the present situation of wage and price controls in Malta--if it led to an excess demand for goods and services that resulted in an increase in price levels. He was not in a position to draw firm conclusions about whether the authorities' strategy would lead immediately to excess demand. The major objective of the authorities' deficit spending was to increase the production capacity and the infrastructure of the economy, which could not lead automatically to inflationary pressures.

Anyway, drawing on the accumulated balances was not the only way in which the authorities would finance their new development strategy, Mr. Zecchini pointed out. The authorities were well aware that they had to mobilize a larger amount of private savings in support of their strategy. Of the two policy instruments that the authorities were considering, a more active interest rate policy was expected to be an important instrument for raising the level of private savings. The other option under consideration was the issuance of new financial instruments. The Development Plan was not specific in that respect, in that it did not give a precise breakdown of the composition of those instruments; it referred to private placing of bonds under syndicated or other arrangements and to share capital increases.

Finally, noting Executive Directors' calls for caution in the use of policy instruments in the pursuit of the new strategy, Mr. Zecchini said that prudence had always been a characteristic of Malta's policy management and that there was no ground to doubt that prudence would be used in the future to effect the new policies.

The Acting Chairman then made the following summing up:

> Executive Directors generally endorsed the appraisal in the staff report on the 1986 Article IV consultation with Malta. They noted the low rate of inflation and the renewal of growth in the economy, and welcomed the slight decrease in the level of unemployment. Directors commented, however, that the upturn had been led principally by a rise in domestic demand, accompanied by a decline in the savings ratio, and had resulted in a deterioration in the current account of the balance of payments. From a short-term perspective, those developments were not considered serious, since a very high level of international reserves had been accumulated, and foreign debt was very small. Nevertheless, Directors indicated that a sustained growth of exports of goods and services was essential in the period ahead. In that regard, they welcomed the authorities' actions in 1985 to reverse the earlier appreciation of the real effective exchange rate and the intention to enhance further export competitiveness, which would help Malta to regain market shares.
>
> Directors noted the deterioration in public sector finances, although they acknowledged the authorities' desire to improve infrastructure and to increase employment through public sector investment, and recognized that the deficits followed a period of sustained surpluses. While the deficits were viewed as being

currently manageable, Directors believed that their continuation could present dangers and expressed some concern about the possible size of the deficits for 1987-88. They also observed that the deficits in 1984-85 had been one cause of monetary expansion and noted the present highly liquid position of both the commercial banks and the nonbank public. Directors considered that the monetary authorities would be wise to endeavor to reduce that liquidity. They also believed that caution should be exercised in considering any change in the level of real interest rates.

Directors welcomed the basic thrust of the authorities' longer-term policies, which emphasized the development of a competitive and expanding external sector and envisaged an increasing role for private investment, including foreign investment. However, some inconsistency might exist between those aims and the continuation of a large degree of official intervention in the economy. Some Directors expressed disappointment that the opportunity was not being taken to relax the wage/price freeze in 1986, when international price developments--for example, oil prices--were particularly favorable. More generally, they considered that a more market-oriented set of economic policies would be conducive to the longer-term growth of the private sector and the economy at large, which the authorities wished to encourage.

Directors welcomed the relaxation of some controls on trade and payments but noted that such controls and regulations were still extensive, and encouraged the authorities to liberalize further the trade and payments system.

It is expected that the next Article IV consultation with Malta will be held on the 18-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Malta's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1986 Article XIV consultation with Malta, in the light of the 1986 Article IV consultation with Malta conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. As described in SM/86/171, the restrictions on the making of payments and transfers for current international transactions are maintained by Malta in accordance with Article XIV, Section 2 except that the restrictions on exchange allowances for foreign travel and the restriction evidenced by a bilateral payments arrangement with a Fund member are subject to approval under Article VIII, Section 2(a). The Fund welcomes the actions

by Malta to reduce exchange restrictions through increases in exchange allowances for foreign travel and the termination of two bilateral payments arrangements with Fund members and urges Malta to terminate the remaining bilateral payments arrangement with a Fund member.

Decision No. 8373-(86/138), adopted
August 27, 1986

2. MALAYSIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Malaysia (SM/86/164, 7/7/86). They also had before them a report on recent economic developments in Malaysia (SM/86/173, 7/17/86).

The staff representative from the Asian Department made the following statement:

The staff has been informed of the reasons leading to the recent suspension of Bank Negara's guidelines on nonaccrual of interest on nonperforming loans (page 12, SM/86/164). The authorities have indicated that in an environment of economic slowdown, poor business conditions, and tight cash flows, the Government felt it was not timely to implement the Bank's guidelines on interest in suspense. Bad debt provisions are not affected by this decision. In deferring implementation, Bank Negara left it to the individual boards of management of the commercial banks, finance companies, and merchant banks to adopt their own rules. As a matter of practice, however, the authorities have indicated that all institutions have since voluntarily adopted the Bank's guidelines on nonaccrual of interest as their own.

Separately, financial problems have emerged in cooperative societies, which resulted in the recently announced measures by the Minister of Finance to freeze the assets of 23 cooperative societies and those of their directors and families. The cooperative societies in Malaysia are supervised by the Cooperative Development Department of the Ministry of National and Rural Development. The authorities have indicated that in the current economic slowdown, most cooperative societies were faced with liquidity problems and were unable to meet customers' demands to withdraw deposits. The cooperative law is inadequate and does not provide for last-resort facilities to help the cooperatives. To deal effectively with the situation, the Essential (Protection of Depositors) Regulations, 1986, were brought into force on July 23, 1986. Since then, Bank Negara has investigated a total of 24 deposit-taking cooperatives. The Government is expected to announce shortly a plan to resolve the problem of deposit-taking cooperatives.

The authorities have also informed the staff that the current fiscal outlook anticipates an overall deficit of the Federal Government of about M$8 billion or the equivalent of 12 percent of GNP in 1986. However, assuming normal shortfalls in expenditure, the overall deficit may be reduced to M$7.0-7.5 billion, equivalent to 10-11 percent of GNP. For 1987, the Government intends to take measures that will include new revenue initiatives, getting government agencies to service their debt to the Federal Government and repay the principal as scheduled, reducing budgetary allocations for government agencies and nonfinancial public enterprises with surplus funds, and making efforts to have agencies improve their financial performance and declare dividends to the Government. With these measures the Government hopes to reduce substantially the expected large fiscal deficits in the current account and contain the overall fiscal deficit.

Finally, the authorities have indicated that a comprehensive review of the Fifth Malaysia Plan is being made. This review is expected to lead to a decrease in the development expenditure of the public sector for 1987. Revisions are being recommended to the Cabinet in terms of the growth target and the expenditure allocation. A 30 percent reduction in allocation is being recommended, affecting the Federal and State Governments and the nonfinancial public enterprises.

Mr. Jaafar made the following statement:

I would first like to convey to Directors the appreciation of my authorities for the excellent 1986 reports relating to the Fund's Article IV consultation with Malaysia. They share broadly the thrust of the staff's appraisal contained in the main paper. They found it to be similar in substance to the theme taken earlier by the staff in their report at the 1985 Article IV consultation--namely, on the need for a continued judicious mix of intensified fiscal adjustments and more active use of exchange rate policy.

They agree that the medium-term outlook for the balance of payments and the external debt burden are disquieting if the trends as projected in these reports materialize.

Directors may find it instructive in drawing their own conclusions from the current review to compare it with the estimates and projections made last year at the 1985 Article IV consultation. The concerns expressed by the staff last year can be succinctly captured from the following excerpt of that report:

> Notwithstanding the substantial adjustment achieved, the outlook and stance of policies for 1985 contain disquieting elements. On the one hand, the impetus to growth

> from external demand is expected to be much lower. On the other hand, the fiscal outlook does not envisage significant further adjustment in the year. In these circumstances, the external deficit in current account is expected to increase to almost 8 percent of GNP. This prospective widening of the external deficit will exacerbate the problems of adjustment in the coming years. (Page 18, paragraph 1, 1985 staff report)

The above conclusion was based mainly on the forecast increase of the external current account deficit to US$2.5 billion, equivalent to nearly 8 percent of GNP, and with the estimated overall deficit in the federal budget to be slightly over 7 percent of GNP. The forecast growth in real GNP was a brisk 5 percent. The implications on the government adjustment efforts required and the needed external financing to sustain the large imbalances were, therefore, obvious.

The results were otherwise. Economic growth in 1985 decelerated sharply to almost 3 percent in real terms, owing to a combination of factors--in particular, a substantial slack in external demand for Malaysia's major exports and a sharply weaker internal stimulus. The latter was largely a reflection of the ongoing government fiscal austerity. More important, the fiscal restraint, equivalent to nearly 2 percent of GNP above that projected in the 1985 staff report, had led to a large shortfall of US$2 billion from the projected import figures, leading thereby to a significantly lower current account deficit equivalent to only 3 percent of GNP instead of the 8 percent as forecast.

This performance was achieved not without cost in terms of the loss in employment and output. Real income after correcting for the adverse terms of trade, in fact, declined in 1985, and unemployment rose to about 8 percent.

The outturn in the external account for the whole of 1986 may also differ significantly from the estimate made during the consultation. On the basis of the actual data for the first half of this year, the estimates for 1986 point to a lower current account deficit than expected. Because of a better performance in the exports of Malaysia's commodities in palm oil, tin, and natural rubber, as well as in manufacturing, it is now possible to revise the original estimate of the merchandise exports--US$12.2 billion--upward to US$12.7 billion. In the first six months of 1986, gross imports recorded a decline at an annual rate in excess of 16 percent. For the whole year, it is now estimated that total imports may decline by as much as 9.5 percent instead of the 10.5 percent estimated earlier (Table 6, page 20 of SM/86/164). My authorities are, therefore, optimistic that the current account deficit for 1986 will not exceed an estimated US$1.5 billion, equivalent to about 5.6 percent of GNP; this would be nearly US$1 billion lower than the estimated deficit of US$2.3 billion, equivalent to 8.5 percent of GNP in the report.

The figures for the medium-term projections could be equally tentative if comparisons are taken, for example, of the projections in Table 6 of the 1985 staff report (page 25, SM/85/180, 6/26/85) and those in Table 6 of the current one (page 20, SM/86/164).

Last year, the major assumption was an average US$30 a barrel oil price a year during the 1986-89 period, with real growth in GNP to be at a moderately faster pace of 5 percent annually. This had led to a projection of a more sustainable current account deficit of US$2.4 billion a year, equivalent to 6 percent of GNP, and with an average debt service ratio of 15.6 percent. In contrast, the more recent projections assumed an oil price of US$14 a barrel annually during 1987-91 and a lower average real GNP growth of 4 percent a year. These had led to the projections of US$2.5 billion current account deficit annually, equivalent to 8 percent of GNP on average, with a debt service ratio of 20 percent a year.

My authorities believe that modified projections are now possible in the light of the revised estimates for 1986, and in view of the policy stance, either firmly in place or being contemplated within the framework of a revised Fifth Malaysia Plan (1986-90). Indeed, assuming that policy measures are undertaken as envisaged now to narrow the imbalance in the fiscal position of the Government, my authorities expect a lower deficit in the external current account, probably not exceeding 3.5 percent of GNP on average, in the medium term.

For the current year and 1987, my authorities fully share the staff's concerns over the fiscal outlook, particularly in FY 1987, when the full impact of the fall in oil revenue will be felt. For FY 1986, the Federal Government expressed its full determination to take all the necessary steps it possibly can to pare the budget and remain on course in its austerity drive. Steps have been taken, for example, to reduce the operating expenditure of the Federal Government. This should be reflected this year in an overall federal deficit that is somewhat smaller than had been anticipated in the staff report.

My authorities are fully aware that careful fiscal measures are also necessary to contain the unfavorable fiscal outlook for FY 1987. In this regard, the 1987 fiscal package will include such measures as a new revenue initiative, getting government agencies to service their debt to the Federal Government as scheduled, reducing allocations in the budget for government agencies and NFPE's with surplus funds, and getting agencies to improve their financial performance and declaring dividends to the Government. It is also expected that a significant cut in development expenditure of the public enterprises will also be taken in the coming year. Steps toward this end have already been set in motion or are under consideration. In this connection, a study by the Malaysian Institute of Strategic and International Studies is now being finalized on the possibilities of reducing the size of the public service. My authorities are hopeful that this could provide a basis for a more systematic approach in containing the size of government.

A complete review is now being undertaken of the HICOM projects (heavy industries projects) with the assistance of the World Bank. At the same time, the Asian Development Bank (AsDB) is also assisting the Government in reviewing the Sabah Gas Projects, with a view to their privatization. These reviews are expected to result in major adjustments in the projects of these enterprises.

For the medium term, the Government is currently making a comprehensive review of its Fifth Malaysia Plan. A major result of this exercise will be a significant reduction in the size of the development allocation. It is expected that the smaller allocation will have important implications on the projection of growth, which is now revised downward from 5 percent to a more realistic level of 3 percent a year during the Plan period. The external current account deficits and the government external financing needs will also ease by comparison to earlier projections. This review is expected to have an important effect on the role of the Government in the economy.

The longer-term strategy of promoting growth through private sector initiative is being put into place, including deregulation in the manufacturing sector and in foreign equity ownership and instituting safeguards in the financial system and capital markets, to protect investors and private individual interests. In the agricultural sector, consultations and policy studies are being used by the Government to explore how best to revitalize the major primary commodity industries, such as palm oil and natural rubber, to meet the challenges in the international markets.

In sum, what lies within the control of my authorities is in terms of adopting the right internal policies to foster efficiency, quality, and competitiveness in the production of primary commodities and manufactures. They strongly felt, however, that what lies beyond their control--but could play a crucial role--is a commitment by the industrial countries to keep their markets open to our exports.

Mr. Murakami commended the authorities for their steadfast adjustment efforts since 1983. The authorities had continued to pursue those efforts during 1985, and had reduced the federal government deficit further, to 5.4 percent of GNP. The current account of the balance of payments had continued to improve. Moreover, in 1985, the authorities had undertaken refinance operations to alleviate the bunching of external debt repayments during 1986-92, and thereby to improve the maturity profile of Malaysia's external debt.

During the course of 1985, however, Malaysia had experienced a deterioration in external conditions, as the export prices of its major primary commodities had weakened, Mr. Murakami noted. That weakening had been accompanied by a decline in domestic demand, owing to a slack in construction activity and a drop in crude oil production. There also seemed to have been a considerable loss in business confidence. As a result, the real GDP growth had slowed to a historically low 2.8 percent level.

The sharp drop in crude oil prices early in 1986, together with the unfavorable trends of 1985, posed a concern for the prospects of the Malaysian economy in 1986 and beyond, Mr. Murakami observed. Under such circumstances, it seemed necessary for the authorities to persevere and even intensify their adjustment efforts.

According to the statement of the staff, the authorities were anticipating that an overall deficit of the Federal Government could reach 12 percent of GNP in 1986, Mr. Murakami continued. While the authorities had already implemented some additional adjustment measures, such as increased taxes on domestic sales of petroleum products, they needed to intensify their efforts in that area. Given the lagged impact of lower oil prices on the payment of income taxes and the financial position of Petronas, the prospect for the 1987 budget was even more unfavorable.

Since the authorities had found only limited scope for curtailing current expenditures, they should first focus their efforts on the revenue side, Mr. Murakami considered. Therefore, he shared the staff's view that there was scope to expand the base of indirect taxes and to improve tax administration. In that context, he welcomed the authorities' new revenue initiatives for 1987. In addition to the revenue-raising measures, the authorities needed to undertake a more fundamental assessment of the role and size of the public service, including that of state governments.

He supported the legislative reforms that had been adopted in early 1986 to strengthen the financial system and the Central Bank's authority over banking supervision, Mr. Murakami stated. As for monetary policy instruments, a substantial amount of foreign currency swaps had been used in 1985 and early 1986 to augment the liquidity position of commercial banks. However, the authorities should not rely excessively on foreign currency swaps, given the risk of undue accumulation of short-term external debt. Under the circumstances in which the Government's surplus deposits with commercial banks were expected to be withdrawn over the coming period, it was appropriate for the Central Bank to consider introducing additional monetary policy instruments to manage bank liquidity.

The decline in interest rates thus far was welcome, under the present circumstances, Mr. Murakami added. However, given the slowdown in the growth of private sector deposits with commercial banks, he wondered what measures could be taken to encourage such deposits. Any comments by the staff on that point would be helpful.

Major, welcome steps had been taken in 1985 in the area of industrial policies toward the relaxation of the guidelines for foreign equity participation in the manufacturing sector and the liberalization of the Industrial Coordination Act, Mr. Murakami went on. While the sharp drop in commodity prices had substantially altered the basic assumptions for the Fifth Malaysia Plan, he could support the principal elements in the Plan, namely the reduction in the size of the public sector, the improved efficiency of public sector investment, and the promotion of private investment in productive sectors.

Given a decline in primary commodity exports, Malaysia's current account deficit was expected to increase in 1986, Mr. Murakami remarked. The staff had projected that the external outlook would be more difficult in 1987; indeed, according to the medium-term scenario, the current account deficit would remain relatively high over the medium term. Assuming that additional adjustment measures would be undertaken, the authorities seemed to have drawn a brighter medium-term picture, although the details of the basic assumptions had not been provided. While the staff's scenario reinforced the importance of intensified fiscal restraint, more active use of exchange rate policy would have a role to play. During 1985, the Malaysian ringgit had depreciated by nearly 9 percent against its composite basket of currencies, but that had reflected mainly the downward trend in the value of the U.S. dollar over the same period. Given the uncertainties with respect to the future development of the value of the U.S. dollar vis-à-vis other major currencies, the active use of exchange rate policy had become all the more important.

Mr. Templeman made the following statement:

> As Mr. Jaafar has pointed out, the outcome of economic developments in Malaysia in 1985 proved to be rather different from what the Board was expecting at the time of the last Article IV consultation. Some of the news was better than expected, but other news was worse. For example, the rate of real growth of GNP last year proved to be only about half the 5 percent that had been expected, while domestic demand actually fell in real terms. However, the slower pace of economic activity contributed to virtually no rise in consumer prices and a fall in imports. Moreover, the current account deficit was about 3 percent of GNP rather than 7-8 percent, and the Federal Government's fiscal deficit was under 5 1/2 percent of GNP, against an expected 7 1/4 percent.

For 1986 and 1987, the decline in oil and other commodity prices will have an important negative impact on the economy, given that oil exports represented about 24 percent of total exports last year and that fiscal receipts from oil represent about 30 percent of the total. Nonetheless, external events do not fully explain the unexpected dramatic worsening of the fiscal and current account balances. For example, a rise in public expenditures would be a much more important cause of the increase in the fiscal deficit than would the shortfall in oil revenue, and the drop in non-oil exports would be larger than that of oil exports. We recognize that the authorities have had only limited time to react to the changing economic environment, but the potential imbalances are so large that there is little time to lose.

In the fiscal accounts, the authorities' better than expected success in reducing the deficits of the Federal Government and of the overall public sector last year was commendable. The cuts in the federal deficit from a peak of 16.9 percent of GNP in 1982 to 5.4 percent last year and in the public sector from 17.2 percent to 8.1 percent, were impressive. However, neither of the 1985 figures offers a favorable base for absorbing the negative developments that have now occurred. Of course, the decline in the oil price and the general slowdown in economic activity are expected to hurt fiscal receipts, but it is on the expenditure side that the largest shifts would occur. For example, current expenditures would rise by about 13 1/2 percent in both nominal and real terms. The purchase of goods and services--other than wages and salaries--would rise by nearly 41 percent, and subsidy and transfer payments would rise by nearly 31 percent, accounting together for more than 80 percent of the rise in current federal expenditures.

In contrast, the rise in interest payments would be a fairly small component of the total rise and the nominal wage and salary bill would be quite stable. We would welcome some clarification of the reasons for the rise in these current expenditures. Also unclear is the anticipated increase in the deficit of the rest of the public sector, from 2.7 percent of GNP last year to 4.8 percent in 1986. We note that a public spending program was introduced late last year. Perhaps this program explains in part the expected rise of about 1 1/2 percent in the capital spending ratio to GNP and the rise in the deficit of the rest of the public sector. In any case, we wonder what the status of this program is now, and whether some scaling back might, at a minimum, be possible. More generally, we join the staff in urging that the authorities embark on both strong, immediate adjustment measures and on a comprehensive review of the role of the public sector on the spending and revenue side. In particular, a more determined privatization effort for the public enterprises could be a valuable tool for restraining the fiscal deficit and strengthening the business sector.

I have already mentioned the authorities' important achievement last year in reducing the current account deficit of the balance of payments to about 3 percent of GNP. Unfortunately, a 13 percent decline in nominal imports owing to the slowdown of economic activity was a principal explanation. The current account outlook for this year will clearly be seriously affected by the expected drop of US$1.5 billion in oil exports, but the staff report estimates that non-oil exports will fall even farther, by US$1.6 billion. However, on the basis of actual data for the first half of 1986, Mr. Jaafar suggests that exports may do better than the staff forecast and that the current account deficit could be significantly lower this year. He also indicates that the current account deficits over the medium term could be much lower than the staff has estimated. I would welcome staff comment on these assessments.

A flexible exchange rate policy clearly needs to be followed in the face of present uncertainties. We do not know just how to evaluate the adequacy of the present rate. We note in Chart 5 of SM/86/164 that early in 1986, the real effective rate had returned approximately to its level of early 1981 and late 1979. However, it is not clear whether that level was particularly appropriate, even then. Since the current account deficit exceeded 10 percent of GNP in 1981, this may not have been the case. We would welcome staff comments on this point.

We are increasingly struck by the very rapid buildup of Malaysia's foreign debt, from 34 percent of GNP in 1981 to nearly 65 percent last year and 76 percent expected this year. At the same time, the debt service ratio has risen from a low 8 percent in 1981 to more than 15 percent in 1985 and to more than 19 percent expected in 1986. In sum, Malaysia has rapidly moved into the ranks of the heavily indebted developing countries. Nonetheless, it has apparently been able to restructure its 1986-92 debt maturities and to increase its borrowing from foreign financial institutions, including an increase of US$1 billion last year. Nevertheless, it is hard to avoid the conclusion that the past good image of Malaysia in international financial markets may now be in jeopardy, not just because of the present higher level of debt, but in the light of the medium-term outlook as well.

In the face of the continued slowdown this year in economic activity, the authorities' accommodative monetary stance may be justified but it is not risk free. The growth targets for M3 of 5-10 percent and for credit to the private sector of 10-15 percent may prove to be acceptable, without reigniting inflation. However, with real economic growth of only 1 1/2 percent to 2 percent, there may now be more risk than before of any inflationary impact if such a level of expansion materialized. We support the efforts of the monetary authorities to deal with some weaknesses in financial institutions and the stock market, and their longer-term efforts to find new and more effective monetary instruments, with technical assistance from the Fund. We would be interested in a further staff assessment of the adequacy of the measures to instill more confidence in financial institutions and in staff views on whether the weaknesses of these institutions have adversely affected monetary policy in a macroeconomic sense.

I feel less assured about the approach taken by the authorities concerning economic planning and industrial policy. I recognize that there has been some shift from heavy dependence on the public sector toward a more favorable environment for the private sector. Nonetheless, the adverse effects of past inefficient public sector investments are apparently still being felt, including on·foreign trade policy, with the implication that protectionism in Malaysia may grow as a result. I also recognize that there have been some liberalization measures with regard to equity ownership in foreign direct investment, the licensing of capacity increases, and business tax incentives. Nevertheless, the continued deep administrative involvement of the Government in the economy may be, in itself, an impediment to domestic and foreign business investment.

In conclusion, the authorities are now confronted with a grave challenge to both domestic and external growth stability. Large imbalances in the fiscal and external accounts have persisted for some years. Although good progress has been made through 1985 in a number of areas, both imbalances had remained quite large and domestic and foreign confidence had already been eroded to some extent. The way in which the authorities respond to the worsened external environment now will likely go a long way toward either supporting international confidence, or eroding it further. I hope that the authorities will act promptly and resolutely, both to deal with the immediate problem and to demonstrate that they intend to pursue prudent policies over the longer term.

Mr. Ebrill made the following statement:

Since 1982, the Malaysian authorities have been consistently pursuing an adjustment policy aimed at eliminating the external and internal imbalances that had emerged in the economy. This policy has been broadly successful. The federal fiscal deficit, expressed as a percent of GNP, declined from about 17 percent in 1982 to about 5 percent in 1985. Furthermore, the current account deficit declined sharply and, significantly, the economy entered a period of sustained growth. I commend the authorities for these achievements.

Unfortunately, these developments have recently been marred by a broadly based deterioration in Malaysia's external environment. This deterioration has, in turn, exacerbated internal imbalances. To elaborate, the federal fiscal deficit is projected to be in the range of the equivalent of 10-12 percent of GNP in 1986, with the consolidated fiscal deficit being even greater. Moreover, some of the adverse impact of the downturn in external conditions will not be felt until 1987. Such deficits are unsustainable, and, in particular, could feed upon themselves, with ever greater expenditures being allocated to interest payments. I note from the medium-term scenario that Malaysia's external debt in 1991 could be equivalent to 85 percent of GNP, in contrast to 47 percent in 1982. Nevertheless, as Mr. Jaafar has explained, recent data on external developments, when taken in conjunction with the current review of the Fifth Malaysia Plan, suggest a less gloomy outcome.

More generally, I am encouraged by Mr. Jaafar's assurances that the authorities are aware of the situation and are committed to a continuation of the adjustment efforts already under way. In particular, I commend the authorities for their emphasis on reducing the fiscal imbalances.

On fiscal policy, I believe that most emphasis should be placed on expenditure cuts. Currently, federal expenditures amount to more than 40 percent of GNP, which is large in absolute terms.

The main contribution of taxation to deficit reduction should occur as a byproduct of the ongoing efforts to improve and modernize the tax system. In this connection, for example, the 10 percent sales tax yields only 6 percent of total revenue, suggesting that exemptions have eroded the tax base. If this is correct, removing these exemptions would have the effect of reducing the distortionary impact of the tax while yielding increased revenue. Staff comment on this point would be appreciated.

On monetary policy, I commend the authorities for their efforts to liberalize the financial sector, so as to reduce segmentation and increase competition. The authorities have also taken commendable measures to bolster confidence in the financial system as a whole. In view of the shocks that have hit the financial system, the actions taken to strengthen the supervisory role of the Bank Negara are both notable and appropriate. Particularly welcome is the rapidity with which the Bank Negara has moved to resolve the difficulties recently being experienced by the deposit-taking cooperatives.

On structural policy, the combination of a growing debt service ratio and weak prospects for some of Malaysia's traditional exports places a premium on encouraging further export diversification. Great strides have been made in this area; the share of manufactured goods exports in total exports increased from 23 percent in 1981 to 32 percent in 1985. The authorities are wisely continuing to de-emphasize capital-intensive public investments. I look forward to the completion of the review of HICOM projects with the assistance of the World Bank. In this context, I believe that the greater emphasis now being given to export-oriented expansion will require an intensification of the authorities' efforts to liberalize industrial policy. To ensure the success of these policies, Malaysia's major trading partners must grant ready access to their markets for those products in which Malaysia has a comprehensive advantage.

In conclusion, the Malaysian economy is currently facing some short-term difficulties. The authorities are aware of these difficulties. Given their commendable record of adjustment over the recent past, I am confident that they will continue to respond appropriately to the situation.

Mr. Foot remarked that the sharp worsening of the external background had made the past year difficult for the authorities, and as a result, the significant strengthening of the external position that they had achieved over the past few years had been set back. In the face of the worsening conditions, the authorities had taken some time to formulate a comprehensive policy response. He was glad to learn from Mr. Jaafar that the authorities recognized the need for such a response and had begun to formulate it in some detail. The staff's medium-term balance of payments scenarios made obvious the need for further action, although oil prices were recovering more quickly than the baseline scenario would suggest, and even if the 1986 outturn currently looked better than it had when the staff report had been written. Thus, even in the higher oil price scenario, the debt to GDP ratio would rise from about 65 percent in 1985 to an uncomfortably high level of nearly 80 percent by the start of the next decade. Nevertheless, it was encouraging that financial markets still recognized the creditworthiness of Malaysia as witnessed by the recent successful, substantial Eurodollar loan. He agreed with Mr. Templeman that it was important for Malaysia to guard its excellent reputation in the financial markets.

The outlook did thus emphasize the need for the authorities to implement further measures to achieve a more sustainable external position, Mr. Foot continued. The staff had suggested two essential components of such a strategy, namely that fiscal policies needed to be tightened and that a more active exchange rate policy was required. The situation for 1986 now looked better than it had when the staff report had been written. While that was clearly an encouraging, helpful development, the conclusion to be drawn seemed to be that more needed to be done, although less than had been recommended by the staff. He joined other speakers in commending the idea that there was room for a reexamination of the operations of the public enterprises. The study by the Malaysian Institute of Strategic and International Studies was particularly timely.

The flexible policies followed by the authorities had led to a recent, significant fall in the real exchange rate since the second half of 1984, Mr. Foot commented. As Mr. Templeman had indicated, it was important for the authorities to maintain those flexible policies.

Adjustment to the changing external circumstances should, of course, include important structural adjustments, Mr. Foot went on. In that regard, the authorities had recently made some significant, useful changes to improve the flexibility and performance of the economy. For example, the measures taken in July 1985 to ease the controls on foreign equity participation were a welcome step toward increasing the supply of foreign capital and expertise available to the economy. Subsequently, additional reforms had eased the licensing requirements on production and investment in the manufacturing sector. Those changes had been adopted in anticipation of the recommendations of the Industrial Master Plan, announced earlier in 1986.

In general, the objectives of the plan to shift the industrial development strategy away from import substitution toward a more export-oriented approach seemed fully appropriate, Mr. Foot added. The achievement of that objective would require active policy support in a range of areas, including reducing and rationalizing tariff protection, reducing tax and other disincentives to exporting, and relaxing licensing and other restrictions on domestic industry. In the light of those objectives, the reforms that had been put in place over the past year or so were to be welcomed as a significant first step in the liberalization process. However, despite those changes, significant administrative controls and restrictions remained. Furthermore, if those commendable objectives were to be achieved, it was important for all aspects of administrative behavior to conform to those goals. It would thus be essential, as a demonstration of its resolve for the Government not to yield to some of the calls for special protectionist measures that were currently being made by some sectors of the economy.

With respect to monetary policy, the moves by the authorities to reduce segmentation in the financial markets and to strengthen the standing of the financial system were welcomed as part of the structural reforms that had already been mentioned, particularly because in the past, increased financial competition had led to reductions in the cost of financial intermediation, Mr. Foot observed. The increases in the ceiling rates on loans to priority sectors to bring them more in line with market rates had also been a useful step in promoting greater efficiency. In general, however, the problems of the financial system and the responses of the authorities ought to have merited a more detailed discussion in the staff report. Moreover, the staff update had confirmed that need by pointing out how widespread and important those problems had been.

In conclusion, the situation facing the authorities had deteriorated significantly in recent months, largely as a result of adverse external developments, Mr. Foot said. That had resulted in an external position, which, in the absence of further adjustment efforts, would threaten to lead to an unsustainable buildup in the level of external debt over the coming years. The authorities obviously recognized the magnitude of the problem and were enunciating adequate adjustment policies in response.

Mr. Goos said that notwithstanding Mr. Jaafar's observation that the staff might have been too pessimistic a year earlier in assessing the outlook for Malaysia's economy, he felt that the authorities were confronting basically the same economic problems that had existed in mid-1985, so that in general, the Board's recommendations expressed at the conclusion of the 1985 Article IV consultation remained broadly valid. It was even fair to say that the Board's earlier recommendations had assumed additional urgency as a result of the recent renewed exacerbation of domestic and external imbalances and the concomitant further increase in external debt and debt servicing obligations.

Those developments were all the more regrettable since they were taking place after a three-year period of most commendable adjustment efforts that had greatly enhanced the country's financial stability, Mr. Goos went on. Against that background and given the sharp slowdown in economic activity in the second half of 1985, the measures taken at that time to revive the economy could certainly be justified, inasmuch as the weakening in external demand and commodity prices could reasonably be expected to be only temporary. Now, in hindsight, after the plunge in oil prices, those stimulatory measures appeared rather ill-timed, given the pressing need to reinforce domestic savings in response to the greatly exacerbated and probably more permanent pressure on the external accounts. Accordingly, fiscal retrenchment, which undoubtedly would have to remain at the center of the adjustment effort, would become even more cumbersome, the more so because the bulk of the expenditures envisaged under the stimulatory program would become effective only in the period ahead.

That recent experience clearly highlighted not only the great vulnerability of the Malaysian economy to external developments but also the limited room for maneuver of fiscal policy, Mr. Goos considered. There was, therefore, no realistic alternative to continued vigorous adjustment in public sector finances. While he agreed with the more specific recommendations in the staff report, he wondered whether the recent suspension of the system of quarterly budgetary allocations had not been premature in view of the difficult task of further fiscal adjustment and the apparent effectiveness of that system in controlling public expenditure.

He wished especially to support the staff's recommendation that the authorities reassess fundamentally the role of government, the size of the public service, state government finances, and the efficiency of public enterprises, Mr. Goos added. Malaysia had one of the highest public sector employment ratios in the region, and the National Office of the Auditor had recommended recently that most of Malaysia's approximately 900 state enterprises should be closed. Against that background, the authorities' recent efforts to privatize those enterprises and to reduce the size of the public service were particularly welcome.

On monetary policy, he had been surprised to note that the staff--while rightly commending the recent and ongoing financial reforms--had not assessed the appropriateness of the present policy stance, Mr. Goos commented. Given the urgent need for overall financial restraint, such restraint would certainly be appropriate also in the conduct of monetary policy. It was worrisome that Malaysia apparently had a history of high rates of liquidity and domestic credit expansion. Surprisingly, however, those high rates of expansion seemed to have had no significant impact on price developments, which had even followed a pronounced declining trend over the past few years. Since he hesitated to conclude from that experience that money supply did not matter in the Malaysian economy, he wondered whether the staff could enlighten Directors on that phenomenon. Perhaps there was a particularly high propensity to hold liquid assets. However, that situation would raise the question whether there had not been a buildup of excess liquidity over recent years that might have created a strong inflationary potential. In any event, the case for a cautious monetary policy stance in the period ahead seemed to be strong, and he was quite concerned that the supply of domestic credit projected for the current year could turn out to be much too expansionary.

Another puzzling feature of monetary policy was the existence of rather high real interest rates, despite the accommodating stance of credit and liquidity supply, and despite repeated interventions in the domestic money market to bring about a reduction of those rates, Mr. Goos continued. The limited success of those interventions thus far might suggest that the causes for the high level of interest rates did not lie in the monetary sphere but rather in the real economy, including perhaps uncertainties about the future course of economic policy. Other indications to that effect were the weakened business climate, the sluggish growth of domestic deposits, and the apparent reluctance of investors to use the relatively cheap resources of the Investment Fund. Accordingly, his conclusion was that, instead of treating symptoms by intervening in the money markets, the authorities could tackle excessive interest rates much more effectively by embarking on a vigorous, confidence-inspiring adjustment path that would stabilize expectations, thereby reducing the excessive risk premium that seemed to underlie the existing high level of lending rates. In that regard, he wondered whether the task of strengthening overall confidence would not be facilitated greatly if the authorities engaged in a Fund-supported adjustment program.

Perhaps the staff could elaborate further on its advice that the authorities should pursue a more active exchange rate policy, Mr. Goos suggested. It might be true that exchange rate developments had failed thus far to bring about the desired shift of resources into the traded goods sector. However, the depreciation of the real effective exchange rate since late 1984 had led to a strengthening of international competitiveness by no less than 21 percent. That gave rise to the question whether, apart from relative prices, there might not be other factors that were impeding export performance. If so, the more active exchange rate policy advocated by the staff could only develop its full potential if it were supplemented by continued efforts to overcome such other impediments to stronger external performance. The authorities merited particular commendation for their liberalization efforts in the financial markets and in industrial policies, as well as their general strategy of strengthening private sector initiative, which should go a long way toward meeting that concern.

The statements of Mr. Jaafar and the staff had been especially reassuring, inasmuch as they indicated the authorities' continued resolve to face the new external and domestic challenges, Mr. Goos stated. He was particularly heartened to note that the authorities were currently reviewing the Fifth Development Plan with a view to reducing the role of government in the economy and to adjusting the size of development expenditures to more realistic expectations about the future availability of domestic and external resources. Nevertheless, like Mr. Templeman, he felt that the emerging imbalances were so large, that there was no time to lose in formulating the appropriate corrective measures. Finally, he agreed with the thrust of the recommendations in the staff appraisal.

Mr. Bethel made the following statement:

> The fiscal adjustment undertaken by the Malaysian authorities since 1983 to deal with both the Federal Government and current account deficits has been most impressive. This adjustment effort initially coincided with continued strong economic growth. Beginning in 1985, the reduction in prices for a broad range of important Malaysian commodity exports, and weak external demand for manufactured exports, have abruptly altered the situation. Difficulties have been further intensified in 1986 with the collapse of world prices for crude oil. The sharp reduction in export revenue has led to a substantially weaker domestic economy, and reduced government revenue both directly and indirectly. It is now apparent that to constrain a re-emerging fiscal deficit and a possible external imbalance arising from strengthening domestic demand in the face of weak exports, fiscal rentrenchment must be continued. As the scope for adjustment is clearly not the same as was the case in 1983/84, we therefore strongly agree with the staff assessment that, together with a judicious mix of intensified fiscal restraint, a more fundamental assessment of the role of government should be pursued.
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> Quite appropriately, the Government's strategy has been designed to emphasize the role of the private sector, relative to that of the Government, in the economy. The need to promote private investment has been given additional importance by the sharp curtailment in federal development expenditure. To this end, fiscal incentives have been introduced and regulations liberalized, with special emphasis placed on promotion of the export-oriented manufacturing sector, and the encouragement of foreign investment. We wish to stress the importance of pursuing, and possibly strengthening, these measures if Malaysia is to successfully reduce its dependency on commodity exports and

improve investment efficiency. We are pleased to note the recent involvement of the World Bank in issues of adjustment and public investment.

The Malaysian Government must convince potential investors that they need not fear future changes to greater control over investment. The renewed mandate obtained by the Government in recent elections gives it a useful opportunity to reaffirm its intentions. With respect to the Government's objective of strengthening the competitiveness of the economy, we support the staff's view that the response to requests from publicly established industries for protection from overseas competition will be important in establishing the authorities' commitment to an open and efficient economy.

Investor confidence may be further influenced by the stability of the financial system. Malaysia has experienced a number of financial crises of late, most recently taking the form of the freezing of assets of 23 deposit-taking cooperatives and central bank support for the country's sixth largest bank. We welcome the Government's initiatives in extending banking and financial regulations and supervision, but suggest that further measures will need to be taken to ensure the stability of the country's financial institutions and markets. In conjunction with this, measures to liberalize financial markets and reduce segmentation could also be helpful. We are concerned by the apparent contribution of "stickiness" in the downward adjustment of lending rates to the development of high real interest rates, and wonder whether the staff could elaborate on the reasons for the slow adjustment in nominal rates. We would further appreciate the staff's comments on the possibility of future reductions in interest rates, and in credit demand from the real estate sector.

The expected sharp rise in 1986 of the overall deficit of the public sector (to an estimated 17 percent of GNP) is a matter of concern. The Government has recognized the need to avoid financing the deficit by way of commercial banks, and, therefore, we encourage use of multilateral and concessional resources. We also support the staff's suggestion of expanding the base of indirect taxes and improving tax administration, but caution will need to be exercised by the authorities so that changes in tax legislation do not unduly act to the detriment of investor confidence.

The Government has made important progress in restraining the financial claims of the nonfinancial public enterprises. There may be more scope for improved efficiency and expenditure restraint in this area than in federal government expenditures, and we would urge the authorities to continue to promote such efforts. As part of the Government's program to shift emphasis to the private sector, it intends to privatize a number of these companies. However, it is notable in the case of the Malaysian Airline System that even if the Government's share ownership declines below 50 percent, it will retain effective veto power over company policy through the issuance to it of a special share. The implications of this with respect to investor confidence and future government financial responsibility are not clear. The staff report notes that legal complications have delayed further privatization measures. Further clarification with respect to how the Government intends to pursue its policy of privatization would be useful.

Contrary to forecasts, Malaysia has achieved a trade surplus despite lower export values, owing largely to a reduction in imports. However, resurgent domestic demand without any accompanying increase in commodity export prices could lead to a major deterioration in the current account, unless Malaysia is successful in its effort to foster a structural shift in its composition of exports. In this respect, we commend Malaysia's continuing flexible exchange rate policy, noting that it is an important tool for maintaining competitiveness in the traded goods sector.

Mr. Huang made the following statement:

The Malaysian authorities in recent years have made constructive efforts to reduce the economic imbalance that peaked in 1982. These adjustment efforts were so vigorous and successful that the federal government deficit was reduced from 17 percent of GNP in 1982 to less than 7 percent of GNP in 1984, and to 5.4 percent in 1985. The external current account deficit decreased from 14 percent of GNP in 1982 to 5 percent in 1984 and to 3.1 percent in 1985. The positive combination of these achievements and other favorable factors led to an increase in the growth rate of real GNP and a decrease in the inflation rate. The growth of real GNP accelerated from 5.6 percent in 1982 to 6.3 percent in 1983 and to 7.6 percent in 1984, while the annual rate of change of consumer prices came down from 5.8 percent in 1982 to 3.7 percent in 1983 and 3.9 percent in 1984. These achievements are indeed remarkable, and I commend the efforts of the authorities.

Unfortunately, the economy experienced a sharp decline in its growth rate in 1985, which slowed down the growth of real GNP to a historical low level of less than 3 percent and, accordingly, the unemployment rate rose to 7.6 percent. This poor economic performance can be explained both by the deteriorating external environment and the weakeness in economic structure and management. It will require sturdy long-term efforts to tackle these shortcomings. Therefore, I will focus more on economic performance and policies.

The authorities have made a marked improvement in the fiscal position in terms of the reduction in the overall deficit of the Federal Government in the past three years. However, the sharp drop in oil prices was the main factor in the rapid increase in the overall deficit, which has been estimated to rise sharply to 12 percent in 1986, compared with 5.4 percent in 1985. Given this result, it is understandable that the authorities are greatly concerned about the deterioration in the fiscal position. In view of the high interest payments, which accounted for 21 percent of total expenditures in 1985, it would not be desirable for the authorities to resort to further domestic borrowing to finance the budget deficit. It seems that the best avenue by which the authorities can improve the present situation is strict expenditure restraint, even though there is probably less room for curtailing expenditures in 1986 and 1987 than three years ago. In addition, I am in favor of the measures taken by the authorities to increase taxes on domestic sales of petroleum products so as to offset revenue lost because of the drop in oil prices. An appropriate increase in some excise taxes is also, I believe, a way to bring in revenue while at the same time acting as a restraint on aggregate consumption.

I feel that Malaysia's current economic difficulties are largely attributable to the serious deterioration in the external environment, which includes, of course, the sharp drop in oil prices and huge decrease in key commodity prices. This situation reflects the vulnerability of the Malaysian economic structure to the changes in external conditions. It seems that, in the absence of a substantial recovery in oil prices and other key commodity prices, a program of further structural adjustment is needed so as to moderate the adverse impact of external factors.

Although the deterioration in the external outlook for 1986 and 1987 has been a source of serious concern, the external trade performance is better than expected. However, I do not believe we can afford to take an optimistic view on the external outlook for the current year or the next because, among other problems, the low growth rate of the major industrial countries, combined with the protectionism prevailing in these countries, will probably lead to a further deterioration in Malaysia's external position in 1986 and 1987. I am inclined to agree with the staff that the increase in the current account deficit and the debt service will point to a further increase in Malaysia's already substantial external debt. To a considerable extent, the improvement in the external position is dependent on the improvement in the external environment--which is beyond the control of the Malaysian authorities. Concerted efforts by the international community to roll back the protectionist measures prevailing in some of the major industrial countries would lead to an improvement in the external environment not only of Malaysia, but also of other developing countries.

Mr. Jayawardena made the following statement:

Malaysia is a resource-rich Southeast Asian country with a relatively high per capita income (US$1,900), one of whose notable features is that it is somewhat free of the tremendous pressures arising from a high population, which is characteristic of the region. In that sense, Malaysia is fortunate. It is also fortunate in having able leaders who have managed its economy extremely well--which is evident from the rapid economic progress made in recent times--with continuous and meaningful growth and considerable diversification of an economy that had once been highly dependent on a few commodities that were subject to quite volatile world market conditions, namely rubber and tin. The authorities, commendably, have contained inflation and unemployment and have shown great concern about income distribution aspects of growth, making attempts to ensure that benefits of economic growth are better distributed. Malaysia has accepted the obligations of Article VIII of the Fund. Malaysia is noteworthy as a relatively free, open-market economy, which has worked relatively well in terms of growth, welfare, and structural change.

Malaysia's steady progress was strongly influenced by the upsurge in oil prices after 1978, when the authorities accelerated their process of structural change by raising public investment. Naturally, this created intense strains on the economy and raised external debt to levels that caused concern. Fortunately, the authorities commenced taking corrective action in 1983, and the fiscal deficit was sharply curtailed, with attendant benefits for the balance of payments.

However, when the Board discussed the 1985 Article IV consultation with Malaysia, Executive Directors indicated that adjustment was still inadequate and urged stronger action. The wisdom of that advice is now crystal clear, because in 1985 and 1986 Malaysia has been confronted with additional and perhaps more difficult problems, owing not to the authorities' actions, but to a sharp decline in Malaysia's primary export commodity prices and the recent fall in world energy prices. Thus, once again, we see a country following sound economic policies and strong adjustment, yet being thwarted in its efforts by external shocks. Here I would reiterate that the Fund must contemplate seriously the problem of how to underpin and support worldwide adjustment when external shocks, such as slumps in commodity prices, tend to thwart that adjustment. Questions arise about whether our policies are adequate to respond to this problem, which underlies many of the problems facing developing countries in Asia, Africa, and South America.

Another problem might be difficult in the future for Malaysia, namely, growing protectionism in industrial country markets. I note the intensity of conviction that underlies the plea by Mr. Jaafar that Malaysia at this stage could ill afford the closure of industrial country markets to its products, especially when the new exports have been built up so painstakingly as an integral part of Malaysia's diversification plans. A concerted effort to restrain protectionism has now become a prerequisite for the adjustment of developing countries.

We do have some concerns about--in fact, we are somewhat surprised at--the fact that at the time of the staff consultations, the authorities did not have effective contingency plans to face the emerging difficulties. Of course, this is understandable in a way, because 1985 was a year of economic setback, and naturally the authorities may have been wondering whether the adjustment they were undertaking was too strong. Hence, some of the marginally stimulative measures undertaken in late 1985 could be viewed with understanding. However, the authorities now have to contend with bigger problems. We are happy that a strong fiscal adjustment is on the way--which would be very courageous indeed, given that general elections are to be held early next year--and that the Fifth Malaysia Plan is being revised to take the new external situation into account.

We, like other Directors, would underline the importance of fiscal adjustment. While new revenue initiatives would be welcome, we want to emphasize that the gains from improved tax administration and reform of the tax system, per se, should not be underestimated because nonpetroleum revenue of 20 percent of GNP is a good record for a developing country. However, total government expenditure and net lending, hovering around 34-35 percent of GNP in 1982-85, in a country with a free, open-market orientation, appears to be somewhat on the high side. Hence, we welcome the authorities' determination to reduce government expenditure and net lending. In the recent past, larger fiscal deficits were sustained by external financing, but with the debt service rising so high and the Government shifting to domestic resources, it might not be in Malaysia's best interest to pre-empt domestic resources that may be more efficiently used by the private sector.

On monetary policy, we fully understand the difficulties of restraint when the financial system has shown some signs of weakness. We welcome the decisive actions taken to strengthen the system, especially the finance companies and cooperative banks. Revival of confidence in the financial system will be crucial for a revival of private sector activity. It is the private sector that should offset the planned fiscal retrenchment. We would only caution that any measures taken to strengthen the financial system should not impose excessive regulation and centralized direction, as that might prove counterproductive in the long run.

On external policies, we are concerned at the anticipated sluggishness of exports and the continued import compression, which might in turn affect export growth. Hence, like other Directors, we feel that the exchange rate has a role to play. While we welcome the recent depreciation of the ringgit in real effective terms and the authorities' commitment to adopt a flexible policy, we are somewhat puzzled as to how, in an open economy like Malaysia, the ringgit was permitted to appreciate in real effective terms from 1981 to 1984. I wonder whether the staff has any views on this matter. Perhaps it was the result of a rising U.S. dollar, or it was an efficient policy with a view to ease absorption of external resources, with export incomes remaining buoyant. But, Malaysia now faces a different and difficult situation, and we welcome the recent thrust of policy. The authorities perceive that the maximum permissible debt service ratio is 20 percent of GNP--a reasonable figure. Although the absolute debt level is high, most of the debt is of medium- to long-term maturity, and those terms and maturity of debt have been cleverly refinanced to ease the debt service burden.

Malaysia has managed its economy quite well, but it is now faced with some difficult problems of adjustment. Measures taken by the authorities are in the right direction, and we have confidence that future problems will be overcome. Despite its recent achievements in diversification of the economy, Malaysia still remains vulnerable to external shocks, and we would urge the authorities to have contingency plans for such eventualities. I would not worry too much if the Fund makes pessimistic forecasts. In the volatile world we live in today, conservatism in forecasting is always better, because if reality turns out to be better, we can celebrate.

Mr. Salehkhou said that the adverse effects on Malaysia's 1985 overall economic performance had come mostly from external factors beyond the authorities' control. Despite the implementation of corrective fiscal and monetary measures to stimulate the economy, real GDP growth had decelerated to 2.8 percent from 7.6 percent in 1984, and unemployment had risen by 1 percentage point. Continued fiscal restraint, while helping the authorities to reduce the public sector deficit, had weakened domestic demand and had contributed to an improvement in the external current account in spite of unfavorable terms of trade and sluggish external demand. The prospects for 1986 and the medium-term outlook remained uncertain because of recent developments in the international oil market and the continuing fall in commodity prices. In the face of adverse external developments, the authorities had embarked on an adjustment program to correct domestic and external imbalances. During 1983 and 1984, considerable progress had been achieved. Within two years, the Federal Government and current account deficits had narrowed by 10 and 9 percentage points of GDP, respectively, and at the same time, real GDP growth had increased by 2 percentage points.

Given the vulnerability of the economy to the international environment, the weakening of petroleum and other commodity prices in 1985 had forced the authorities to impose further curbs on development expenditures, while current expenditures had risen moderately, owing mainly to higher interest payments, wages, and salaries, Mr. Salehkhou continued. The improved 1985 performance of nonfinancial public enterprises had also contributed to a further decline in the public sector deficit.

Overall, the fiscal adjustment had been stronger than expected, as the consolidated public sector deficit had been reduced by more than 2 percentage points, Mr. Salehkhou added. The three years of fiscal policy restraint and external adjustment had led, however, to a sluggishness in economic activity and had adversely affected business confidence. In order to increase domestic demand and curb unemployment, the authorities had recently taken steps in the right direction by introducing stimulative fiscal and monetary policies. Those policies, including low-cost housing and rural road programs, as well as changes in the tax incentive system, should create a favorable environment and stimulate private sector activities.

Given the accommodative stance of monetary policy, the Central Bank's injection of liquidity into the banking system through the placement of surplus government deposits and the reduction of reserve requirements had helped the authorities to lower interest rates, Mr. Salehkhou remarked. However, lending rates were still above the inflation rate, and a further reduction in interest rates would stimulate economic activity.

The authorities had introduced commendable corrective measures in response to a series of shocks that had hit the financial system, Mr. Salehkhou considered. However, he wondered whether the movement toward privatization, in what had been referred to as a pluralistic system, would not further increase its vulnerability to financial shocks. The question then arose whether the application of other suitable, stable alternatives, or supplements to the present system, would not help the economy more easily absorb those financial shocks.

Despite the adverse effect of unfavorable terms of trade and the sluggish demand for Malaysia's exports, the current account deficit had continued to decrease in 1985 to $0.9 billion or almost one quarter of the 1983 deficit, primarily because of the considerable reduction in imports, Mr. Salehkhou commented. Sizable inflows of long-term capital, which had amounted to $2.2 billion, had not only financed the current account deficit, but also had brought about a substantial increase in gross official reserves, to $5.4 billion or about five months of imports. While he welcomed the improvement achieved in the maturity profile of Malaysia's external debt, through borrowing from favorable markets for debt refinancing, the rising external debt and debt service ratio could become an area meriting serious concern in the future. Therefore, he urged the authorities to continue their cautious approach and introduce appropriate measures to contain the economy's reliance on external borrowing.

The prospects for 1986 remained uncertain, Mr. Salehkhou noted. Recent developments in the world oil market appeared to have reduced the improvements already achieved through the implementation of the three-year adjustment program. The public sector and external current account deficits were expected to rise to 17 percent and 9 percent, respectively, of GNP. The situation thus called for making further adjustment efforts not only to correct rising financial imbalances, but also to stimulate economic activity. While he shared the authorities' view that the scope for adjustment was more limited than in 1983, taking into account the limited room for maneuver on current expenditures and revenues, room remained for further expenditure restraint in investment programs and in the operation of public enterprises.

The external current account deficit, which was estimated to increase to $2.3 billion, was projected to be financed by additional external borrowing, Mr. Salehkhou went on. However, that borrowing would increase debt service payments, particularly if protectionism persisted against Malaysia's exports. In conclusion, while the momentum of the adjustment effort should be maintained, the authorities' reliance on foreign financing could be reduced by better mobilization of domestic resources.

Mr. Romuáldez made the following statement:

> The Malaysian authorities deserve to be commended for having generally maintained the adjustment stance that they assumed in 1983. In spite of adverse external developments beyond the authorities' control, namely a sharp weakening in commodity prices in 1985, the external current account deficit was reduced further. Domestic prices were kept stable, with inflationary pressures kept within control. The growth rate, however, dropped significantly--a development that is a particular cause for concern because much of it is due to a weakened private sector.
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> No small measure of the relative successes in 1985 must be ascribed to the authorities' alertness to external developments and their readiness to strengthen adjustment as necessary. The federal government deficit, for example, was reduced further in 1985 to 5.4 percent of GNP--though this action is not without its dark side, since it meant a significant 19 percent cut in development expenditure, while current expenditure was allowed to rise. To be sure, subsidies and transfers were reduced, but those improvements were offset by higher interest payments and higher wages and salaries. We are pleased to note that the non-financial public enterprises performed more efficiently and thus contributed substantially to the improvement in overall public sector finances. The authorities' general readiness to adjust has been exhibited in their decision to modify the 1986 budget in the light of recent adverse developments in the oil markets.

In spite of many positive aspects of Malaysia's performance--notwithstanding adverse external developments--the medium-term prospects remain uncertain and show increased vulnerability for the economy, particularly because of the growing burden of debt service. We would recommend caution and perhaps even some retrenchment with regard to the stimulative policies taken since late 1985. Unless external circumstances show some improvement, in terms of external demand and its impact on commodity prices, the authorities should continue their plans to strengthen the adjustment efforts, particularly toward greater expenditure restraint. Progress in the reform of Malaysia's industrial policies ought to be encouraged to strengthen the private sector role in the economy. Appropriate signals are being given to the private sector, in the context of the Fifth Malaysian Plan, about liberalization in industrial policy. The authorities could strengthen the impact of privatization, especially the development of the manufacturing sector, by injecting greater flexibility in their exchange rate management.

We welcome the recent shift in the focus of World Bank assistance in Malaysia to external debt monitoring, public investment in transportation and energy, and domestic resource mobilization. We are pleased to note improvements in statistical reporting and data compilation. On the assumption that Malaysia maintains its readiness to adjust, this development should help greatly to enhance the authorities' ability to respond to contingencies.

Overall, the authorities should remain in an adjustment mode, which they have done generally, and which they have shown themselves willing to intensify as needed in the light of external developments.

Mr. Qureshi made the following statement:

We are broadly in agreement with the thrust of staff appraisal. At this stage of the discussion, I shall restrict myself to just one comment. As Mr. Jaafar has noted, the outcome last year with respect to GNP growth and the fiscal and external positions turned out to be significantly different from the one that had been forecast by the staff. Mr. Jaafar also points out certain significant differences beteween the staff's current macroeconomic projections and the corresponding expectations of the authorities, both with respect to 1986 and over the medium term. These differences are particularly significant with respect to the forecast external current account position. Like some previous speakers, I would be interested in elaboration from the staff on these differences between the staff's projections and the authorities' expectations.

The staff representative from the Asian Department, noting Mr. Qureshi's remarks, stated that every estimate and every forecast in the staff papers was arrived at jointly by the staff and the authorities. Any discussions of altered circumstances or altered outlook referred to divergent developments with respect to the expectations of the authorities as well as of the staff. It was not a matter of the staff's view versus the authorities' view.

It was true that the staff's and authorities' common outlook for 1985 had differed from the actual outcome, the staff representative continued. The fiscal adjustment pursued throughout 1985 had been much stronger than the authorities' expectations of April 1985. There had been a further weakening in the terms of trade--and particularly palm oil prices--beyond what had been expected at the time of the Article IV consultation discussions in April 1985. External demand had been weaker, real domestic growth and real incomes had been lower, and consequently, import demand had been affected.

The authorities' expectations with respect to 1986 in the balance of payments were currently different from those of April 1986, the staff representative went on. The staff understood that a major reason for that difference was a lower indicated level of imports. Moreover, the real growth in the Malaysian economy was lower than expected. There did not appear to be any important intensification of fiscal adjustment, according to the authorities' latest outlook. The authorities had indicated that there was no difference in the outlook on expenditure and investment programs for state governments and nonfinancial public enterprises. A somewhat smaller fiscal deficit was currently projected, perhaps in the range of 10 or 11 percent.

The staff could not say why the authorities' outlook for imports differed currently from that of April 1986, the staff representative stated. Nonetheless, the staff could raise important questions: was a deeper inventory adjustment taking place in the economy? If so, how would imports respond in a period of business pickup? One hypothesis that could be put forward was that a fundamental change had taken place in the relationship between stocks of goods and economic growth; another hypothesis was that no such fundamental change had occurred, and as a consequence, if business activity picked up, a reaccumulation of inventories and an exceptionally strong growth in imports would occur. The staff understood that the authorities subscribed to the first hypothesis and did not contemplate such a strong recovery of imports in subsequent periods even if growth did resume at more satisfactory levels.

The authorities had made no important change either in fiscal policy for 1986 or in the public enterprise policy stance, the staff representative added. The authorities aimed both in the review of the Fifth Malaysia Plan and in the budget for 1987 to persevere and intensify adjustment in public sector finances; the staff welcomed those aims.

In response to the question whether the problems in the Malaysian economy were related to monetary, financial, or relative price phenomena, or to real phenomena, the staff representative remarked that although there was a mix, the staff thought that the problems were more closely related to real phenomena. One of the most telling statistics about the economy was the doubling of the incremental capital output ratio between the first half of the 1970s and the first half of the 1980s. Income growth in the current year and the outlook for 1987 pointed to a further rise in that incremental capital output ratio. Productivity of investment had fallen dramatically. Although the authorities had initiated an adjustment strategy in response to those factors in 1983, there was a legacy to be dealt with for the second half of the decade--the economic and financial problems of operating with the unproductive investment put in place in the first half of the decade. The staff welcomed the authorities' approach to the World Bank for assistance in reviewing some of the investments under the Heavy Industries Corporation of Malaysia established by the Government. It was hoped that the review would be comprehensive and would examine not only the outlook and management of the projects but more broadly, the industrial policy of the Government, including the Industrial Coordination Act of 1975.

The staff welcomed the relaxation of Malaysia's New Economic Policy that was implicit in recent statements by the Prime Minister, the staff representative commented. Those statements seemed to reflect a judgment that some of the elements of the New Economic Policy might in fact have impeded private sector activity and caused weakened business confidence. Similarly, the steps to reform the Industrial Coordination Act of 1975 reflected the same growing awareness. The staff anticipated that the authorities would find that convincing signals to alter sentiment in the private sector would emerge slowly and would evoke a relatively slow response.

The authorities were fully committed to the concept of privatization, although they were experiencing some difficulty in implementation, the staff representative noted. It had been relatively easy to privatize the Malaysia Airline System and certain other relatively small operations, but in cases where employment was large or ownership of land was important, difficult legal problems did arise. The authorities had committed themselves to a policy that the transfer of ownership from the public sector to the private sector would not adversely affect any employees in the privatized enterprises. Thus, for instance, questions of pension arrangements posed difficult issues. Similarly, ownership of land was predominantly within the purview of state governments, except in federal territories, and transfers of ownership from the public sector to the private sector thus gave rise to difficult legal and constitutional questions. The authorities had established a commission to look into that particular aspect of the legal environment for privatization.

Responding to a question about the rise in current expenditure in the current year, particularly for other goods and services, the staff representative said that in the fiscal statistics for Malaysia, that item was by and large a residual. For instance, in 1985 the final outcome had been smaller by nearly a M$1 billion than the April 1985 estimate. In projecting a slightly smaller deficit for 1986, the authorities had indicated that all of the reductions were coming in the current operating budget. There was a small increase in development expenditure. The staff expected that at the end of the year, a much smaller stated level of expenditure on other goods and services would be given in the operating budget.

There were important crosscurrents in questions on monetary issues, the staff representative said. Questions raised by Directors had included: Was monetary policy too lax or too tight? Should interest rates be falling more rapidly? What could be done to bring that about? Could measures be taken to stimulate deposit mobilization in the banking system? Are monetary liabilities growing too rapidly? Was monetary policy being constrained in any important macroeconomic sense because of concerns regarding the financial health and confidence in financial institutions? The answer to the last question should probably be yes; monetary policy was being affected by and perhaps constrained by the authorities' concern for problems of confidence and soundness in the financial institutions. It was difficult to judge how much further the staff, during normal consultations, should delve into matters of the integrity of financial institutions.

Given an environment of economic slowdown, poor business conditions, and tight cash flows, the authorities had felt it necessary to suspend the Central Bank's recently adopted guidelines on the treatment of interest on nonperforming loans, the staff representative indicated. While the banks had adopted the Central Bank's guidelines as their own, it was not certain whether the banks were able to comply with those guidelines. For example, it was not clear how well banks were able to maintain their total capital in relation to Bank Negara's regulations on the capital adequacy of banks. Bank Negara had recently indicated a willingness to underwrite a new capital issue of one of the banks, specifically to raise the capital of that bank to a level that would meet Bank Negara's capital guidelines. The authorities had been dealing with troublesome problems in financial institutions for several years. Such problems had been the theme in the staff's discussions with the authorities during those years, namely that the concentration of bank lending in the real estate sector could jeopardize and impinge on the authorities' latitude in the use of monetary policy to support other elements of adjustment.

In terms of external adjustment and overall confidence, the real interest rates in the banking system did not appear to be inordinately high, the staff representative noted. The authorities had recently had to deal with a shift of resources into cooperative societies that had been deemed illegal. That suggested that interest rates in the formal financial system had not been high enough to attract resources, and the authorities had encountered considerable problems of financial integrity in the cooperative societies. Nevertheless, the relative order of magnitude of the cooperative societies in the banking system was not large--less than 5 percent of the total assets of the financial system.

The authorities were also concerned about capital flight, which suggested that real interest rates were not too large, the staff representative continued. However, if one was concerned principally about the lack of a dynamic private sector, one could say that interest rates were high and that they should come down. The banking system was currently tight by historic standards; the loans/deposits ratio, exceeding 99 percent, was at an all-time high. The growth of deposits had clearly not kept pace with the extension of credit by the banks. The banks were locked in part into an extension of credit under long-term loan commitments because of the intensive property development lending that had occurred in the past three to four years, but that was expected to slow down. Although the rate of credit expansion was expected to moderate, it was taking place concurrently with a moderation in the growth of deposit resources in the banking system.

In 1985, swaps and the placing of treasury deposits with the commercial banks had been important instruments for sustaining bank liquidity, the staff representative said. The authorities had become concerned about the growth of swaps by April 1986 and had indicated that they planned not to permit a further increase above the mid-April 1986 level of about M$2 billion. They were, therefore, having to shift to other techniques for management of bank liquidity, which had led to an increase in the rediscounting of bills by the Central Bank. The staff welcomed movements away from both the swaps and from the recycling of treasury deposits, which had seemed to be an unusual form of monetary management. Nonetheless, the problems of managing bank liquidity continued. The Central Banking Department of the Fund had been working closely with the authorities on further liberalization of the financial system, and a team would be visiting Kuala Lumpur shortly to extend the work that had been done during the past 18 months.

Monetary expansion was not too rapid relative to inflation, but it was perhaps too rapid relative to adjustment requirements, the staff representative considered. The major issues in adjustment over the past three years had derived largely from the pattern of public sector expenditure, however, and not from monetary problems. Moreover, a large part of the problem of external adjustment stemmed from deterioration in the terms of trade, particularly price weakness for primary commodities and petroleum. Although those problems were not primarily monetary phenomena, there was a need for greater monetary caution. In fact, monetary caution would have been appropriate three years earlier in terms of the pattern of lending that had taken place.

The staff would not be surprised if the deficit on the current account was somewhat smaller than had been indicated in the April 1986 estimates, the staff representative commented. The authorities had suggested that imports through the first half of 1986 had been running lower than had been expected in April. The staff estimated that economic growth was also running at a lower level, and incomes were declining perhaps more rapidly than had been anticipated.

The currency had appreciated during the period 1981-84 because the authorities had maintained a close link between the ringgit and the U.S. dollar, and the dollar had been stronger then, the staff representative explained. Moreover, the relationship between the ringgit and the Singapore dollar had contributed to that appreciation, because the Singapore dollar had also been a strong currency in that period. However, the ringgit had depreciated in effective terms in 1985 and 1986. In real effective terms, the depreciation had been 11 percent in 1985 and an additional 15 percent depreciation had since occurred. The staff estimated that a further depreciation in real effective terms of perhaps 4-5 percent would occur in the next two months. At the same time, Malaysia's external terms of trade had deteriorated by about 23 percent. Therefore, the depreciation of the ringgit in real effective terms had not been associated with pronounced strengthening in the balance of payments.

The authorities could use exchange policy to help bring about further adjustment, the staff representative from the Asian Department concluded. Because of three fundamental changes in the structure of the balance of payments since 1980--a large deterioration in the terms of trade, a large growth in the external debt, and a large growth in the external debt service payments--the authorities needed to persevere with even more active use of the exchange rate policy. Of course, some of the burden of adjustment would also fall on real growth, incomes, and domestic demand, but the staff was not aware of how the authorities intended to split the burden of adjustment.

Mr. Jaafar recalled that the theme of his earlier statement had been that the economic environment facing Malaysia was most uncertain. A major part of that uncertainty was related to the prospects for oil; that was not a new element, of course, but it was important because roughly one quarter of Malaysia's revenue came from oil. No one could pretend to know with any degree of confidence what course the price of oil would take. Although the authorities had anticipated a fall in the price of oil in 1986, the extent of that fall was unexpected. The Parliament had passed the 1986 budget in November 1985, but the fall in oil prices had thrown that budget out of gear, as Mr. Jayawardena and others had mentioned. The staff had also made some references to the expected budgetary position for the current fiscal year on the basis of communications from the authorities. Because of the fall in oil revenue, the authorities had reduced their estimate of revenue for 1986 by about M$2.3 billion. That drop in estimated revenue had prompted the Government to make cuts in the budget allocation totaling about M$1.6 billion. The authorities were concerned about the sudden turn of events, particularly after they had achieved such success during the past several years in correcting both domestic and external imbalances. A fuller accounting of the authorities' response to the poor outlook would be forthcoming in the next fiscal year and within the context of the medium term.

The sudden changes in the price of oil had also led to dramatic modifications in the authorities' assumptions on the Fifth Malaysia Plan for 1986-90, which had been launched in March 1986, Mr. Jaafar continued.

To exacerbate the situation, exports of Malaysia's major commodities had never recovered as had been anticipated with the global recovery. The terms of trade in 1986 had fared worse than the authorities had contemplated, and were estimated to fall dramatically by a record high of 18 percent or more. The authorities were not sure where that trend would lead in the medium term, although some hopeful signs had begun emerging during the first half of the year, with the stronger performance in the trade account. Meanwhile, the authorities expected the present and prospective austerity drives to keep the 1986 and 1987 budgets within sustainable limits.

Within the context of the medium term, more optimistic projections were warranted for several reasons, Mr. Jaafar considered. First, as he had mentioned earlier, the 1986 base had changed. Second, the medium-term projections could not be taken independently of the policies being planned by the Government in the light of the changing circumstances. A review had been undertaken of the Fifth Malaysia Plan. A deep cut in the development allocation was expected, commensurate with the prospective financing constraints facing the Government. A substantial cut was being recommended to the Cabinet affecting the allocations to the Federal and State Governments and the nonfinancial public enterprises. If all went as planned, as much as a 30 percent reduction of the M$74 billion allocation over the Plan period to 1990 could be expected. The authorities' current thinking was to maintain an external debt service ratio below 20 percent. Also noteworthy was the important revision to the real GDP projection of 3 percent a year instead of the previous high level of 5 percent. That revision reflected the desire of the authorities to keep development financing within bounds. That revision ought to relieve the pressure in the current account of the balance of payments. Current projections envisaged that the current account ratio to GNP would narrow over the Plan period from 5.6 percent in 1986 to about 2 percent by the end of the decade, giving it an annual average of almost 3.5 percent to GNP.

The Government Industrial Master Plan and the Industrial Policy Study were aimed at creating a better incentive structure in the private sector, Mr. Jaafar continued. For example, the recent major relaxation in the guidelines for foreign equity ownership indicated the seriousness that the authorities placed on the private sector response to the Plan, concurrent with the reduced role contemplated for the public sector. Moreover, there was an ongoing review of the HICOM projects, particularly those that were experiencing financial strains. That review was being undertaken with the assistance of the World Bank. Those steps represented a substantial effort by the authorities, particularly given that the current austerity phase had begun more than four years earlier.

In its Information Notice (April 22, 1986) to the Board, the staff had said that the real depreciation of the ringgit was broadly in line with the views of Directors taken at the 1985 discussion of the Article IV consultation with Malaysia (EBM/85/111, 7/24/85) Mr. Jaafar recalled. At that time, Directors had noted that a significant reduction in the current account deficit had been achieved through vigorous fiscal adjustment. In fact, the actual outturn on the current account deficit in 1985 had been less than US$1 billion, compared with the US$2.4 billion deficit anticipated when the Directors had drawn their conclusion. In that respect the authorities remained firmly committed to achieving a sustainable reduction in the current deficits over the medium term, as he had described earlier. Moreover, the authorities were keeping the exchange rates both free and flexible, consistent with the need to maintain stability.

A key point to remember with reference to the deposit-taking cooperative society was that the situation was indeed under control, Mr. Jaafar pointed out. Directors may have read reports in the popular press on that subject, and he would be happy to provide any interested Directors with a copy of the authorities' press release of July 23, 1986 and a copy of the statement by the Finance Minister on August 8, 1986. The authorities were conducting an intensive investigation into the activities of that society, with the findings to be submitted promptly to the Government. Decisions on the future of such cooperatives would be taken in line with the findings of that investigation.

Although none of the Directors had made any reference to the suspension of guidelines on interest in suspense and bad debt provisions, the staff had elaborated on that point in some detail, Mr. Jaafar noted. At a time as difficult as the one Malaysia was experiencing, it would not be realistic to expect the financial institutions and business to perform as well as usual. That was true not only in Malaysia but elsewhere. The authorities did not take much comfort in that, of course, but in an environment of a marked economic slowdown, they wanted to see that stability in the financial system was preserved. That ought to come in terms of the kind of policies and supervision to prevent any failures that could destroy that element of confidence. The record had shown thus far that the authorities had managed to provide that kind of support to the financial system. He had noted that Directors had commented favorably on the prompt actions by the Central Bank in its efforts to strengthen the financial system in Malaysia. The monetary policy stance had been sufficiently accommodative to ensure that adequate liquidity was present. That was also consistent with the objectives of lending support through lower interest rates to stimulate economic activity. Of course, Malaysia was facing a dilemma of sorts in that real rates of interest remained high after corrections for the nearly zero rate of inflation. That situation ought to help stem capital outflows. However, the authorities needed to keep the interest rates low to stimulate the economy.

The Acting Chairman made the following summing up:

Executive Directors generally agreed with the thrust of the views expressed in the staff report on the 1986 Article IV consultation with Malaysia. Directors commended the authorities for their perseverance in the adjustment efforts undertaken since 1982, which had resulted in a reduction in Malaysia's large fiscal and external imbalances and had provided an environment for strong economic growth. Directors also welcomed the further reductions in Malaysia's domestic and external imbalances in 1985. In particular, they welcomed the authorities' success in substantially restraining expenditure by nonfinancial public enterprises. Directors also commented favorably on the reduced reliance on foreign borrowing to finance the federal government deficit in 1985, and on the successful refinancing, on favorable terms, of a substantial part of the external debt maturing within the next seven years.

Directors noted with concern the sharp slowing of economic growth in 1985 and the attendant rise in unemployment. Taking into account the terms of trade, real income had declined. Even more disquieting was the economic and financial outlook for 1986 and over the medium term, given the plunge in oil prices and the concurrent weakness in other primary commodity exports.

The weakening revenue base and the projected rise in the overall government budget deficit to 12 percent of GNP in 1986 were viewed with concern, and Directors urged early and vigorous adjustment in public sector finances. In view of the relatively high share of government expenditures in GDP and the desire of the Government to encourage private sector development, further expenditure restraint in central government operations was considered both necessary and feasible. Thus, Directors welcomed the authorities' actions and intentions to curtail expenditures, and encouraged the authorities to persevere in their efforts. They suggested that the measures should focus more intensively on operations and investment programs of state governments and nonfinancial public enterprises. Directors indicated that in addition to expenditure restraint, the authorities needed to explore avenues for raising additional revenue, particularly through tax administration improvements and an expansion of the base of indirect taxes. Careful monitoring of public sector operations was viewed as essential for the successful implementation of fiscal policy.

Directors observed that while bank credit to the Government had declined in 1985 and 1986, demand for private credit had remained relatively strong. While Directors recognized why the authorities were pursuing an accommodating stance of monetary and credit policies, some Directors expressed concern about the consequences of Bank Negara's monetary targets for external adjustment. Directors encouraged the authorities to continue to strengthen the supervision and regulation of financial institutions. They also urged the authorities to limit reliance on foreign exchange swaps in their management of bank liquidity, and welcomed their recent efforts to develop new instruments to influence bank liquidity. Directors also commented favorably on recent measures to deregulate the credit and securities markets.

The altered outlook for the balance of payments and external debt for 1986 and the medium term was worrisome, Directors observed. Unless oil prices and other primary commodities recovered substantially, the external current account deficit was projected to be in the range of 6 to 8 percent of GNP and the debt service ratio would rise to 20 percent of current receipts during the remainder of the decade. In those circumstances, Directors urged further efforts to reduce and reorient public sector investment expenditure and stressed the importance of measures that would restore business confidence, strengthen exports, and permit more foreign investment. A number of Directors indicated that the authorities' efforts to promote export growth would be greatly helped by a lessening of protectionist tendencies abroad and by sustained growth in Malaysia's major foreign markets. At the same time, Malaysia was encouraged to resist protectionist pressures that could frustrate the needed gains in domestic productivity. Directors welcomed the effective depreciation of the ringgit during the past year and a half, and a number of Directors encouraged a more active and flexible use of exchange rate policy to maintain export competitiveness and offset the weakness in other elements of the balance of payments.

Directors commended Malaysia's past record of responding to major imbalances and welcomed the authorities' determination to respond effectively and promptly to the difficult adjustment problems currently facing the country.

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

The Executive Directors concluded their discussion of the 1986 Article IV consultation with Malaysia, and agreed to reconvene in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/137 (8/25/86) and EBM/86/138 (8/27/86).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/4 through 86/6 are approved. (EBD/86/232, 8/20/86)

Adopted August 26, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/202 (8/22/86) and EBAP/86/204 (8/25/86) and by an Assistant to Executive Director as set forth in EBAP/86/203 (8/25/86) is approved.

APPROVED: May 4, 1987

LEO VAN HOUTVEN
Secretary