FOR AGENDA

SM/85/180

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INFORMATION

June 26, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Malaysia - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Malaysia, which is proposed to be brought to the agenda for discussion on Wednesday, July 24, 1985.

Mr. Scott (ext. 7607) or Mr. In-Su Kim (ext. 7319) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

MALAYSIA

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Article IV Consultation with Malaysia

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

Approved by P. R. Narvekar and Eduard H. Brau

June 24, 1985

Contents | Page

Appendix Tables

Contents

I. Introduction

The 1985 Article IV consultation discussions with Malaysia were held in Kuala Lumpur during April 19-May 3, 1985. The mission had discussions with the Deputy Minister of Finance and the Secretary-General of the Treasury, the Deputy Secretary-General of the Treasury, the Deputy Governor of Bank Negara Malaysia, and other senior officials from the Treasury, Bank Negara, Economic Planning Unit, and Petronas. The staff also met with the Minister of Finance, the Governor of Bank Negara, and the Governor-designate of Bank Negara. The staff team consisted of Messrs. Douglas A. Scott, Johann Schulz, In-Su Kim, Akira Ariyoshi (all ASD), Hema De Zoysa (FAD), and Ms. Lilian Knauseder (ASD).

Malaysia has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Economic Background, 1983-84

The Malaysian economy experienced a rapid deterioration in the balance of payments in the early 1980s, following a marked expansion in public sector expenditure and the international recession. The weakness was most pronounced in 1982, when the current account deficit widened to more than 14 percent of GNP from near balance in 1980; external debt more than doubled over the 1980 level to nearly 50 percent of GNP. In the face of the steadily widening deficits of the public sector and the balance of payments, adjustment efforts were initiated in mid-1982 and intensified in 1983, with a comprehensive review of fiscal policy. The fiscal review was accompanied by a reassessment of development strategies against emerging resource constraints; this was embodied in the Mid-Term Review of the Fourth Malaysia Plan (1981-85). 1/ The thrust of adjustment policy was to reduce the fiscal imbalance, particularly through restraint on government expenditure. Attention also centered on achieving a more effective control over investments by nonfinancial public enterprises. The vigorous pursuit of fiscal adjustment, combined with the recovery in external demand, resulted in a significant improvement in the external payments position by 1984.

Economic growth recovered during 1983-84 from the recession-related slowdown in 1982, as external demand strengthened and production in the oil and gas sector rose. Real GDP growth averaged over 6.5 percent and total employment rose on average by 3 percent each year. (Chart 1 and Appendix Table 1). Crude oil production rose by nearly 50 percent to 446,000 barrels per day and LNG production came on-stream in 1983. Manufacturing production expanded rapidly in response to improved external demand, although signs of a weakening emerged during the second half

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1/ Presented to Parliament in March 1984.

of 1984. However, stimulus from the external sector was partly offset by the substantial slowdown in public sector expenditure. Domestic investment slackened substantially, reflecting both fiscal adjustment and a weakening in private investment. Strong export growth and more favorable external terms of trade helped to raise gross national savings to 27 percent of GNP and the current account deficit narrowed by 8 percentage points to less than 6 percent of GNP by 1984. Domestic inflation remained moderate, averaging less than 4 percent, partly aided by a decline in import prices.

Intensified fiscal adjustment from 1983 led to a substantial improvement in the Federal Government's financial position. The overall deficit fell from M$10 billion (17.3 percent of GNP) in 1982 to M$5.4 billion (7.5 percent) in 1984 (Chart 2 and Appendix Table 2). Expenditure restraint was the principal focus of fiscal adjustment. Development expenditure and net lending declined by about one third in two years. Operating expenditure expanded only moderately, notwithstanding a rapid rise in interest payments and some expansion in wage and salary expenditure. Revenue and grants increased, about in line with GNP growth. This reflected both substantial new tax measures in 1983 and a growing contribution from the oil sector. The fiscal deficit was financed mainly through external borrowing and captive sources of domestic savings; recourse to the banking system was relatively small. In relation to GNP, Federal Government debt rose by 8 percentage points to 79 percent during the two years.

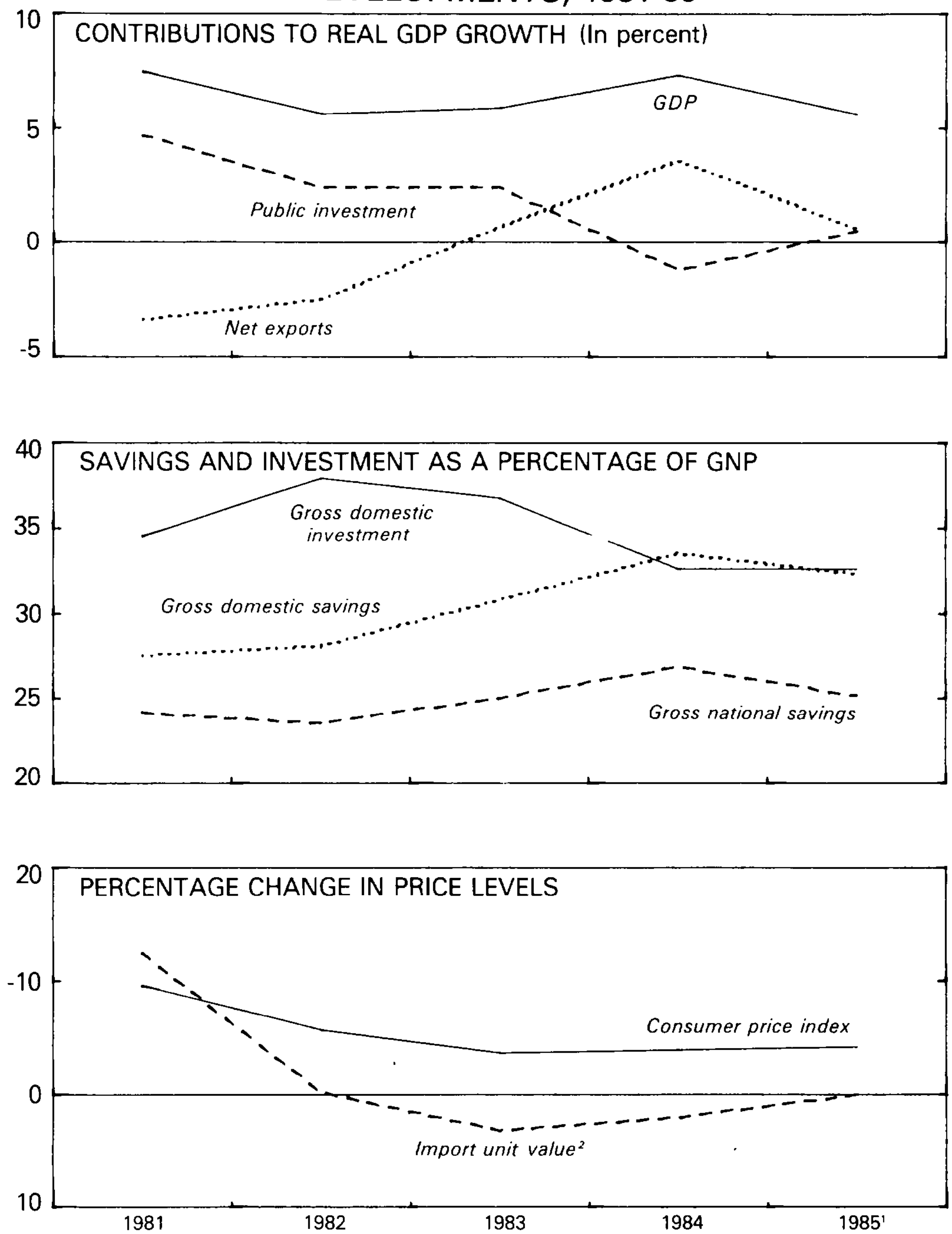
Progress in restraining investment expenditure of nonfinancial public enterprises was hampered by the absence of a comprehensive delineation of the public sector, both in regard to policy planning and statistical monitoring. Contractual commitments on several large projects also reduced flexibility. However, investment expenditure by nonfinancial public enterprises slowed gradually in 1984, as rephasing efforts were strengthened and certain large projects in the oil and transport sectors were completed. The major portion of investment expenditure by nonfinancial public enterprises was concentrated in projects for electricity, oil and gas, transport and communications, and the development of heavy industry.

Monetary policy, which had been accommodative in 1982, became more restrained during 1983-84. The growth of reserve money slowed and, with credit demand remaining strong, the liquidity position of financial institutions tightened (Chart 3 and Appendix Table 3). However, total liquidity (M3) grew at an average annual rate of 15 percent, as the money multiplier rose substantially (Appendix Table 4). This reflected both a marked fall in the currency/deposit ratio and a shift in deposits to nonbank financial institutions, which are subject to lower statutory

CHART 1

MALAYSIA

SELECTED INDICATORS OF MACROECONOMIC DEVELOPMENTS, 1981-85



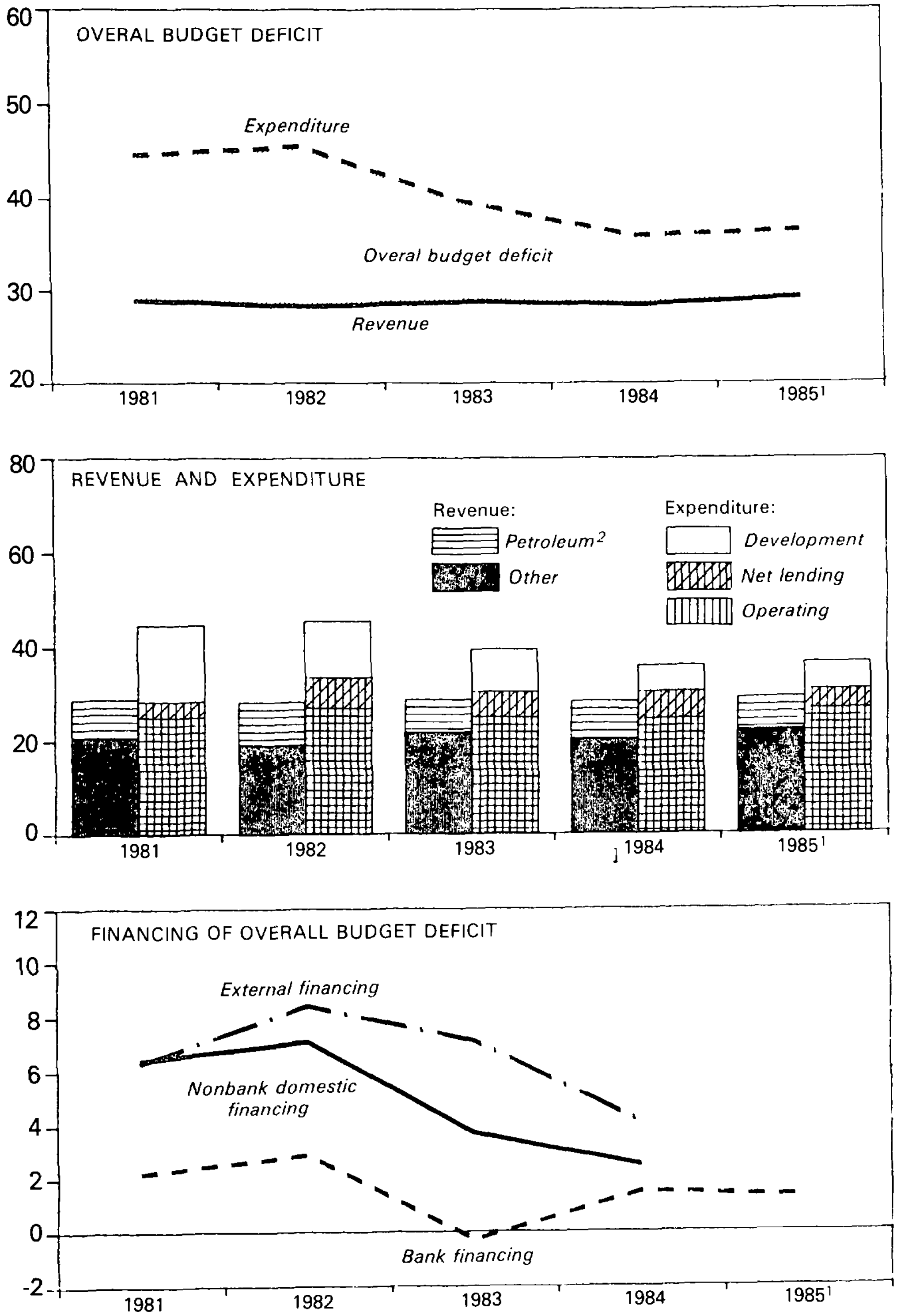
Source. Data provided by the Malaysian authorities.
[1]Forecast.
[2]Based on provisional 1980 trade weights.

CHART 2

MALAYSIA

FEDERAL GOVERNMENT OPERATIONS, 1981-85

(In percent of GNP)



Source: Data provided by the Malaysian authorities.

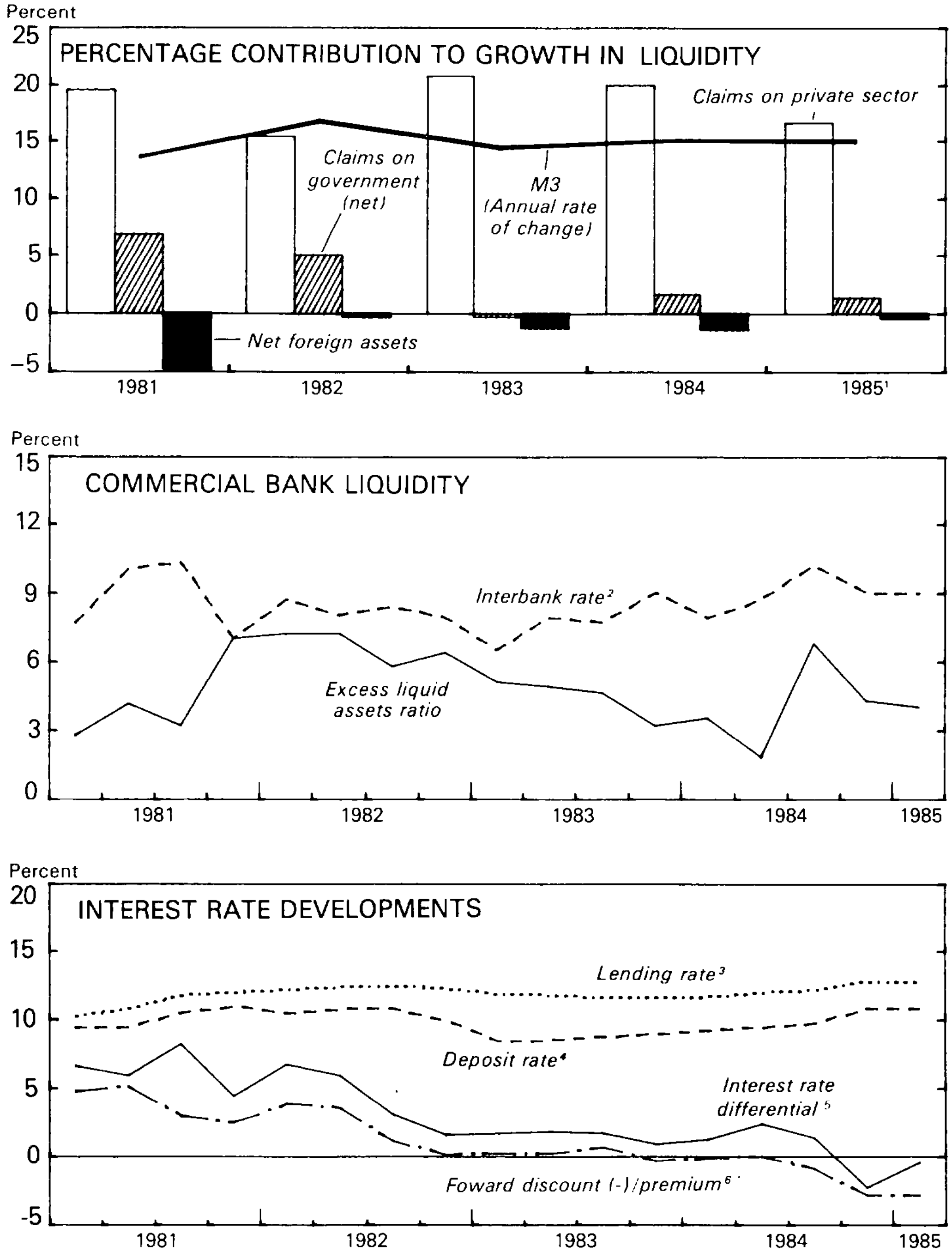
[1] Revised estimates

[2] Consisting of petroleum company tax, export duties, and royalties and dividends paid by the oil company

CHART 3

MALAYSIA

MONETARY DEVELOPMENTS, 1981-85



Source Data provided by the Malaysian authorities

[1]Official estimates.

[2]Seven day rate, weekly average in last month of quarter

[3]Weighted average lending rate of commercial banks.

[4]One year fixed deposits of commercial banks; end of period.

[5]Three month LIBOR on U.S. dollar minus three month interbank rate, period average.

[6]Forward discount (–)/ premium implicit in swap margin for representative three month swap effected through foreign exchange brokers; quarterly average of end of month data.

reserve ratios. 1/ These developments reflected aggressive deposit mobilization by nonbank financial institutions, partly through offering higher interest rates and some further branch expansion. The tightening of credit conditions, particularly during the second half of 1984, resulted in strong upward pressure on interest rates; the one-year deposit rate at the commercial banks rose by almost 2 percentage points to 11 percent. However, credit to the private sector grew rapidly (an average rate of 22 percent during 1983-84), with strong loan demand stemming from the construction and real estate sectors. 2/

The recovery of external demand, strong fiscal adjustment, and expansion in the oil sector led to a substantial improvement in the balance of payments during 1983-84. The current account deficit narrowed to US$1.8 billion (5.8 percent of GNP) by 1984 (Chart 4 and Appendix Table 5). Despite a weakening in oil prices, net oil exports expanded by US$1 billion, reflecting the marked increase in production and a slackening in domestic consumption of petroleum products. A strong expansion in electronics and electrical equipment exports raised the average growth of manufactured exports to 27 percent. However, other traditional non-oil exports, with the exception of palm oil, generally stagnated. Total imports grew at an appreciably slower pace during 1983-84; the growth of import volume declined from 9 percent in 1982 to 5 percent in 1984 and import prices fell by about 3 percent in each year. However, the service account deficit widened markedly, due mainly to larger net investment income payments (interest on foreign debt and profits) and a sharp increase in fees and payments in respect of foreign contractors associated with implementation of major projects.

The financing of the current account deficit and the continued deficit on errors and omissions was met primarily by nonmonetary capital inflows, largely through government and government-guaranteed borrowings. Net official borrowing declined from about US$2.7 billion in 1983 to US$2.1 billion by 1984, including US$0.6 billion for prepayment of maturities falling due primarily during 1988-90. 3/ The overall deficit narrowed to a near balance by 1984 from US$0.4 billion in 1982. Gross official reserves registered only a moderate decline to US$4 billion at the end of 1984, equivalent to 3.6 months of imports. Notwithstanding the sharply reduced external deficit on current account, external debt and the debt burden increased rapidly during 1983-84. Outstanding

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1/ This shift and completion of the exchange of bank notes begun in 1983 caused the narrow money supply (M1) to fall in 1984.

2/ This rate of expansion in credit to the private sector is computed on the basis of the banking survey (M3), including the finance companies, merchant banks, and discount houses. For commercial banks alone, the expansion in 1984 was 18 percent.

3/ Of this amount, about US$150 million was used for prepayment during 1984. About US$330 million is expected to be used for prepayments in 1985.

external debt rose to about US$18 billion (60 percent of GNP), with medium- and long-term debt accounting for slightly over US$15 billion. Debt service payments increased to US$2.5 billion (13 percent of gross current account receipts) in 1984. The ratio of total external debt to current receipts rose from 85 percent at end-1982 to 97 percent two years later.

The ringgit registered a continuing, though moderate, real effective appreciation in 1983, mainly on account of an appreciation in nominal terms (Chart 5). During the first nine months of 1984, the ringgit appreciated further by 4 percent in real effective terms. However, there has been a gradual, but steady, weakening of the ringgit vis-a-vis the Singapore dollar (3.5 percent) and the U.S. dollar (6.1 percent) during October 1984-April 1985. This contributed to a depreciation of the ringgit by 5 percent in real effective terms during this most recent period.

III. Report on Discussions

The discussions focused on adjustment policies in 1984, the economic outlook and policy stance for 1985, and prospects for the medium term. They took place amid the preparation of the Fifth Malaysia Plan (1986-90) which will cover the final period of the Outline Perspective Plan (1971-90). Medium-term projections and possible scenarios prepared by the staff and Malaysian officials provided the background for assessing policies with respect to developments in the domestic economy, the balance of payments, and the growth and burden of servicing Malaysia's external debt.

1. Adjustment policy in 1984

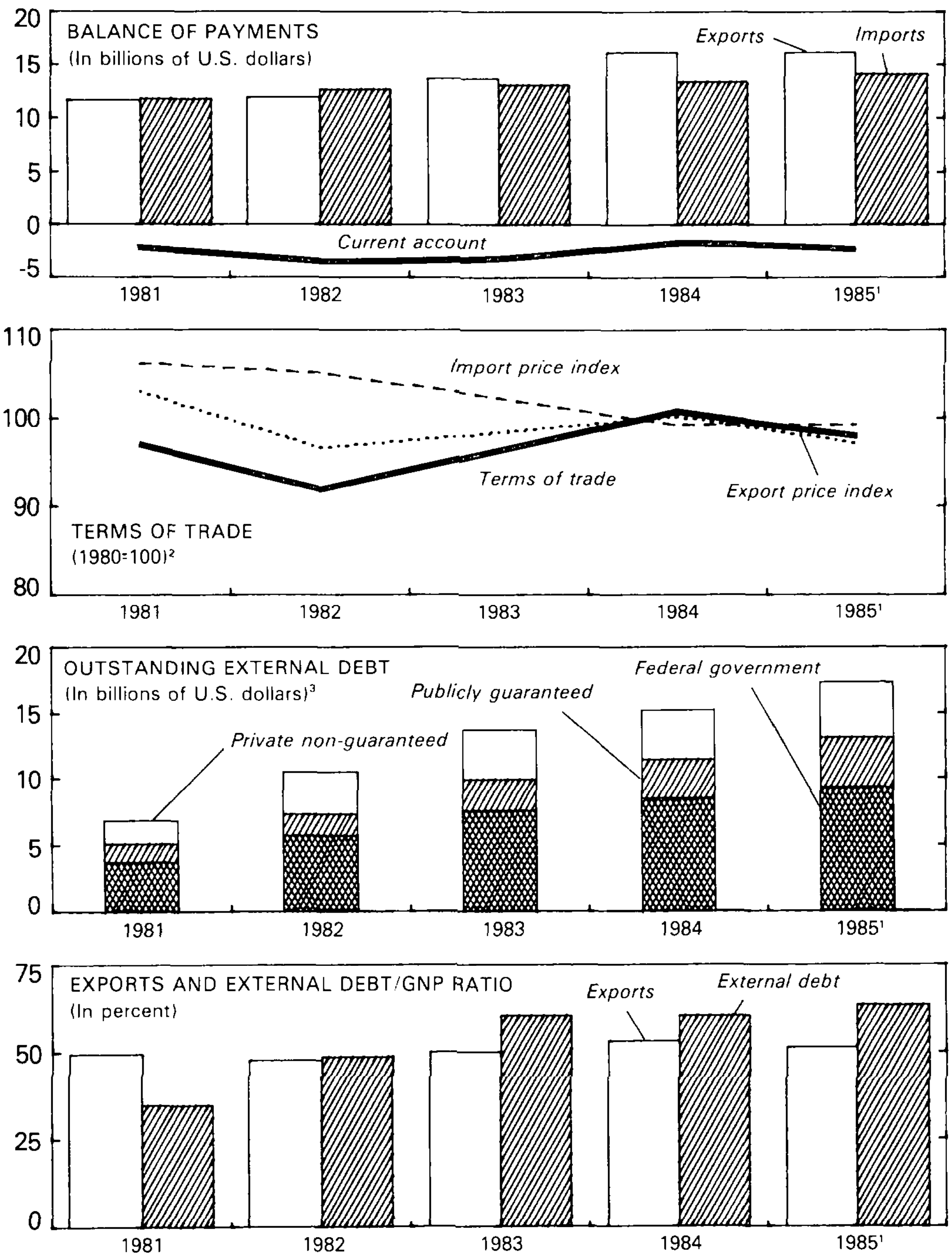
The 1984 budget was framed to consolidate the substantial progress made in fiscal adjustment in 1983. However, a further reduction of the overall deficit was considered to be difficult, because of pressure on wages and salaries, a higher interest burden, and some uncertainty regarding the extent to which the rephasing of projects initiated in mid-1983 would contribute to adjustment in 1984. Revenues, before taking into account dividends from Petronas, were estimated at M$19.4 billion, resulting in an overall deficit of M$7.4 billion (10 percent of GNP), up from the then estimated budget deficit of M$6.6 billion (10 percent of GNP) for 1983.

The preliminary outturn of the 1984 budget, however, indicates significant progress in fiscal adjustment, with the overall deficit lower by M$2.0 billion from the budget estimate. Much of adjustment came from a reduction in operating expenditure by about M$1.3 billion, consequent on the elimination of the remaining subsidies on the domestic

CHART 4

MALAYSIA

EXTERNAL INDICATORS, 1981-85



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

[1] Forecast

[2] Based on provisional export and import price indices with 1980 weight; indices are in terms of U.S. dollar.

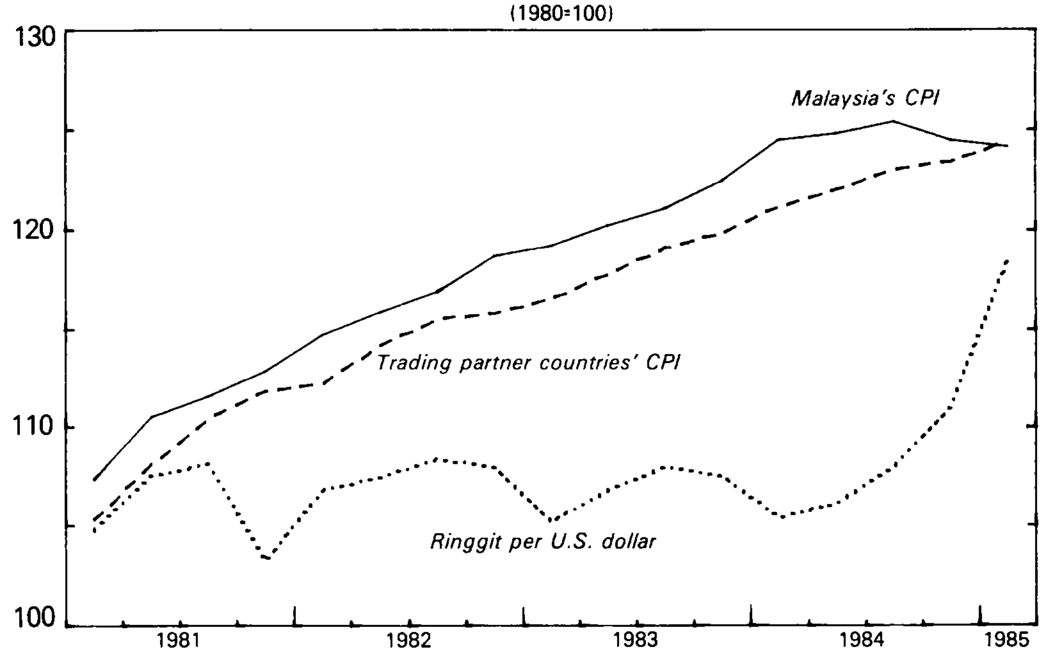
[3] Outstanding external debt of original maturity of one year and over.

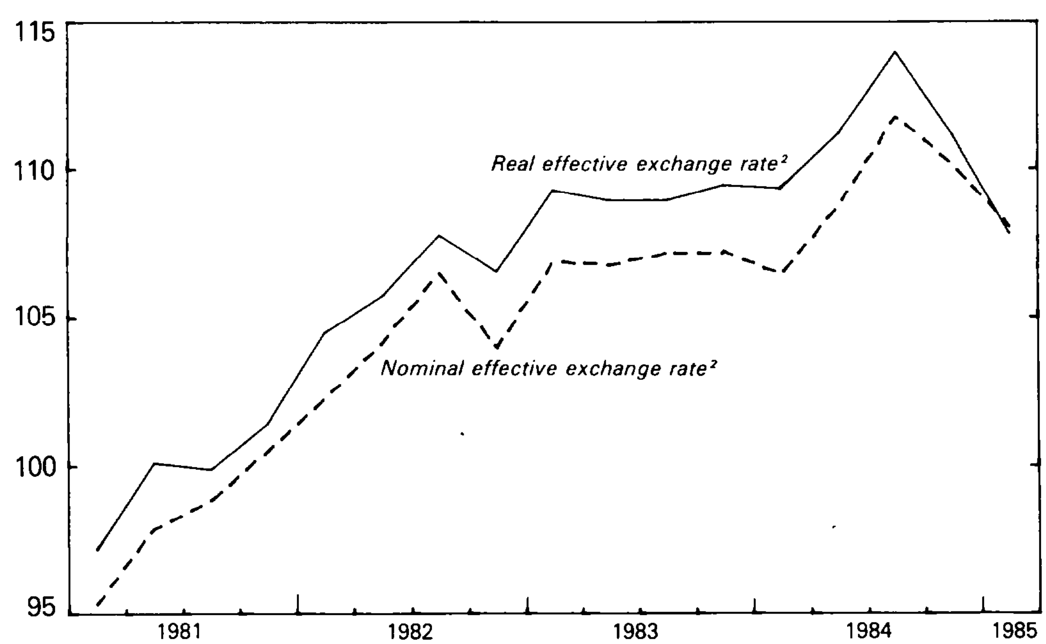
CHART 5

MALAYSIA

DEVELOPMENTS IN RELATIVE PRICES AND EXCHANGE RATE INDICES[1], 1981-85

(1980=100)





Sources: Data provided by the Malaysian authorities; IMF, *International Financial Statistics;* and staff estimates.
[1] Indices calculated using last month data for each quarter.
[2] Increase in the index indicates appreciation of the ringgit.

sales of petroleum products and a downward revision in external interest payments. With direct development expenditure also kept below the budget estimate, total expenditure in 1984 declined by M$1.1 billion when compared with the budgeted provision of M$26.8 billion and was virtually unchanged from the 1983 outturn. The burden of the expenditure restraint was borne mainly by defense, construction, and other economic services and general public services. The revenue outturn was also more favorable than earlier estimates, mainly reflecting a much larger than anticipated increase in revenues from the oil sector.

The rapid increase in expenditure by nonfinancial public enterprises and the absence of effective control over their activity were concerns for the authorities, which were also shared by Executive Directors in the 1984 Article IV consultation. To address this issue, the authorities established a high level inter-agency committee to lay down guidelines on the definition of public sector entities and monitor their activities within the framework of national economic planning. In the course of its work, the committee increased the number of nonfinancial public enterprises, subject to immediate monitoring, reporting and investment review, from 13 a year ago to 26. 1/ The authorities indicated that the investment strategy for the public sector under the Fifth Plan would be evaluated within this more comprehensive framework.

The control over investment expenditure by nonfinancial public enterprises strengthened in 1984, with a reassessment of projects planned for the year. Investment expenditure of the 13 enterprises identified in 1984, which had been estimated to increase by 75 percent at the time of the 1984 consultation discussions, grew by only 6 percent. This much lower expansion was partly a result of a rescheduling of investment expenditure by Petronas (the national oil company) and the Heavy Industries Corporation of Malaysia Bhd. (HICOM) but also reflected an overestimation of intended investments. Preliminary information indicates that the growth of development expenditure on the basis of the more comprehensive scope of public entities was held to 12 percent in 1984, down from the 33 percent growth in 1983. Investment by these public entities accounted for more than two thirds of total public sector investment in 1984.

The relatively accommodating stance of credit policy, which allowed a rapid expansion in credit to the private sector during the first quarter of 1984, was of concern to Executive Directors in the 1984 consultation. Credit policy was gradually tightened during the year; the impact of the tighter policy was compounded by capital outflows in October 1984

1/ As a result, the public sector was redefined as comprising the Federal Government, 13 State Governments, and 40 public entities (4 local authorities and 36 nonfinancial public enterprises). For a more complete description, see the forthcoming report on recent economic developments in Malaysia.

during a period of speculation against the ringgit. Credit policy was relaxed somewhat toward the end of 1984, in view of the exceptionally tight liquidity conditions that had developed, emerging signs of a slowdown in economic activity, and a decline in capacity utilization in manufacturing industries. Nevertheless, credit growth to the private sector by commercial banks was limited to 18 percent, as targeted, for 1984 as a whole. 1/ While the authorities intervened actively in the money market to forestall volatile fluctuations in interest rates, 2/ the general policy stance was one of permitting a rise in rates in response to the strong credit demand.

The strong demand for credit continued to be associated with real estate and property development activities. Bank Negara intensified its efforts to discourage lending to new projects in these sectors, and guided those few financial institutions whose lending operations were unduly concentrated in property development to restructure their loan portfolios. Guidelines were introduced in September that limited credit to a single customer to 30 percent of capital funds for domestic banks and of net working funds for foreign banks. Furthermore, a new guideline was issued in early 1985 proposing accounting standards for treatment of interest on nonperforming loans.

The external adjustment realized in 1984 was substantially larger than anticipated. The smaller current account deficit mainly reflected the further restraint on government expenditure and the rephasing of public sector investment. Imports grew at a substantially slower pace than anticipated, with a sluggish expansion in imports of intermediate and investment goods. External developments were also aided by a stronger than anticipated export growth due to a large increase in oil production and favorable demand for manufactured goods and palm oil.

2. Outlook and policies for 1985

Economic growth is estimated to slow to about 5.5 percent in 1985, primarily reflecting weaker external demand and lower export growth. Crude oil production is estimated to decline by about 6 percent in response to a softening in the oil market. Manufacturing production is expected to be adversely affected by a substantial weakening in the external demand for electronic goods. Domestic expenditure is estimated to be somewhat more buoyant than in 1984, as private sector investment benefits from higher investment in oil and gas and public sector consumption rises more rapidly. However, further curtailment in Federal Government net lending envisaged for 1985 will moderate the growth in

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1/ This growth rate for credit to the private sector is computed on the basis of the monetary survey (M2), i.e., excluding finance companies, merchant banks and discount houses.

2/ During a brief period in October, the rate for 7-day deposits rose to 20.5 percent compared to 10 percent at end-September.

domestic investment. Gross national savings as a proportion of GNP is estimated to decline somewhat, partly reflecting a fall in the terms of trade, while gross investment relative to GNP is projected to remain unchanged at the 1984 level. Thus, the domestic resource gap is expected to widen and the current account deficit to increase to 7.7 percent of GNP. The increase in consumer prices is projected to remain moderate, primarily due to stagnation in import prices.

a. Fiscal policy and public sector expenditure

The central role of fiscal adjustment in reducing Malaysia's external imbalance was firmly established in the Mid-Term Review of the Fourth Malaysia Plan. The budget for 1985 reflects a continuation of this strategy against the background of the substantial adjustment achieved in 1983-84, the burden of projects previously deferred, and the aim to set an environment to encourage private sector activity as the scope of and stimulus from the public sector decreased. The revised fiscal outlook (at the time of the discussions) was for a small increase in the overall deficit of the Federal Government to M$5.5 billion; in relation to GNP, however, the deficit was expected to decline moderately. Total development expenditure, including net lending, was expected to show a small decline, whereas operating expenditures were expected to rise by 15 percent. One half of this increase reflected higher interest expenditure on the public debt. Revenue growth of 10 percent had been revised downward to reflect changes in oil prices and production levels. 1/

The Malaysian authorities indicated that their commitment to reducing the fiscal deficit and strengthening the government financial position remains firm at both the political and administrative levels. The restraint on development expenditure would continue to be the principal avenue for fiscal adjustment, even if it entailed a lower rate of economic growth. At the same time, they noted that further fiscal adjustment would require a greater rationalization of expenditure priorities and a reassessment of government functions in economic development. The latter consideration is reflected in the growing emphasis on privatization of some public enterprises, a key initiative that will be reflected more fully in the Fifth Malaysia Plan. The authorities noted that the increase in direct development expenditure envisaged in 1985 reflected mainly the earlier rephasing of projects and a carryover of payments due on projects previously completed. In their view, there was little room for underspending because of the stringent expenditure review and control in 1984. The authorities currently estimate that projects valued at M$13 billion would be carried over to the Fifth Plan as a result of delaying implementation of projects

1/ These estimates also include dividend income from Petronas of M$950 million which was not included in the budget estimates presented in October 1984.

approved for the Fourth Malaysia Plan. However, these projects would be reassessed in light of new priorities set under the Fifth Plan and would be reduced or further phased out over 2-3 years.

The pressure on operating expenditures remains strong in 1985, mainly reflecting structural rigidities associated with statutory expenditures, including interest payments on Federal debt. The authorities indicated that efforts are being made to trim employment at the Federal and State levels, while maintaining the quality of essential services including health and education. The freeze on filling of vacancies that had been in effect in the Federal Government in 1984 would be continued; this also applied to the State governments and major statutory authorities. The 5 percent rise in total wage and salary expenditure reflected primarily promotions and annual increments. No provision had been made for a general salary increase (the last such increase was implemented in 1980-81). Although there was some pressure for a general increase, the authorities indicated that broad considerations of fiscal policy and external adjustment would continue to be accorded priority in consideration of public service salary issues.

Tax measures introduced with the 1985 budget were directed at reducing the higher marginal rates of individual and corporation income taxes. These reductions were aimed at improving incentives for private saving and investment. Offsetting measures to raise revenues included higher import duties (cars, tires, and plywood), road transport fees, and a share transfer tax on land-based companies. The authorities noted that revenues other than from the oil sector had remained relatively stable in relation to GNP (about 21 percent). In the circumstances, the scope for improving the tax system lay principally in improving administration and reducing exemptions of the sales tax. In view of relatively frequent changes in tax rates in recent years, the authorities indicated that greater stability in the tax system should be sought to improve compliance. The historic dependence on export taxes, particularly of rubber, had been a weakness slowly being overcome. 1/

The authorities indicated that careful review of the investment activity of the nonfinancial public enterprises would continue. Investment expenditure of the 13 major public enterprises, identified at the time of the 1984 consultation discussions, is estimated to increase only marginally to M$3.5 billion in 1985. For all major nonfinancial public enterprises, total investment expenditure in 1985 is estimated to decrease by M$0.5 billion.

1/ In April, the threshold price at which the export tax would apply was again raised; at prospective rubber prices in 1985, this change would effectively eliminate revenue from this source. This change, which could reduce revenue by M$185 million, has not been reflected in Appendix Table 2.

The staff representatives noted that the financial return to Government from its previous investments in public enterprises had been modest. Other than dividends from Petronas and Bank Negara, the returns had been negligible; in one instance, a very large loss had been sustained. There were indications that several of the major industrial projects coming to fruition would not be able to make an economic return in the environment currently envisaged. The imbalance for the budget between rising interest payments and only modest financial returns on investments in most public enterprises could become a growing structural weakness in public finances.

b. Monetary policy

The objectives of monetary and credit policies in 1985 are to create a financial environment conducive to sustaining moderate economic growth by accommodating private sector investment. This is consistent with continued fiscal adjustment, less robust expansion of public enterprise investment, and efforts to streamline the regulatory environment affecting business investment.

Money market conditions had been tightened abruptly during a brief period in October when there had been speculation against the ringgit. The authorities acted vigorously to tighten conditions and end the speculation. Subsequently, Bank Negara moved to restore more normal market conditions by injecting liquidity and permitting swap contracts (predominantly with branches of foreign banks) to rise by M$0.4 billion. Nevertheless, interest rates on time deposits and loans rose by almost a full percentage point during the last quarter of the year.

The stance of monetary policy for 1985 is aimed at providing a modest stimulus against the background of some weakening in manufacturing output and private investment. The authorities indicated that measures to promote competition among financial institutions and to improve the responsiveness of interest rates to changes in money market conditions were under active consideration. 1/ In April, as part of a broader aim of integrating more fully the nonbank financial institutions into the financial system, the statutory reserve ratio for commercial banks was reduced from 5 to 4 percent and for merchant banks it was raised from 1.5 to 2.5 percent. The former step is not expected to add appreciably to bank liquidity because of the withdrawal from commercial banks of government deposits which had been a source of temporary accommodation during the latter part of 1984. For 1985, the expansion of total liquidity, M3, was targeted at 15 percent. This expansion was consistent with a projected growth of 17 percent in credit to the private sector by the broader banking system. In this context, the authorities commented that the strong expansion of reserve money in the

1/ This work has been supported by technical assistance from the Fund's Central Banking Department.

first quarter of 1985 was partly due to seasonal factors associated with the Chinese New Year. The growing importance of nonbank financial institutions, higher interest rates offered on deposit substitutes, and other factors had caused the narrowly defined monetary aggregates to become less stable indicators of economic activity, and hence less useful as intermediate targets for monetary policy. Consequently, primary emphasis would be placed on broader liquidity and credit aggregates in the financial system. 1/

As indicated earlier, during 1984 Bank Negara monitored closely the domestic loan portfolios of financial institutions to avert undue concentration of lending for property development, real estate, and construction. The boom in high-rise construction since 1982 has caused concern that an oversupply could affect the cash flow and profitability of such projects during 1985-87 with potential repercussions for any overextended institutions. Strengthening of prudential guidelines, taken in conjunction with more intensive supervision work, were aimed at avoiding undue liquidity stress in financial institutions.

c. Petroleum policy

Following the robust expansion during 1982-84, crude oil production for 1985 was originally targeted at 460,000 bpd, up slightly from 1984. However, emerging signs of price instability during the latter part of 1984 led the authorities to revise downward the target to 420,000 bpd in December. The authorities noted that, as with a number of other producers, the maintenance of price stability was an important objective and this was reflected in their decisions with respect to oil production. The authorities currently envisage that crude oil production will be raised to 470,000 bpd in 1986 and gradually thereafter to 500,000 bpd by 1989. The projected production pattern is aimed at ensuring prudent reservoir management and maintaining an adequate financial return to production-sharing contractors. The authorities noted that Malaysia's excess production capacity over the projection period was relatively small.

Exploration activity slowed substantially during 1982-84, reflecting the expiration of the five-year exploration periods under contracts with the two principal foreign companies operating in Malaysia. Contracts with other companies, including a subsidiary of Petronas, had been signed in 1983 and the rise in exploration expenditure in 1985 was related to a more active stage of operations by these contractors. The authorities have been reassessing the adequacy of oil exploration/production-sharing terms in light of global trends toward slackening in

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1/ This shift in focus is being supported by technical assistance of the Bureau of Statistics to help prepare the broader consolidated banking survey also encompassing finance companies, merchant banks and discount houses.

exploration and more generous terms being offered by several producing countries. The revisions currently under consideration include provision of higher production shares to oil companies in new fields deemed to be of marginal size (less than 50 million barrels of recoverable reserves) where existing incentives for exploitation are least attractive.

Domestic consumption of petroleum products declined in 1984, after rising at an average annual rate of about 6 percent during 1980-83. This decline reflected an increased substitution of petroleum products by natural gas and coal, an expansion in hydroelectric generation, and possibly some effects from removal of remaining product subsidies. These were eliminated at the beginning of 1984 and prices were increased during the year to reflect movements in the exchange rate of the ringgit against the U.S. dollar. Over the medium term, the domestic consumption of petroleum products is expected to be critically influenced by the gas development program currently underway which could substantially reduce oil as a fuel in power generation. Malaysia's recoverable gas reserves presently are estimated at 50 trillion SCF, about three times the extent of oil reserves in energy equivalent terms.

d. Balance of payments outlook and policies

The balance of payments is expected to weaken in 1985; the current account deficit is estimated to widen to US$2.4 billion (7.7 percent of GNP), following the improvement in 1984. Exports are projected to remain unchanged at the 1984 level, due primarily to a weak external demand for oil and electronic goods. The weaker export outlook is compounded by a further, though moderate, rise in imports and continuing deterioration in the service account. The authorities indicated that the balance of payments outlook for 1985 was a source of concern, but felt that few effective policy options were available in the short run to counter the expected deterioration. They stressed that Malaysia's balance of payments problem would be best dealt with, as they were doing, by persistent adjustment efforts over the medium term, mainly through restructuring of public sector investment, the privatization policy with concurrent improvement in the environment for private investment, and measures to reduce the deficit on the service account. The latter included promoting tourism in Malaysia and national shipping and insurance services.

The current account deficit is to be financed primarily through foreign borrowing by the Government and by public enterprises with government guarantees. Net capital inflow in 1985 is projected to rise to US$3.0 billion, with official borrowing accounting for US$1.7 billion. Net official borrowing includes amounts for further prepayments on existing debt of US$0.9 billion; this is aimed at alleviating further some of the amortization burden expected during 1988-90. The resources for prepayments have been raised through two recent floating rate note issues amounting to US$1.2 billion with 15-year maturity. 1/ The authorities intend to refinance existing debt whenever opportunities arise that would permit both a lowering of the interest burden and lengthening of the maturity profile.

International reserves policy continues to be determined by the need to maintain an adequate level in light of the openness of the economy, the liberal exchange system, and fluctuations in export earnings which are heavily dependent on primary commodities. The authorities considered that official reserves equivalent to about 3.5 months of imports would be a minimum level needed to pursue prudent economic management. The potential for unsettling exchange market transactions, and the pressures this could place on official reserves was a factor also taken into consideration.

e. Exchange rate policy

During the 1984 Article IV consultation, Executive Directors expressed the view that exchange rate policy be used with flexibility to maintain export competitiveness and support external adjustment, while recognizing that the weaker external payments position in recent years was attributable to the fundamental domestic imbalance associated with the sharp rise in public expenditure from 1979. Commenting on recent developments in the exchange rate, the authorities indicated that the appreciation of the ringgit in real effective terms during the first nine months of 1984 was the result of maintaining a stable relationship against a basket of currencies. However, from October the nominal and real effective exchange rate indices had moved in the direction of depreciation and by April 1985 had returned to the level prevailing during the second half of 1983. The authorities noted that this recent development, although relatively small, was consistent with the need to strengthen the balance of payments and competitiveness. Available indicators showed rapid increases in labor costs and output per worker in a number of industries during 1981-83, but there were no clear indications of an erosion in competitiveness. The authorities noted that major gains in productivity were being achieved in those industries where new investment incentives were being structured to promote modernization and increase domestic value added. They were concerned that

1/ Both issues permit an extension of the maturity with the consent of the lenders, considerably beyond 15 years.

undue volatility in the exchange rate could cause unwarranted speculation as had occurred last October. The authorities reaffirmed the importance they attach to managing exchange rate policy to support external adjustment and also to prevent an erosion in export competitiveness.

3. Medium-term outlook

a. Fifth Malaysia Plan

The authorities indicated that the development strategies and objectives of the Fifth Malaysia Plan would be oriented to ameliorate the major problems identified in the Mid-Term Review of the Fourth Malaysia Plan. These included: the significant increase in the size of the public sector since 1979; the slackening in private investment; the increasing strain on the balance of payments and the rapid rise in external debt; the decline in agricultural productivity; and the narrow production base of manufacturing, dependent on the free trade zones and few industries with important industrial linkages. The authorities stated that the primary objectives of the Fifth Plan would be to further consolidate fiscal adjustment, restructure public sector investment, and reduce the external current account deficit. To this end, major efforts would be made to improve the overall investment climate conducive to a more dynamic expansion in the private sector and to promote higher productivity and efficiency, particularly of the export-oriented manufacturing sector.

Although final decisions had not been taken, economic growth for the Fifth Plan period would most probably be targeted at a lower rate than an average annual rate of 6.4 percent estimated for the Fourth Plan period, and perhaps even less than 5 percent. Under the Plan, the role of the public sector as an engine of growth would be reduced substantially. Public sector projects already under firm contractual obligations would be implemented, but there was little scope to initiate new projects on any substantial scale during the first two years of the Plan period. To reduce the relative size of the public sector and enhance the efficiency of the economy, privatization of selected public enterprises and services, including the Telecommunications Department, the Malaysian Airline System, and the container terminal at Port Kelang, *would be pursued aggressively.* 1/ *The authorities are confident that,* with the provision of adequate incentives, the private sector's response would be favorable.

1/ In the future, privatization would be extended to public entities engaged in health services, custodial services in public buildings, etc.

b. Foreign direct investment and industrial policy

Policies regarding foreign direct investment are under review with the aim of promoting private industrial development and encouraging the rapid transfer of technology. Measures being considered include the relaxation of limits governing equity control by foreign investors. The authorities noted that a further liberalization of foreign direct investment policies would be essential for the success of privatization, in view of sizable capital requirements and the need for continuous upgrading of technology in privatized enterprises. Foreign participation in such enterprises was receiving active consideration. A shift to a more liberal policy stance has also been made possible by a more rapid restructuring of foreign corporate ownership than originally anticipated. Some estimates indicate the share of foreign equity in the corporate sector in aggregate has already been reduced to the target level of 30 percent, well ahead of the terminal year of 1990 envisaged in the New Economic Policy.

The major thrust of industrial policy during the Fifth Plan would be to promote the expansion of export-oriented industries. The principal measures under consideration include provision of enlarged export refinancing facilities, selective tax incentives, and simplification of the licensing and regulatory environment. The Industrial Coordination Act of 1975, in which the basic framework of industrial licensing was established, has been under review with a view to reducing administrative impediments to existing and new investment. Export promotion policy would be supported by selective but generally limited tariff protection for import-competing investments to reduce the present bias against exporting and to promote a more competitive manufacturing sector. Certain recently established heavy industries may need substantial protection over a prolonged period, but it was hoped that linkages would develop to support associated industries. Detailed subsector analyses to explore the industrial potential of the Malaysian economy, including both selective export-oriented industrial development and import substitution, are currently being undertaken and will be embodied in an Industrial Master Plan.

c. External outlook

The external outlook for the medium-term was discussed against a scenario which is characterized by sustained domestic and external adjustment, a relatively weak international oil market, and evolution in the world economy roughly in line with the central scenario assumed in the recent WEO exercise. 1/ Under this scenario, Malaysia's balance of payments is projected to remain under pressure. The current account deficit would remain about US$2.5 billion over the medium-term, although in relation to GNP it is projected to decline progressively to about 5 percent by 1989 (Appendix Table 6). The trade account surplus is projected to widen to 7.6 percent of GNP by 1989. However, this strengthening would be more than offset by a substantial increase in the service account deficit, due mainly to a rise in investment income payments. External debt, including short-term debt, is projected to reach about US$32 billion by 1989, equivalent to 69 percent of GNP or 107 percent of gross current account receipts; medium- and long-term debt would amount to about US$28 billion. Debt service payments would rise to US$4.9 billion and the debt service ratio to 16.4 percent of gross current account receipts by 1989.

The projected medium-term outlook is not appreciably different from the one envisaged at the time of the 1984 Article IV Consultation. 2/ In the present projection, however, the external debt service burden is somewhat smaller than earlier estimates, mainly reflecting the refinancing undertaken in 1984-85 and lower interest rates assumed in the current projections. The refinancing is estimated to reduce the debt service burden in 1988 and 1989 by 0.6 and 1.3 percentage points, respectively, compared with earlier estimates. But the rising trend in external debt and the ratio of debt to exports during the second half of the decade suggests that a heavy debt service burden would persist during most of the ensuing decade. This outlook is sensitive to developments in international interest rates. A one percentage point

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1/ Key assumptions in the scenario are that (i) domestic real growth during the Fifth Malaysia Plan is limited to 5 percent and the income elasticity of investment goods imports falls from about 1.5 in recent years to 1.0 by 1989, (ii) Malaysia's crude oil production is raised to 470,000 bpd in 1986 and increases thereafter at an average annual rate of about 2 percent to 500,000 bpd by 1989; (iii) oil prices fall slightly in nominal terms during 1985-86 and remain constant in real terms during the subsequent years; (iv) the growth of domestic consumption of petroleum products continues to rise at a fairly rapid pace (about 6 percent), partly reflecting the limited scope for additional gas substitution until 1989; (v) international inflation remains at about 5 percent, and there is no substantial change in the terms of trade over the medium-term; (vi) the rate of interest in terms of Eurodollars falls progressively from 9.5 percent in 1985 to 8.0 percent by 1989; and (vii) gross reserves are maintained at about 3-3.5 months of imports.

2/ One of the important assumptions in the projections presented in the 1984 consultation report was a substantial strengthening of adjustment policies. This was achieved in 1984.

change in the rate of interest compared with that assumed in the base case, would change Malaysia's debt service burden during 1987-89 by something equivalent to one percent of gross current account receipts.

Under an alternative scenario incorporating further downward pressure on oil prices, 1/ Malaysia's external outlook is disquieting. The current account deficit is projected to widen to 7-8 percent of GNP over the medium-term, and external debt is forecast to reach US$34 billion by 1989. The debt service ratio would rise to 17 percent of gross current account receipts by 1989, with a heavier debt service burden expected to persist in the 1990s. The ratio of external debt to current account receipts would rise to 126 percent by 1989 compared to about 107 percent in the base scenario.

4. Work of the IBRD

The Bank has maintained an active economic dialogue with the Malaysian authorities on a range of macroeconomic and sector issues. Where the principal concern was one with agriculture and rural poverty, the Bank has in the recent past begun to concentrate on the problems of adjustment, public sector investment and industrial development. Over the past 18 months, the staff of the Bank has prepared reports on external debt monitoring, public investment in transportation and energy, the statistical reporting system, poverty measurement and, most recently, on domestic resource mobilization and development strategies. A country economic report planned for the second half of 1985 will provide an issue-oriented review of the industrial and agricultural sectors. The Bank staff has supported the authorities' adjustment strategy and particularly the need to reduce public sector expenditure and reorient priorities, giving more emphasis to considerations of economic efficiency.

Lending to Malaysia in FY 1984 was only US$70 million for one power project. In FY 1985, three projects were financed in the agriculture and industry sectors and a total of US$90 million was committed. However, recent discussions between the Bank and the Malaysian authorities have paved the way for an enlarged program amounting to about US$300 million per annum, starting in FY 1986. While the traditional sectors--agriculture, transport and education--will continue to receive attention, the Bank hopes to broaden the range of its operations to embrace energy development and industrial lending.

1/ The principal assumptions underlying this case include: (i) oil prices fall by US$4 per barrel to US$24 per barrel in 1986 and remain roughly constant in real terms in the subsequent years; (ii) Malaysia's crude oil production is limited to 420,000 bpd until 1986, and increases moderately to reach 470,000 bpd by 1989; and (iii) international inflation rises at an annual average of 3.5 percent during 1987-89; and (iv) the level of interest rates is lower than in the base case by 1.0-1.5 percent.

5. Statistics

The Malaysian authorities have intensified efforts to improve economic and financial statistics. Nevertheless, considerable further work is required (and underway) to develop appropriate statistics for nonfinancial public enterprises, prepare a consolidated public sector account, and revise national income accounts to reflect a more appropriate delineation of the public sector. 1/ Also, reliable indicators of productivity and labor costs in important segments of manufacturing industry are lacking. This is an area where further work is needed to assess key trends in industry, including external competitiveness.

IV. Staff Appraisal

Stimulus from external demand and continued fiscal adjustment helped the Malaysian economy to attain stronger growth with reduced imbalances in 1984. Gross domestic product rose strongly, reflecting rising output of oil and gas, a strong performance in export-oriented manufacturing industries and in construction. Expansion of total domestic demand continued to slow in 1984, with investment falling in absolute terms, while the recovery in international trade and lower import growth resulted in a much stronger contribution to growth of net exports. Stability of import prices helped to contain price pressures.

Malaysia made important strides during 1983 and 1984 in domestic and external adjustment. This is most evident in the effective expenditure restraint in Federal Government operations and reduction in the fiscal deficit by an amount equivalent to 10 percent of GNP from the record level of 1982. The staff strongly supports the broad reassessment of government programs and investment priorities which has taken place and is continuing. Although there have been less striking developments in revenue growth, the ratio of non-oil revenues to GNP remains relatively high and within this total there has been a welcome shift away from export taxes on primary commodities, particularly rubber. Investment expenditure by nonfinancial public enterprises also grew less strongly in 1984. This is an area, however, where more emphasis on monitoring developments, increasing profitability, and assessing priorities within a broader context should result in further domestic adjustment.

The balance of payments strengthened appreciably in response to fiscal adjustment during 1983 and 1984, strong growth in external demand and increased output in the oil and gas sector. Nevertheless, even at the reduced level of 6 percent of GNP, the current account deficit is

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1/ This work has been supported by technical assistance from the Fund's Bureau of Statistics.

large. The additional external borrowing in two years raised the debt to GNP ratio to 60 percent and the debt service ratio to 13 percent; the latter is more than double the ratio that obtained in 1979. Interest on the rising debt is a major factor contributing to the increasing deficit on services. In sum, although the Malaysian economy underwent very marked domestic and external adjustment in these two years, the current account deficit remains large and consequently the pressure of rising debt and burden of its servicing, although moderated, also remains large.

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.

The fiscal outlook for 1985 has been clouded by weakness in petroleum markets and tax revenues from production and export of oil. The recent reduction in export tax on rubber, although welcome, adds further pressure on the revenue side. These and other possible revenue slippages coincide with pressures for substantial wage and salary increases in the public service. The staff broadly supports the thrust of tax policy in the budget and also the view that too frequent changes in tax rates should be avoided. Nevertheless, there is scope for modernizing the sales tax, broadening its base through reduced exemptions, and in general, strengthening tax administration. Efforts in these areas are underway but should be intensified. The scope for further expenditure restraint in the Federal Government may be limited because of commitments postponed from earlier years. Nevertheless, the staff would encourage the authorities to persevere in the review, along all dimensions, of government programs and functions with a view to reducing the level of total expenditures further in relation to GNP. This review should also continue in the projects of nonfinancial public enterprises. Financial planning should aim at enabling the Government to secure an adequate return on these investments, something which, with the important exception of Petronas and Bank Negara, has not been achieved.

The financial system is undergoing fundamental change reflected in the decline of M1 in 1984 and continued rapid expansion of nonbank financial institutions. The staff welcomes the shift in focus of monetary targets from the narrowly defined monetary aggregates to more comprehensive aggregates embracing also the major nonbank financial institutions. The authorities aim to accommodate growth in M3 at 15 percent, anticipating a somewhat higher rate of growth in the comparable domestic credit aggregate. The staff team noted that in recent years the M3/reserve money multiplier has risen strongly; the reduction in the statutory reserve ratio for commercial banks would enhance that trend. In these circumstances, the staff team urged very close monitoring of domestic credit developments in light of external objectives, the underlying demand for liquidity, and the strong expansion of reserve money in the first quarter of 1985. The staff welcomes the steps that have been taken to limit undue concentration of lending by individual financial institutions, moves to establish standard accounting requirements for interest accrual on nonperforming loans, and more intensive supervision to prevent undue risk exposure of financial institutions. More vigorous measures should be taken if continued credit expansion to the property development sector impinges unduly on the liquidity position of individual financial institutions. The tightening liquidity conditions and resulting rise in interest rates during the second half of 1984 was appropriate in light of the continuing strong credit demand.

Strong fiscal adjustment in 1984 has helped the economy to move successfully along a medium-term path toward a sustainable balance of payments. The outlook has been further improved by successful refinancing on more favorable terms of debt maturities due primarily in 1988-90. Nevertheless, further domestic adjustment is required to reduce the external deficit to 5 percent of GNP by 1989 indicated in the base scenario. Even this level would leave the economy unduly vulnerable to risks of a potentially less favorable outlook, particularly regarding oil prices and output or less buoyant growth in external demand. In light also of the need to accommodate traditional capital movements identified only in errors and omissions, the staff urges the authorities to aim at achieving a fuller degree of domestic and external adjustment during the Fifth Malaysia Plan than indicated in the base scenario.

The ringgit appreciated in real effective exchange rate terms through September, continuing the trend evident since 1981. However, more recently, the ringgit has depreciated against the Singapore and U.S. currencies and in real effective terms depreciated to the level obtaining during the latter part of 1983. The staff supports this reversal in the trend of appreciation and believes that exchange rate policy could be used more actively in support of other elements of the adjustment effort. In light of the openness of the economy and its exchange market, Malaysia must maintain sufficient reserves to meet probable developments and unforeseen temporary disturbances. Sustaining an adequate level of gross reserves should thus be anticipated in medium-term planning.

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

Table 1. Malaysia: Output, Demand, and Prices, 1981-85 1/

(Percentage change over previous year)

	1981	1982	1983	1984	1985 Official Proj.
GDP at market prices	7.1	5.6	5.9	7.3	5.6
Agriculture, forestry, and fishing	4.2	7.4	-1.0	3.0	3.4
Mining and quarrying	-2.0	2.8	18.5	20.0	-3.3
Manufacturing	4.9	3.8	6.6	11.1	8.0
Construction	15.1	9.5	10.6	8.3	8.0
Wholesale and retail trade	6.9	4.8	7.8	7.2	6.3
Government services	17.1	7.5	5.0	4.0	4.0
Net factor payments to abroad	-4.8	35.1	45.1	29.0	12.1
GNP at market prices	7.5	4.7	4.3	6.0	5.1
Imports of goods and nonfactor services	7.4	12.6	7.0	4.4	2.3
Demand					
Domestic demand	10.0	7.5	4.8	3.3	4.8
Consumption	5.6	3.9	4.0	4.7	5.1
Private	(2.5)	(2.7)	(4.2)	(5.5)	(4.0)
Public 2/	(15.0)	(7.1)	(3.6)	(2.6)	(8.1)
Investment 3/	23.0	10.9	7.3	-4.9	4.4
Private	(9.3)	(6.3)	(-0.2)	(-2.9)	(5.7)
Public 2/	(44.5)	(16.4)	(15.5)	(-6.8)	(3.2)
Exports of goods and nonfactor services	0.5	9.1	10.4	13.6	3.8
Crude oil production	-6.6	17.5	26.5	16.8	-5.8
Consumer prices (period average)	9.7	5.8	3.7	3.9	4.0-4.5
Terms of trade	-3.0	-5.3	4.7	4.9	-3.0
			(Ratio to GNP)		
Memorandum item:					
Gross national saving	24.1	23.5	25.0	26.8	24.9
Gross domestic investment	34.5	37.9	36.7	32.6	32.6

Source: Data provided by the Malaysian authorities.

1/ Output and demand based on constant 1970 prices.
2/ Includes 4 local authorities and 36 major nonfinancial public enterprises.
3/ Excludes changes in stock.

Table 2. Malaysia: Summary of Federal Government Operations, 1981-85

	1981	1982	1983	1984 Prelim. Actual	1985 Rev. Est.
			(In billions of ringgit)		
Total revenue and grants	15.7	16.6	18.5	20.3	22.3
Of which: Nonpetroleum revenue 1/	(11.1)	(11.3)	(14.0)	(14.5)	(17.0)
Total expenditure and lending 2/	24.3	26.7	25.4	25.7	27.8
Of which:					
Operating	13.6	15.8	16.1	17.7	20.4
Development	8.9	7.1	5.8	3.8	4.4
Net lending	2.2	4.1	3.6	3.7	3.0
Overall deficit	-8.6	-10.1	-6.9	-5.4	-5.5
Financing (net)					
External	3.4	4.9	4.6	3.0	...
Domestic 3/	4.7	5.8	2.2	2.8	...
Of which:					
Banking system 4/	1.2	1.7	-0.2	1.1	...
			(As percent of GNP)		
Total revenue	28.9	28.3	28.8	28.4	29.2
Of which: Nonpetroleum revenue	20.5	19.2	21.8	20.3	22.3
Total expenditure	44.7	45.6	39.5	35.9	36.5
Of which:					
Operating	25.0	27.0	25.0	24.7	26.8
Development	16.3	12.1	9.0	5.4	5.7
Net lending	4.1	6.9	5.6	5.2	4.0
Overall deficit	15.8	17.3	10.7	7.5	7.3
External financing	6.3	8.4	7.1	4.1	...
Domestic financing	8.6	9.9	3.4	4.0	...

Source: Data provided by the Malaysian authorities.

1/ Excluding taxes on net income and profits of oil production companies, export taxes, petroleum royalties, and dividends from Petronas.

2/ Includes adjustments for accounts payable.

3/ Excludes statistical discrepancy that arises mainly from the differences of recording transactions in the Treasury and the Central Bank.

4/ Includes Central Bank and commercial banks.

Table 3. Malaysia: Banking Survey, 1981-85 1/

	1981 Dec.	1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec. Proj.
	(In billions of ringgit; end of period)				
Foreign assets (net)	7.7	7.6	7.1	5.4	5.1
Domestic credit	37.2	45.0	54.1	65.1	75.6
Claims on government (net)	4.3	6.2	6.1	7.0	7.8
Claims on private sector	32.9	38.8	48.0	58.1	67.8
Total liquidity (M3)	37.9	44.3	50.7	58.3	67.1
Other items (net)	7.0	8.3	10.5	12.1	13.6
Memorandum items:					
Narrow money (M1) 2/	11.2	12.7	13.7	13.7	...
Broad money (M2) 3/	32.5	37.8	41.4	46.2	...
	(Percentage change)				
Domestic credit	30.9	20.8	20.3	20.2	16.2
Government (net)	114.2	44.4	-1.1	13.8	11.4
Private sector	24.6	17.7	23.7	21.0	16.7
Total liquidity	13.6	16.8	14.5	15.1	15.0
Narrow money	12.5	13.3	7.9	-0.1	...
Broad money	16.9	16.3	9.5	11.5	...

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

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

2/ Comprises currency outside banks and demand deposits of the private sector, including public enterprises and other financial institutions, with the central bank and commercial banks.

3/ Includes narrow money and time and savings deposits of the broadly defined private sector with commercial banks.

Table 4. Malaysia: Key Monetary Indicators, 1981-85

	1981	1982	1983	1984	1985 Proj.
			(Percentage change)		
Total liquidity (M3)	13.6	16.8	14.5	15.1	15.0
Domestic credit	30.9	20.8	20.3	20.2	16.2
Credit to private sector	(24.6)	(17.7)	(23.7)	(21.0)	(16.7)
Reserve money	9.7	16.6	4.7	4.3	4.7
		(Percentage contribution to growth in M3)			
Net foreign assets	-4.7	-0.2	-1.2	-1.4 1/	-0.4
Claims on Government (net)	6.8	5.0	-0.2	1.7	1.4
Claims on private sector	19.5	15.4	20.8	19.9	16.7
			(Ratios)		
Money velocity (M3) 2/	1.44	1.32	1.27	1.23	1.14
Money multiplier (M3) 3/	5.2	5.2	5.7	6.3	6.9
			(In percent)		
Excess bank liquidity	7.0	6.4	3.2	4.3	4.0 4/
Interbank rate 5/	7.0	7.9	9.0	9.0	....
Average lending rate 6/	12.0	12.3	11.6	12.8	....
Deposit rate 7/	11.0	10.0	9.0	10.8	10.8 8/
Interest rate differential 9/	4.5	1.6	0.9	-2.2	-0.4 10/
Forward premium/discount 11/	2.5	0.2	-0.3	-2.8	-2.8 10/
Memorandum items:					
Rate of inflation (end of period) 12/	8.8	5.2	3.1	1.7	4.0-4.5
Real GNP growth	7.5	4.7	4.3	6.0	5.1

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

1/ Adjusted for M$ 1 billion write-off of commercial banks' foreign assets.
2/ Ratio of GNP (at current prices) to M3 (end of period).
3/ Ratio of M3 to reserve money (end of period).
4/ January.
5/ Seven-day rate (weekly average in December).
6/ Weighted average lending rate of commercial banks (end of period).
7/ Interest rate on one-year fixed deposits at commercial banks; end of period.
8/ February.
9/ Three-month LIBOR on U.S. dollar minus three-month interbank rate; period average (fourth quarter).
10/ January-March.
11/ Forward premium/discount (-) implicit in swap margin for three-month swap effected through foreign exchange brokers; period average (fourth quarter).
12/ Percentage change in consumer price index for Peninsular Malaysia.

Table 5. Malaysia: Balance of Payments and External Debt, 1981-85

(In billions of U.S. dollars)

	1981 1/	1982 1/	1983	1984	1985 2/
Balance of payments					
Current account	-2.4	-3.6	-3.2	-1.8	-2.4
Trade balance (f.o.b.)	-0.1	-0.7	0.7	2.7	2.1
Exports	(11.7)	(12.0)	(13.7)	(16.2)	(16.2)
Imports	(11.8)	(12.7)	(13.2)	(13.5)	(14.1)
Services and transfers (net) 3/	-2.3	-2.8	-3.7	-4.5	-4.5
Capital account (net)	2.6	3.6	4.0	2.5	3.0
Of which: Official long-term	(1.3)	(2.2)	(2.7)	(2.1)	(1.7)
Private long-term	(1.2)	(1.3)	(1.2)	(0.9)	(1.0)
SDR allocation	0.1	--	--	--	--
Errors and omissions	-0.7	-0.4	-0.8	-0.7	-0.6
Overall balance	-0.5	-0.4	--	--	--
Outstanding external debt 4/	8.5	12.2	16.6	17.8	20.0
Medium-and long-term debt	6.9	10.5	13.6	15.3	17.3
Public sector	(5.1)	(7.3)	(9.9)	(11.5)	(13.1)
Private sector	(1.8)	(3.2)	(3.7)	(3.8)	(4.2)
Short-term debt	1.6	1.7	3.0	2.5	2.7
Debt service	1.1	1.5	1.8	2.5	3.5
Amortization	0.5	0.7	0.7	1.0	1.8
Of which: Prepayments	(--)	(--)	(--)	(0.2)	(0.9)
Interest payments	0.6	0.8	1.1	1.5	1.7
Memorandum items:					
Gross official reserves 4/	4.4	4.1	4.1	4.0	3.9
(In months of imports)	(4.5)	(3.9)	(3.7)	(3.6)	(3.4)
Current account/GNP ratio 5/	-10.4	-14.4	-11.7	-5.8	-7.7
Outstanding debt/GNP ratio 4/ 5/	35.0	48.3	60.5	60.3	63.6
Debt service ratio 6/	8.0	10.2	10.9	13.1	18.1
Amortization	3.4	4.5	4.1	5.5	9.3
Of which: Prepayments	(--)	(--)	(--)	(0.8)	(4.6)
Interest payments	4.6	5.7	6.8	7.6	8.8

Source: Data provided by the Malaysian authorities.

1/ Four LNG tankers delivered in 1981 and one delivered in 1982 to the Malaysian National Shipping Company at a cost of about US$800 million are not included in imports and the capital account.

2/ Partly staff estimates.

3/ Includes payments of factor services.

4/ End of period.

5/ In percent.

6/ Ratio to gross current account receipts.

Table 6. Malaysia: Projections of Balance of Payments and External Debt, 1984-89

	1984	1985	1986	1987	1988	1989
	(In billions of U.S. dollars)					
Current account	-1.8	-2.4	-2.2	-2.4	-2.4	-2.4
Exports	16.2	16.2	18.1	20.2	22.5	25.2
Imports	-13.5	-14.1	-15.5	-17.4	-19.4	-21.7
Services (net) 1/	-4.5	-4.5	-4.8	-5.2	-5.5	-5.9
External debt 2/	17.8	20.0	22.3	25.4	28.6	31.8
Of which: Medium- and long-term 3/	(15.3)	(17.3)	(19.4)	(22.3)	(25.3)	(28.2)
Debt service	2.5	3.5	3.1	3.6	4.3	4.9
Amortization	1.0	1.8	1.3	1.5	2.1	2.6
Interest payments	1.5	1.7	1.8	2.1	2.2	2.3
	(In percent)					
Current account/GNP	-5.8	-7.7	-6.4	-6.2	-5.8	-5.2
External debt/GNP	60.3	63.6	64.7	66.2	68.2	68.9
Of which: Medium- and long-term 3/	(51.7)	(55.0)	(56.3)	(58.6)	(60.3)	(61.2)
External debt/gross current receipts	97.2	104.5	104.6	106.6	107.7	107.4
Of which: Medium- and long-term 3/	(83.4)	(90.4)	(91.1)	(93.5)	(95.2)	(95.4)
Debt service ratio 4/5/	13.1	18.1	14.7	15.1	16.3	16.4
Amortization	5.5	9.3	6.1	6.4	8.0	8.6
Interest payments	7.6	8.8	8.6	8.7	8.3	7.8
Major assumptions						
Real GNP growth (percent)	6.0	5.1	5.0	5.0	5.0	5.0
Increase in GNP deflator (percent)	5.1	1.5	4.5	4.8	5.0	5.0
Oil: Domestic production 6/	445	420	470	480	490	500
Export volume 6/	343	316	364	374	384	394
Price (US$ per barrel)	29.7	28.0	28.0	29.4	30.9	32.4
Domestic consumption of petroleum products 6/	185	195	208	221	235	250
Increase in export unit value (percent) 7/	1.8	-3.0	1.6	5.0	5.0	5.0
Increase in import unit value (percent) 7/	-2.9	--	3.5	5.0	5.0	5.0
Income elasticity of investment goods imports	...	1.35	1.25	1.15	1.10	1.00
International interest rates 8/	10.5	9.5	9.0	9.0	8.5	8.0
Gross official reserves 9/	4.0	3.9	4.0	4.6	5.3	6.2
Export volume growth (percent)	15.6	3.3	9.9	6.4	6.2	6.4
Import volume growth (percent)	5.0	4.4	6.5	6.6	6.5	6.3

Source: Information provided by the Malaysian authorities and staff projections.
1/ Includes transfers (net).
2/ At end of period.
3/ Original maturity of one year and over.
4/ Including interest payments on short-term debt.
5/ Ratio to gross current account receipts.
6/ Thousand barrels per day.
7/ In terms of U.S. dollars.
8/ LIBOR.
9/ In billions of U.S. dollars.

Malaysia: Selected Economic and Financial Indicators, 1981-85

Area:	127,581 square miles
Population (1984)/population growth:	15.2 million/2.3 percent (1979-84)
GNP (1984); per capita:	US$30.5 billion; US$2,010
Exchange rate: ringgit per US$:	2.4800 1/

(Annual percent changes, unless otherwise specified)

	1981	1982	1983	1984	1985 2/
National income and prices					
GNP at constant prices	7.5	4.7	4.3	6.0	5.1
Crude oil production	-6.6	17.5	26.5	16.8	-5.8
GNP deflator	1.0	4.0	4.2	5.1	1.4
Consumer prices (period average)	9.7	5.8	3.7	3.9	4.0-4.5
Total employment	3.7	2.6	2.8	3.1	...
Unemployment (percent of labor force)	5.5	5.5	6.1	6.6	...
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	-9.3	2.5	14.7	17.8	0.2
Imports, f.o.b.	12.6	8.0	4.0	1.9	4.4
Non-oil imports, f.o.b.	11.0	10.7	4.7	5.7	4.4
Export volume	-11.9	9.3	12.6	15.6	4.8
Import volume	6.1	9.0	6.8	5.0	5.5
Terms of trade (deterioration, -)	-3.0	-5.3	4.7	4.9	-3.0
Nominal effective exchange rate (depreciation, -)	3.6	3.4	3.1	2.8	...
Real effective exchange rate (depreciation, -)	4.0	5.1	2.7	1.6	...
Government budget					
Revenue					
Excluding grants	13.5	5.5	11.7	9.7	9.9
Including grants	13.5	5.5	11.7	9.7	9.9
Total expenditures 3/	41.8	9.8	-4.9	1.4	8.2
Operating expenditures	34.3	16.4	1.5	10.3	15.4
Development expenditures	67.9	-20.1	-18.2	-33.6	13.4
Money and credit					
Domestic credit	30.9	20.8	20.3	20.2	16.2
Government	114.2	44.4	-1.1	13.8	11.4
Private sector	24.6	17.7	23.7	21.0	16.7
Total liquidity (M3)	13.6	16.8	14.5	15.1	15.0
Velocity (GDP relative to M3)	1.44	1.32	1.27	1.23	1.14
Interest rate (annual rate, one-year time deposit)	11.0	10.0	9.0	10.8	...

Malaysia: Selected Economic and Financial Indicators, 1981-85 (Concluded)

	1981	1982	1983	1984	1985
			(In percent of GNP)		
Gross domestic investment	34.5	37.9	36.7	32.6	32.6
Gross national savings	24.1	23.5	25.0	26.8	24.9
General government deficit	16.8	16.5	10.9	7.9	8.0
Federal Government budget deficit	15.8	17.3	10.7	7.5	7.3
Domestic bank financing	2.2	2.9	-0.2	1.5	...
Foreign financing	6.3	8.4	7.1	4.1	...
Tax revenue	23.9	22.3	24.6	23.8	24.5
Federal government expenditure	44.7	45.6	39.5	35.9	36.5
External current account deficit	-10.4	-14.4	-11.7	-5.8	-7.7
External debt 4/ (Inclusive of use of Fund credit)	35.0	48.3	60.5	60.3	63.6
Debt service ratio 5/ 6/	8.0	10.2	10.9	13.1	18.1
Of which: Prepayments	(--)	(--)	(--)	(0.8)	(4.6)
Interest payments (in percent of exports of goods and non-factor services)	4.6	5.7	6.8	7.6	8.8
			(In billions of US$, unless otherwise specified)		
Exports, f.o.b.	11.7	12.0	13.7	16.2	16.2
Imports, f.o.b.	11.8	12.7	13.2	13.5	14.1
Oil imports	2.0	1.8	1.8	1.4	1.5
External current account	-2.4	-3.6	-3.2	-1.8	-2.4
Overall balance of payments	-0.5	-0.4	--	--	--
Gross official reserves (weeks of imports)	4.4 (19.5)	4.1 (16.6)	4.1 (16.0)	4.0 (15.5)	... ...
External debt outstanding	8.5	12.2	16.6	17.8	20.0
Of which: Short-term debt	(1.6)	(1.7)	(3.0)	(2.5)	(...)

1/ April 30, 1985.
2/ Based on official and staff estimates.
3/ Includes net lending and adjustment for accounts payable.
4/ Includes short-term debt of less than one year maturity and use of Fund credit.
5/ Expressed as a ratio to gross current account receipts.
6/ Includes interest payments on short-term debt.

Malaysia--Fund Relations
(As of May 31, 1985)

I. Membership status

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

A. Financial Relations

II. General Department

(a)	Quota:	SDR 550.6 million
(b)	Fund holdings of ringgit:	SDR 589.3 million (107.0 percent of quota)
(c)	Fund credit:	SDR 259.6 million (47.2 percent of quota)
	Compensatory financing facility:	SDR 80.7 million (14.7 percent of quota)
	Buffer stock financing facility:	SDR 117.3 million (21.3 percent of quota)
(d)	Reserve tranche position:	SDR 159.3 million
(e)	Operational budget:	An early repurchase of SDR 61.6 million during the period March-May 1985
(f)	Lending to the Fund:	None

III. Current stand-by or extended arrangement and special facilities

(a)	Current stand-by or extended arrangements:	None
(b)	Special facilities:	Compensatory financing facility: SDR 189.8 million (September 1981). Buffer stock financing facility: SDR 58.5 million (June 1982); SDR 67.8 million (March 1983).

IV. SDR Department

(a)	Net cumulative allocations:	SDR 139.05 million.
(b)	Holdings:	SDR 92.4 million (66.4 percent of net cumulative allocation).
(c)	Current Designation Plan:	SDR 15.6 million (March-May 1985).

Malaysia--Fund Relations (continued)

V. Administered accounts

(a) Trust Fund loans:	None
(b) SFF subsidy account:	None

VI. Overdue obligations to the Fund: None

VII. Use of Fund resources to date: Yes

B. Nonfinancial Relations

VIII. Exchange rate arrangement: The ringgit is pegged to an undisclosed composite of currencies of Malaysia's major trading partners, and the weighting reflects the importance of currencies used in settlement as well as trade shares. Margins of 2.25 percent are maintained, but occasionally and for relatively short periods, the rate has been allowed to exceed margins. The representative exchange rate of the ringgit under Rule 0-2 is the mid-point between the buying and selling rates for the U.S. dollar quoted at noon on the Kuala Lumpur foreign exchange market; the mid-point on May 31, 1985 was 2.5255 per US$1. Malaysia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Payments and transfers for current international transactions are free of restrictions except to Israel and South Africa. Capital transactions above certain limits require prior approval; approvals are freely given except for investments by Malaysian residents in Israel and South Africa.

Malaysia--Fund Relations (concluded)

IX.	Last Article IV consultation:	The Executive Board discussed the Staff Report on July 13, 1984. Staff discussions were held during April 6-20, 1984 (SM/84/137; SM/84/140).
X.	Technical assistance (from 1982 to date):	
	(a) CBD:	Study on interest rate policy (October 1984).
		An advisor for economic research and econometric modeling (from February 1985, initially for one year).
	(b) Fiscal:	Study on tax system (January-February 1982); study on fiscal reporting and cash management (May 1982).
	(c) Bureau of Statistics:	Statistical assistance on government finance (June-July 1983); the balance of payments (July 1984); financial statistics (November 1984); government finance (May-June, 1985).
	(d) Other:	None
XI.	Resident Representative/Advisor:	None

Malaysia: Relations with the IBRD

IBRD lending (as of March 31, 1985):

	(Millions of US$)	(Percent)
Total loans approved	1,606.0	
Repaid:	298.8	
Total commitments in 1984:	70.0	
Total disbursements in 1984:	63.1	
Total commitments (1979-84):		
Agricultural and rural development	341.3	46.8
Power	206.3	28.3
Education	78.6	10.8
Transportation	86.2	11.8
Urbanization	--	--
Sewage	--	--
Population	17.0	2.3
Total	729.4	100.0

Technical assistance: The IBRD provides technical assistance to Malaysia through its standard lending operations for projects. In addition, it is the executing agency for a number of studies related to industrial sector planning and funded by UNDP, and is currently assisting the Government with the macro-frame for the next five-year plan.

Recent economic and sector missions: Poverty Monitoring and Evaluation (May 1984); Institutional Design for External Debt Management (June and October 1984); Domestic Resource Mobilization (November 1984); Science and Technology Policy (October 1984); Export Credit and Insurance (March 1985).

Malaysia - Statistical Issues

1. Outstanding Statistical Issues

a. Monetary accounts

There are no substantial differences between IFS data and those used by the Asian Department. A technical assistance mission in monetary statistics was undertaken in November 1984. A number of the mission's recommendations including the development of an M3 concept and the inclusion of state government deposits in monetary aggregates have already been adopted and work is continuing in other areas. Changes resulting from the implementation of the mission's recommendations will be reflected in both IFS data and in data used in Staff Reports and in Fund reports on Recent Economic Developments.

b. Government finance

Data published in the 1984 Government Finance Statistics Yearbook (GFSY) are available through 1981. However, data for 1982 and 1983 have recently been received in response to the 1985 questionnaire. The data in GFSY cover the operations of the Central Government (budgetary Central Government and social security funds) and the 13 state governments. No data have been provided in respect of local governments or the extrabudgetary government agencies.

A technical assistance mission was undertaken in June/July 1983, focussing principally on the delineation of the public sector and its subsectors with a view to adopting a consistent classification of public entities in the various areas of economic statistics. Following the mission's recommendations, the authorities have made progress in identifying the major off-budget agencies and have initiated a systematic collection of data with a view to monitoring the performance of these agencies as well as compiling a consolidated account of the nonfinancial public sector.

A technical assistance mission in the area of public enterprise statistics visited Malaysia in May/June 1985. The purpose of the mission was to advise on the development of a financial data base around the broader concept of the public sector which would be the focus of economic planning and policy formulation in the context of the next five-year plan (1986-90).

c. External sector

(1) Balance of payments

A technical assistance mission took place in July 1984. The recommendations contained in the mission report and their implementation were discussed in detail with the authorities during the recent Article IV consultation mission. The authorities noted that they had not experienced any substantial difficulties in implementing the recommendations of the technical assistance mission, except for those relating to the external transactions of the oil and gas sector. The authorities also plan to set up a working group, comprising staff from Bank Negara and the Department of Statistics, to initiate the preparation of quarterly balance of payments estimates.

(2) External trade

Official indices of volume and unit value are currently compiled in terms of 1970 prices. During the recent Article IV consultation, the authorities expressed interest in receiving Fund technical advice on the rebasing of these indices to reflect 1980 trade weights, particularly in the context of the preparatory work that is being undertaken on the formulation of the next five-year economic plan (1986-90).

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Malaysia in the May 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank Negara (with the exception of balance of payments data which are reported by the Department of Statistics), which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in May 1985 IFS
Real sector	- National accounts	1983
	- Prices	January 1985
	- Production	November 1984
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	Q3 1984
	- Financing	Q3 1984
	- Debt	Q4 1984
Monetary accounts	- Monetary Authorities	January 1985
	- Deposit money banks	December 1984
	- Other financial institutions	September 1984 December 1984 (partial)
External sector	- Merchandise trade: Value	November 1984
	Prices	November 1984
	- Balance of payments	1983
	- International reserves	February 1985
	- Exchange rates	March 1985