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Minutes of Executive Board Meeting 85/111

10:00 a.m., July 24, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
	S. Kolb, Temporary
	G. Nguyen, Temporary
	A. H. Mustafa, Temporary
H. Fujino	
	B. Goos
	D. Hammann, Temporary
J. E. Ismael	Jaafar A.
R. K. Joyce	
	H. A. Arias
	K. A. Hansen, Temporary
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	A. Steinberg, Temporary
	A. V. Romuáldez
	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: D. Berk, Western Africa Regional Office; D. Dutt, East Asia and Pacific Regional Office. African Department: M. W. Bell, E. L. Bornemann, E. A. Calamitsis, K. G. Dublin, C. Enweze, D. E. Syvrud. Asian Department: A. Ariyoshi, I.-S. Kim, D. A. Scott. Exchange and Trade Relations Department: M. Guitián, Deputy Director; J. T. Boorman, S. Kanesa-Thasan, P. Stella. European Department: W. L. Hemphill. Fiscal Affairs Department: H. R. de Zoysa, C. Schiller. IMF Institute: U Tun Wai, Deputy Director. Legal Department: W. E. Holder, J. M. Ogoola. Treasurer's Department: M. F. Melhem. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, S. M. Hassan, J. Hospedales, J.-C. Obame, G. W. K. Pickering, T. Sirivedhin, E. M. Taha. Assistants to Executive Directors: W.-R. Bengs, M. B. Chatah, J. J. Dreizzen, C. Flamant, S. Geadah, G. D. Hodgson, L. Hubloue, O. Isleifsson, Z. b. Ismail, J. M. Jones, H. Kobayashi, M. Lundsager, D. J. Robinson, J. E. Rodríguez, M. Sarenac, B. D. White.

1. MALAYSIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Malaysia (SM/85/180, 6/26/85). They also had before them a report on recent economic developments in Malaysia (SM/85/196, 7/10/85).

Mr. Jaafar made the following statement:

It is my pleasure to inform Executive Directors that my Malaysian authorities have no difficulty with the staff report for the 1985 Article IV Consultation and they concur broadly with the staff's findings. In noting their appreciation for the excellent report, they observed that the consultation discussions in Kuala Lumpur had been frank and fruitful.

Fiscal adjustment

I draw the Executive Board's attention to a letter from my Malaysian authorities--circulated as the Secretary's Memorandum of October 6, 1983--regarding the fiscal adjustment measures that had then already been under way since mid-1982.

This letter was prepared following a comprehensive review by my authorities of the domestic and external outlook for 1983 and for the balance of the Fourth Malaysia Plan (1981-85). The need for adopting vigorous and comprehensive measures was accepted, and the following targets established:

	1982	1983	1984	1985
	(Percentages of GDP)			
Fiscal deficit	19.0	12.5	9.1	6.0
Current account deficit	12.9	9.5	5.0	4.8

The progress toward adjustment over the past three years can be assessed on the basis of the the 1985 Article IV consultation with Malaysia, which concluded in Kuala Lumpur on May 3, 1985. The magnitude of domestic and external adjustment achieved over the period has been impressive. In 1982, federal expenditure amounted to 46 percent of GNP, and the overall fiscal deficit was equal to 17 percent of GNP. The external imbalance in the current account reached a record 14 percent of GNP for the same year. My authorities recognized that those fiscal and external deficits would be difficult to sustain and introduced corrective measures in 1982, in the form of restraint on expenditure and some revenue measures, which have brought dramatic improvement on the fiscal side. Federal expenditure decreased sharply to 36 percent of GNP, and the overall fiscal deficit fell to 7.5 percent of GNP, by 1984. The burden of adjustment fell mainly on development expenditure, which declined by almost

35 percent (M$2 billion), following declines of 18 percent (M$1.3 billion) in 1983 and 20 percent (M$1.8 billion), in 1982. The external current account deficit narrowed to less than 6 percent of GNP in 1984, reflecting the intensified fiscal adjustment as well as the continued strengthening of external demand.

	1983	1984	1985
	(Percentage of GDP)		
Fiscal deficit 1/	10.7	7.5	7.3
Current account deficit 1/	11.7	5.8	7.7

Although further cuts in development expenditures have become increasingly difficult, in view of the substantial reductions already made in the past three years, my authorities nonetheless aim at sustaining fiscal restraint in the years ahead in the context of the Fifth Malaysia Plan, 1986-90. The latest reassessment of the federal budget for 1985 suggests a more favorable outturn than previously expected. Total expenditure is estimated to be at least M$1 billion smaller than earlier estimates, reflecting stringent control and monitoring of spending. Operating expenditure is also expected to be much smaller, because of lower interest payments on government debt, in spite of the recently announced public sector wage settlement estimated to cost M$389 million on an annual basis. Consequently, the overall fiscal deficit is currently projected to be limited to 7.1 percent of GNP.

Other adjustment measures

An area that drew wide attention, both in this Board last year and in Malaysia, was the nonfinancial public enterprises sector, comprised of off-budget agencies (OBAs) in Kuala Lumpur, which were not brought within the overall control of the budget at the time of the 1984 consultation discussion. That was a matter of legitimate concern, as the operations of the OBAs had affected the balance of payments and external debt positions significantly. For example, despite the obvious improvement in the federal finances, its contractionary impact on the current account in 1973 was partly offset by continuing expansion in OBA expenditures.

Since last year, however, significant progress has been made in monitoring and controlling the activities of the OBAs. A high-level interagency committee is now in place to assume that function. Twenty-six OBAs previously classified in the private sector have been classified in the public sector in the national account for analytical and policy purposes and been made

1/ SM/85/180.

subject to immediate monitoring. Comprehensive data have begun to be collected on these enterprises, partly through Fund technical assistance.

Th 1983-84 experiences highlighted other weaknesses in the balance of payments, which continue to receive close attention from the Malaysian authorities. Despite the marked strengthening of the trade account, the current account deficit did not fare as well by comparison, mainly because of the rising invisible deficit, which doubled in five years to US$4.5 billion in 1984. Four major areas were identified as contributing to these deficits and given high priority in the Fifth Malaysia Development Plan. These are tourism, shipping and insurance, payments for services from abroad (mostly contract and professional charges), and investment income payments.

An important step has already been taken to promote foreign investment, which is essential for expansion in the export-oriented industrial base. At a pre-1986 budget dialogue on July 8 with the private sector, the Malaysian authorities announced that foreign entrepreneurs could be allowed to own up to 80 percent of the equity in companies that export 80 percent or more of total output. Depending on the merits of the case, the authorities could approve 100 percent foreign ownership. This latest measure represents a significant departure from the previous policy stance, where foreign-equity ownership was limited to only 30 percent. My authorities believe that their liberal foreign investment policy will help to stimulate more nondebt-creating longer-term capital inflows into the country.

Aside from these weaknesses in the external position, it should also be stressed that the strength in the balance of payments continues to lie with merchandise exports, mainly from primary commodities--including oil--and increasingly manufacturing. A comprehensive program has been drawn up recently with the assistance of experts from the World Bank to promote expansions on the capacity and capability of manufacturers and exporters to compete effectively overseas.

For 1985, on account of a better than expected outturn on the merchandise trade account, the deficit on current account has been revised significantly by US$0.2 billion, consequently reducing the projected 1985 deficit from 7.7 percent of GNP to 7.0 percent.

External debt

By international standards, Malaysia's external debt is not excessive. Nevertheless, in retrospect external indebtedness rose rapidly over the last five or six years, and the debt service burden almost doubled to 13 percent of current account receipts between 1979 and 1984. The debt burden would depend, of course, on both external developments--particularly in interest rates--and the stance of policies at home. While the external debt burden still remains relatively moderate, my authorities firmly believe that in order to prevent a further deterioration in the external account, debt and debt servicing must be contained at prudent levels, consistent with stability. Consequently, parallel with the restraint on public sector expenditure, efforts have been strengthened to minimize resort to external borrowings. At the same time, my authorities have taken steps to improve the debt maturity profile in the medium term. For example, capitalizing on very favorable market conditions in 1985, the authorities raised two floating rate issues, equivalent to US$1.2 billion with a 15-year maturity, to pay off higher-interest loans taken out in the early 1980s. This should serve to clarify the sudden jump to 18 percent in the debt service ratio for 1985 before the expected sharp fall thereafter.

My authorities have expressed their intention to continue to refinance existing debt whenever opportunities arise to reduce the interest burden and lengthen the maturity profile.

Monetary policy

The stance of monetary policy in 1984 was neutral for the first half but gradually became more restrictive during the second half. Executive Directors might recall that, in the previous Board discussion in 1984, they concurred with the staff appraisal that a more restrictive monetary stance was appropriate to forestall undue expansion in private sector liquidity. As it turned out, the tightening was more pronounced than warranted during October 1984, when speculation on the Malaysian ringgit emerged on a fairly large scale. The stance of policy since then has been in line with the need to promote economic activity and growth. The authorities consider a less restrictive stance appropriate, in view of continuing strong fiscal restraint and sluggish private domestic demand, especially private investment in manufacturing.

The threat on inflation and inflationary expectation is forecast to be minimal at this time. Inflation last year remained low at 4 percent. According to the latest data, the CPI declined by 0.1 percent for the first four months of 1985. Consequently, the overall inflation rate is now expected to be of the order of 2-3 percent, instead of the 4-4.5 percent forecast earlier.

During the year, there have been significant structural changes in the demand for liquidity, as nonbank financial institutions began to offer more competitive interest rates for deposits. The shift toward higher-interest deposits has changed significantly the patterns of liquidity within the banking system; narrow money (M-1) declined by nearly 1 percent in 1984, and broad money rose by 15 percent.

This change in the pattern of liquidity is expected to complicate monetary management. In addressing this problem, the authorities have been in close touch with the Fund, through technical assistance programs, to revise the compilation and consolidation of banking statistics and the formulation of monetary aggregates.

Conclusion

In spite of the impressive gains made over the past three years, the Malaysian authorities recognize that there continue to be some areas of concern, particularly the external sector, where the deficits on the current account are projected to be larger than desired in the medium term. Some important measures have already been taken to improve the imbalances but should be expected to take more time to bear results. Policies to continue moderation in the growth of public expenditure and rationalizations of taxes and administration, among others, should prove helpful in narrowing the gap between public sector investment and savings. More degrees of freedom to maneuver should also come with economic growth globally and improvement in the international economic environment, such as on trade liberalization and significant progress on international interest rates. In addition, the external situation remains of concern to the authorities on account of uncertainties in the international oil market.

Mr. Fujino said that the Malaysian authorities deserved commendation for their notable achievements since mid-1982 in implementing adjustment policies. The magnitude of domestic and external adjustment was impressive: both fiscal and external deficits had been cut by more than half from their record highs in 1982; at the same time, a rapid growth rate had been maintained, despite a substantial cut in public investment spending. Although economic growth in 1984 had been due mainly to buoyant exports, a steady expansion in domestic private demand had also played an important role. In addition to the rise in private consumption, private investment, excluding the oil and gas sectors, had increased by 9 percent, although private investment as a whole had declined for two consecutive years.

Because he believed that the private sector should be the engine of growth over the medium term in the Malaysian economy, he could generally endorse the recent restraint in public investment and the movement toward privatization of public sector enterprises, Mr. Fujino continued. While expenditure by the Federal Government had been sharply reduced, expenditure by public enterprises had tripled since 1980; the large deficits of those enterprises--exceeding 6 percent of GNP--had necessitated substantial amounts of fiscal lending and external borrowing. One of the important roles of public investment was to develop social infrastructure, so it was understandable that some projects might not yield a high rate of return. However, there was evident at present rather low profitability across the board in public investment, with the notable exception of Petronas. A clearer distinction between projects that required financial support and those that were self-financing might usefully have been included in a more detailed sectoral analysis of public investments in the staff paper. As noted by the staff, the World Bank could play an important role in examining investment prorities; in that respect, he welcomed the steps toward strengthening the monitoring of off-budget agencies in Malaysia through a high-level interagency committee.

In moving toward privatization of public sector enterprises, the authorities must strike a balance between encouraging the vitality of the private sector and maintaining necessary public services for the economy, Mr. Fujino remarked. The telecommunications industry, the airlines, and container terminals had been cited by the staff as areas of priority in privatization in the first stage; he would be interested in hearing what criteria would be used in selecting other areas for privatization.

Further efforts to strengthen domestic resource mobilization, particularly those aimed at raising the private savings ratio, seemed necessary in order to maintain high investment without relying too much on foreign resources, Mr. Fujino commented. He had noted with concern the fluctuations in gross national savings and the drop of about 2 percent from 1984 to 1985, which according to the staff had been due partly to the worsening terms of trade. It was understandable that corporate savings had been affected by those developments, and it was thus important to have a steady increase in household savings. In that regard, there had been a rapid growth of quasi-monetary deposits associated with a higher money multiplier over the period when real interest rates had steadily increased. While that growth might be due partly to shifts in money demand away from a noninterest-bearing component to an interest-bearing component, the recent rapid increase in quasi-money deposits might also suggest that private savings were sensitive to changes in real interest rates. If so, interest rate policy could play a useful role in mobilizing domestic resources.

Incentives to encourage private initiatives for investment were important, Mr. Fujino considered. The emphasis on further liberalization of foreign direct investment was a welcome development in that regard. Mr. Jaafar had explained the steps taken to allow large foreign participation, especially in areas where 80 percent or more of a product went toward exports. He presumed that those steps would have a beneficial impact on private investment activities as well as export promotion.

Endorsing the thrust of the staff appraisal, Mr. Fujino said that it was encouraging that the fiscal adjustment in 1984 had turned out to be much stronger than originally planned, reflecting restraint in both development and operating expenditures. Although he welcomed the authorities' efforts to reduce the fiscal deficits from 7.3 percent of GNP to 7.1 percent of GNP, he was concerned that the size of the deficit would place undue pressure on the external position and make it difficult for the monetary authorities to provide sufficient credits to the private sector without undermining price stability. He would welcome a clearer presentation by the authorities of a medium-term strategy for reducing the fiscal deficit during the period of the Fifth Malaysia Plan.

It was understandable that the scope for further expenditure restraint was severely limited by the burden of high interest payments, exceeding 15 percent of total expenditure in Malaysia, Mr. Fujino remarked. However, a closer look at the budget suggested that there might be some room for further restraint over the medium term. For example, wages and salary payments had increased by 10 percent in 1984 in order to meet the so-called normal annual increments, including the 3 percent increase in employment, which seemed to be somewhat on the high side by comparison with a rate of inflation of less than 4 percent. He appreciated the authorities' clear commitment toward sustaining fiscal restraint during the remainder of the decade.

On the revenue side, Mr. Fujino observed, it might not be feasible to increase the overall tax burden substantially, especially in view of the authorities' intention to improve incentives for private investment. However, it should be possible to raise tax revenues by shifting the composition away from inelastic export duties to more elastic taxes on domestic transactions, income, and profits.

Malaysia's balance of payments position remained vulnerable, with prospects for exports clouded by the recent weakness in external demand for oil and electronic goods and also by uncertainties regarding prices of primary commodities, Mr. Fujino noted. Although Malaysia was experiencing no major problems in debt servicing capacity or in external credit standing at present, medium-term projections showed that the current account deficit would remain at more than 5 percent of GNP in the later half of the 1980s. Coupled with the downside risks in export performance, those projections gave cause for some concern about the viability of the external position. Persistent efforts to promote export-oriented industries and to improve the profitability of public investment would be important. In sum, while considerable progress had been made toward necessary adjustment in Malaysia, further steps would be desirable based on clear-cut, medium-term strategies.

Mr. Kabbaj observed that Malaysia's economic and financial performance in 1984 had been largely satisfactory, as the authorities had intensified the adjustment policies initiated in 1983 and the economy's terms of trade had recorded a further significant improvement. The progress achieved since 1983 was in marked contrast to the financial deterioration of the previous two years, which had been related to a great extent to the prolonged international recession but had also reflected a strong expansion in the public sector. Expansionary financial policies had enabled Malaysia to endure the adverse impact of the recession and to achieve relatively high rates of real growth; unfortunately, they had also resulted in large and unsustainable deficits in the public sector finances and the current account of the balance of payments and, more important, in a rapid accumulation of external debt.

The control gained in 1983 and 1984 over Malaysia's fiscal and external imbalances was impressive, Mr. Kabbaj continued. The public sector deficit in relation to GNP had been trimmed by nearly 10 percentage points over the period, while the current account deficit had been reduced to 5.8 percent of GNP from 14.4 percent in 1982. Malaysia had also restored strong economic growth, with real GDP having averaged 6.5 percent in 1983 and 1984 despite substantial cutbacks in development expenditures implemented under the adjustment program, the impact of which had largely been offset by external demand. Moreover, domestic inflation had been kept below 4 percent, reflecting to some extent declining import prices and possibly an appreciation of the exchange rate.

Although the recent performance of the Malaysian economy was encouraging, the prospects for 1985 and the medium term did not signal a significant easing in domestic and external imbalances, Mr. Kabbaj remarked. As growth in external demand slowed, and despite continued fiscal and monetary restraint, the remainder of 1985 was likely to be marked by lower real economic growth, a continued high public sector deficit in terms of GNP, and a widening of the external current account deficit. Those developments would represent a reversal of the progress achieved in 1983 and 1984 and would highlight the urgent need to deal with Malaysia's rising external debt. In that context, he broadly shared the staff's analysis and appraisal of Malaysia's situation and prospects.

While the authorities seemed to be aware of the direct link between the public sector deficit and Malaysia's external balance, they were projecting an increase in the budgetary deficit for 1985, as a result of higher interest payments on public debt, earlier rephasing of development expenditures, and lower than expected growth in oil revenues, Mr. Kabbaj noted. The burden of adjustment over the past two years had fallen mainly on development expenditures; the same pattern would continue in 1985, as total development expenditures were expected to show a further decline. Moreover, although there had been no general salary increase for civil servants since 1980-81, pressures on operating expenditures remained strong.

Fiscal difficulties were compounded by the authorities' reluctance to increase non-oil revenues, Mr. Kabbaj commented. Tax rates in Malaysia were already higher than in neighboring countries, and the authorities wanted to maintain their policy of improving incentives for private investment to compensate for the more restrained role of the public sector in investment and production. However, those considerations should not prevent the authorities from seeking a more appropriate balance between the relative contribution of revenues and expenditures to the goal of budgetary balance in the face of a recognized need for stronger fiscal adjustment, especially since the more sluggish external demand might not offset, as it had in the past, the impact of reduced development expenditures on Malaysia's real economic growth.

The authorities' objective of maintaining price stability in the petroleum sector, ensuring a cautious management of oil reserves, and encouraging resource conservation through, inter alia, the elimination of all subsidies on petroleum products and the orientation of domestic consumption toward natural gas was welcome, Mr. Kabbaj remarked. Unlike most oil exporting countries, Malaysia had been able to increase production by nearly 50 percent over the past two years. Moreover, although a moderate decline would be recorded in 1985, oil production was expected to increase to near maximum capacity by 1989.

The authorities' efforts to refinance existing debt to alleviate some of the amortization burden expected in 1988-90 were welcome, as was the restoration of the exchange rate to the level having prevailed in 1983, Mr. Kabbaj said. However, the external debt problem deserved a greater effort from the authorities than they had put forth in recent years, despite Malaysia's relatively low external debt service. Overall debt and interest payments had been increasing rapidly in line with the external current account deficit, which was expected to widen further to 7.7 percent of GNP in 1985 and stay at about 5 percent of GNP throughout the decade, assuming that fiscal and external adjustment efforts were maintained over the period. Moreover, the steady increase in oil production and exports expected in the medium-term projections might look optimistic, considering the uncertain prospects of the world oil market. Those projections and the need to maintain a level of international reserves commensurate with the importance of trade in Malaysia and the general openness of the economy clearly suggested that more aggressive adjustment efforts might be required than had been assumed in the staff projections.

Mr. Steinberg noted that economic developments in Malaysia in 1984 had been positive, with GNP growth at 6 percent--up from the previous two years--inflation at below 4 percent, and the current account deficit reduced to US$1.8 billion. Those achievements had been partly due to exogenous factors, such as the recovery in external demand, and partly to the adjustment efforts undertaken by the authorities, particularly in the public sector, through a further reduction in the Federal Government's budget defict and lower than planned investment expenditure by the nonfinancial public enterprises.

Unfortunately, preliminary data for 1985 indicated a gathering of clouds on the horizon, Mr. Steinberg continued. Unchanged exports and higher imports would increase the current account deficit and lead to a sharp increase of 12 percent in the external debt to US$20 billion, with the debt service ratio rising to 18 percent. For the period beyond 1985, under the base-case scenario, the balance of payments was projected to remain under pressure. The staff, aware that its assumptions on oil prices were already out of line, had prepared an alternative scenario under which the current account deficit might widen to nearly 8 percent of GNP and the external debt could reach US$34 billion. The possibility that such scenario might be realized should encourage the authorities to adopt a more stringent adjustment program before the cost of adjustment grew very large.

The staff had rightly attributed some of Malaysia's economic difficulties to the domestic resource gap, Mr. Steinberg observed. Over the past three years, gross domestic investment had been on the decline; however, at 33 percent of GNP, it remained relatively high for the region and was about 5 percentage points above domestic savings. The additional resources needed were being imported and financed by increasing Malaysia's external debt. The authorities could obviously narrow the gap either by increasing domestic savings or by lowering investment, two elements predominantly connected to public sector activities. In that regard, the authorities deserved commendation for their achievements in restraining the Federal Government's operations and reducing the fiscal deficit, tightening control over the nonfinancial public enterprises and scaling down their investment expenditures. At the same time, the staff's call for continued and intensified efforts in those areas should receive the full support of the Board, especially as public sector consumption seemed to be growing at 4 percent in real terms in 1985, a development that would likely widen the resource gap. He was pleased to note from Mr. Jaafar's statement that the authorities, also concerned with the size of the expenditures and deficits of the nonfinancial public enterprises, had made significant progress in monitoring and controlling the activities of those enterprises, resulting inter alia in better than expected improvements in the current account deficit and the rate of inflation. The authorities had argued rightly that gradual action to reduce fiscal imbalances would over time improve the balance of payments position; however, he tended to agree with the staff that such an approach might take more time than the authorities could afford.

The function of the Fund in an Article IV consultation was to evaluate the economic situation of a country and make recommendations on the stabilization process, Mr. Steinberg considered. It was up to the authorities to choose from among those recommendations which they would adopt; it was to be hoped that they would choose wisely. Of course, some comfort could be taken from the fact that the authorities had followed the advice given by the staff in 1984 for a more active use of exchange rate policy, as evident from the change in the trend that had taken place from October 1984 onward. Depreciation of the ringgit could help to restore export competitiveness--particularly in manufactured goods, which represented nearly one third of total exports--provided that the gains were not eroded by too rapid a wage increase. Wages were an essential variable in the assessment of an economy's prospects, and a more accurate picture of wage movements could serve the authorities well. The same applied to data on public sector activities, particularly those of public sector enterprises. Improvements in data collection were needed; the several recent Fund technical missions on statistical matters had been helpful. In sum, it appeared that the perceptions by the authorities and the staff of the economic situation of Malaysia were similar, and there was general agreement on the corrective measures needed, although each side held different views on the precise recipe for their implementation.

Mr. Joyce remarked that since the early 1980s the Malaysian authorities had faced an unsettled and difficult balance of payments situation, which had forced them to review their overall development strategy. They had also been obliged to carry through a comprehensive realignment of fiscal policies, scale back public investment sector outlays, and exercise a greater degree of monetary restraint, all of which had produced positive results in 1983/84. While a recovery of external demand and a continued expansion in the energy sector had certainly contributed to the strong improvement in the balance of payments in 1984, he suspected that fiscal adjustment had been at least as important as those more exogenous factors. Moreover, the adjustment process in 1983/84 had been accompanied by increases in the overall growth rate and in the rate of national savings, both laudable achievements in the circumstances. The authorities deserved commendation for reducing operating expenditures--and thus cutting the overall fiscal deficit by some US$2 billion more than initially projected--and for exercising greater control over public sector investment and monetary and credit policy. Also appropriate in the circumstances had been the measures taken to mobilize and promote foreign private investment.

Against the background of the progress made, he was concerned about the authorities' announced plans for 1985, Mr. Joyce continued. The current account was expected to weaken markedly during the year; while he had been reassured somewhat by Mr. Jaafar's indication that the current account deficit for 1985 was expected to increase only to 7 percent of GDP because of stronger export growth, even that increase from the 1983/84 figure was a matter of concern. Despite the sizable reduction in the current account deficit that had been achieved in 1983/84, Malaysia's external debt had risen by 50 percent over the past two years to nearly US$18 billion. The debt service ratio had also increased and was expected to reach 18 percent in 1985 and remain at or above 15 percent for the rest of the decade. While Malaysia's debt burden was not excessive by international standards, it was approaching the upper end of the manageable range rather quickly, and it might not be prudent to permit the current account deficit to rise even to the forecast level of 7 percent of GDP.

The authorities had already taken or were planning to take important measures to restrain government expenditures further in 1985, Mr. Joyce noted. The hiring freeze in the public sector and the decision not to grant a general salary increase to civil servants were important; the commitment to reducing the fiscal deficit over the medium term was commendable. Nonetheless, it seemed that the current levels of budgetary deficit-running at about 7.5 percent of GDP--were higher than the economy could sustain over the longer term. With projected growth rates for the economy in 1985 in excess of 5 percent, there might be some room for withdrawal of fiscal stimulus and a further tightening of demand. He encouraged the authorities not only to limit their current expenditures further and to re-evaluate the public investment program but also to intensify their efforts to broaden and modernize the tax base. It was important for them to concentrate on the quality rather than the quantity of investment so that the Government and people could gain a better financial return.

Supporting the staff's recommendations on monetary policy, Mr. Joyce remarked that the less favorable outlook for the balance of payments should convince the authorities of the need to restrain credit and monitor credit developments carefully. Concern about the concentration of lending within one or two sectors of the economy--particularly in real estate and property development--was well placed.

He would welcome further elaboration on the conduct of exchange rate policy in Malaysia, Mr. Joyce said. In particular, he wondered whether, in the view of the authorities, the pegging arrangements had permitted a sufficient degree of flexibility. Given the degree of adjustment that had already occurred elsewhere in the economy, it might be that the projected upward movement of the current account deficit in 1985 carried an important message about exchange rate policy. Malaysia had a surplus on the trade account, but the question of the adequacy of the current exchange arrangements at least bore examination. In conclusion, he hoped that in the future the authorities would exercise the same good judgment in policy choices that they had exercised over the past two years, in order to avoid losing ground already gained.

Mr. Hammann observed that Malaysia had made progress in 1984 in reducing its external and internal imbalances while maintaining a remarkable rate of growth. Depite rising interest payments, the current account deficit had been cut nearly in half, the general government deficit had been reduced by one third, and inflation had remained within comfortable limits. That generally positive outcome had been aided by strengthened external demand and an ongoing fiscal adjustment; however, prospects for 1985 and the medium term gave evidence that the momentum of adjustment might be slackening. An increasing resource gap that was expected to remain high after 1985 would translate into growing external indebtedness. Like others, he had noted that the disquieting outlook was sensitive to international interest rates, which, notwithstanding the external constraints, suggested a continued remarkable real rate of growth. Nevertheless, there was a clear need to contain the resource gap by fostering domestic savings and further strengthening financial policies. Measures to improve the structural efficiency of the economy deserved particular emphasis as well; in that latter respect, the recent steps to promote foreign direct investment were welcome.

The critical areas of concern in the Malaysian economy continued to be fiscal policy, the overall size of the public sector, and the performance of public sector enterprises, Mr. Hammann continued. It appeared that the behavior of domestic savings was strongly influenced by the amount and structure of public revenue and expenditures, and the staff had noted that there was considerable scope for broadening the tax base--making it less dependent on exports--and for improving the administrative structure for tax collections.

The scope for streamlining public enterprises also seemed quite large, Mr. Hammann remarked. It was regrettable that, while the public enterprise sector used up a large part of public investment, only a few enterprises turned out to be profitable. The authorities would be well advised to tackle the problem with determination before it became a major hazard for the overall conduct of fiscal policy. A comprehensive approach aimed at dealing with the problem should also include the liquidation or privatization of public sector enterprises. In a recent speech delivered at an international monetary conference in Hong Kong, the Prime Minister of Malaysia had observed that "perhaps the most important element in their South Asian countries' success has been the adoption of a free-enterprise system and the successful development of a dynamic and aggressive private sector." In that context, he welcomed Mr. Jaafar's indication that the so-called off-budget agencies would in future come under tighter control.

He agreed with the staff that the Malaysian authorities should carefully monitor credit and liquidity aggregates in the light of external developments, Mr. Hammann commented. Given the changing structure of financial intermediation and the need to improve the rules affecting banking supervision, the Bank Negara Malaysia was faced with a difficult task. In the framework of an improved regulatory setting, it seemed appropriate that the conduct of monetary policy should be guided by a market-oriented approach to the determination of interest rates and by a high degree of continuity in the implementation of monetary policy. It was to be hoped that those two principles would be upheld in future and that the authorities would not unduly relax the stance of monetary policy.

On the external side, Mr. Hammann said that he was happy to note that the authorities had strengthened their commitment toward a more outward-oriented strategy. Particularly commendable were the recent steps to allow foreign equity ownership in export-oriented industries. If that new policy were implemented quickly and efficiently, it should contribute toward more foreign direct investment. Finally, after several years of continued real appreciation of the ringgit, the authorities had recently adopted an exchange rate policy that was more in line with its external requirements. He hoped that they would continue to gear exchange rate policy to strengthening and diversifying exports.

Mr. Mustafa observed that Malaysia had enjoyed a long period of remarkable economic growth and financial stability before the international recession of the early 1980s, when certain weaknesses in the economy had been uncovered. The countercyclical policies of fiscal expansion and an accommodating monetary policy adopted to sustain economic growth had proved inappropriate and had given rise to relatively large financial imbalances. Still, economic developments during 1983 and 1984 had been largely favorable, as a result of both the recovery in external demand for Malaysian exports and the adjustment policies initiated by the authorities in mid-1982. Real GDP growth had averaged more than 6 percent, domestic inflation had moderated to less than 4 percent, and both the external current account deficit and the fiscal deficit had narrowed substantially in terms of GNP. Notwithstanding the substantial progress achieved thus far, further adjustment was required to address the remaining areas of concern, particularly the external imbalances.

The adjustment already undertaken in Malaysia had focused on reducing the fiscal deficit and on tightening control over the investment expenditures of the nonfinancial public enterprises, Mr. Mustafa continued. The authorities' success in reducing the budget deficit in terms of GNP had been impressive, although progress had been achieved mainly through expenditure restraint, with most of the burden falling on development expenditures. The fiscal outlook for 1985 reflected a continuation of such adjustment, which could entail lower growth over the medium term in the absence of offsetting increases in private investment. The improvement in control over the operations of the nonfinancial public enterprises had been significant, and efforts toward further improvement were continuing; it would be advisable to expedite the process, particularly in view of the adverse impact that the nonfinancial public enterprises had on the budget and the balance of payments and in view of the reported modest return to the Government from its previous investments in those enterprises.

Monetary policy during 1983-84 had been generally satisfactory, Mr. Mustafa remarked. The growth of reserve money had slowed, although credit demand had remained strong and total liquidity had expanded at a higher rate than nominal GNP growth. The strong demand for credit had continued to be associated with real estate and construction activities. Interest rates had been permitted to rise but had undergone volatile fluctuations during 1984, perhaps reflecting changes in the authorities' credit policy stance and speculation against the ringgit. The significant efforts of the authorities to stabilize the money market and rationalize credit allocation were worth noting, but an intensification of those efforts might be needed, especially in view of the change in the pattern of liquidity, which was expected to complicate monetary management in Malaysia.

A flexible interest rate policy could play an important role in resource allocation and mobilization, Mr. Mustafa noted. At the same time, excessive or volatile fluctuations in the interest rate entailed certain costs. Such fluctuations had occurred in Malaysia in 1984, and he would welcome staff comment on whether they could have been prevented or contained. More generally, he would appreciate comment on the advisability of fully flexible interest rates in relatively small and open developing economies and whether, in some cases, it might not be preferable to adopt adjustable interest rate ceilings that preserved adequate flexibility but helped to avoid excessive and costly fluctuations.

Malaysia's balance of payments had reflected a substantial improvement over the 1983-84 period, although the projected medium-term outlook remained a source of concern for the authorities, Mr. Mustafa commented.

The current account deficit had narrowed to below 6 percent of GNP in 1984 as a result of the recovery in external demand and the strong fiscal adjustment; it was expected to widen in 1985 to 8 percent of GNP. As the external current account deficits had been financed mainly through borrowing, external debt and debt service had increased rapidly during 1983 and 1984. While external debt service remained relatively moderate--13 percent of gross current account receipts in 1984--an early containment of its rising trend appeared advisable in view of the expected continued weakness in the balance of payments in the period ahead. More generally, the medium-term scenario prepared by the staff pointed to the need to continue the pursuit of firm adjustment policies and the promotion of private investment activity to achieve a viable external payments position and bring about a more effective use of the economy's strong resource base.

Mr. Templeman remarked that, over the past 12 months, the Malaysian authorities had continued their good record of growth and price stability while making substantial progress in reducing the economy's two principal economic imbalances. The ratio of the general government deficit to GNP had fallen by 3 percentage points, from 10.9 percent to 7.9 percent, while the ratio of the current account deficit to GNP had fallen by nearly 6 percentage points, from 11.7 percent in 1983 to 5.8 percent in 1984. Nonetheless, both ratios remained high by international standards, and, while the ratios in 1985 were currently expected to be somewhat lower than had been projected in the staff report--at 7.1 percent and 7.0 percent--they were still higher than would seem desirable over the medium term, especially in light of economic uncertainties, such as the price of oil, which could significantly affect the deficits.

Prospects for growth and inflation in Malaysia in 1985 were quite favorable, Mr. Templeman continued. Average real growth rates of GNP of more than 4.5 percent in each of the past four years and a growth rate of 5 percent expected in 1985 were respectable figures. Still, the composition of demand suggested caution, with expected real GNP growth in 1985 partly dependent on an 8 percent growth in public consumption and a decline in foreign demand from nearly 14 percent in real terms in 1984 to less than 4 percent in 1985. Moreover, the projected 5 percent GNP growth rate depended on a significant recovery in private investment, from small negative figures in the two previous years to nearly 6 percent in 1985; public investment would also experience a turnaround. On the inflation front, he was pleased to note that the latest expectation was for a growth in the consumer price index in 1985 of only 2-3 percent, rather than the 4-4.5 percent increase projected in the staff report.

The authorities had made impressive progress in reducing the large fiscal deficits that had typified the period 1981-83, Mr. Templeman commented. Particularly striking had been the decline in the ratio of federal expenditure to GNP from about 45 percent in 1981 and 1982 to just over 35 percent in 1984. Of course, the largest share of the decline had been in development expenditures, and, normally, a drop in that component of public expenditures might raise questions. However, in Malaysia, the high level of development expenditures in earlier years and serious questions about the economic viability over the medium term of some investments provided justification for a certain decline in the development expenditure ratio. In that connection, he would appreciate hearing from the staff or Mr. Jaafar any estimate of the extent to which some of Malaysia's past investments were proving to be uneconomic and what their eventual cost to the budget might be. He endorsed the staff's call for continued monitoring of public expenditures--including development expenditures--by both the Federal Government and the public sector enterprises, especially since development expenditures were expected to grow by more than 13 percent in 1985. Particularly welcome were the cuts in subsidies to domestic petroleum-product consumption. On the revenue side, the authorities had properly cut the high marginal rates for private and corporate income taxes and had shifted away from export taxes on primary commodities. Still, there appeared to be some room for modernizing the sales tax and improving tax administration. In general, while progress had been made in reducing fiscal deficits, little additional improvement was expected in 1985, which would see a deficit ratio at a still high 7 percent of GNP, assuming that uncertainties in the oil markets did not create additional difficulties. In the circumstances, it was essential for the Malaysian authorities to persevere in their fiscal adjustment efforts in all components of the public sector.

Despite the reductions in the current account deficit in 1984 in both absolute and relative terms, the ratio of the deficit to GNP remained high and was in fact expected to rise somewhat during 1985, Mr. Templeman remarked. Moreover, over the medium term, it was expected to remain in the range of 5-6.5 percent of GNP, which would result in a continued increase in the ratio of foreign debt to GNP, from 60 percent to 69 percent between 1984 and 1989, as well as an increase in the debt service ratio from 13 percent to 16.5 percent. The debt/GNP ratio, in particular, was high by international standards; while the debt service ratio was expected to remain moderately low, the outcome could be perceptibly worse under less favorable circumstances, such as lower oil prices. Recent efforts to refinance part of the outstanding debt on more favorable terms, taking advantage of Malaysia's continued good image in international credit markets, were welcome. However, it appeared that current account deficits would continue to be financed mainly through foreign borrowing. He wondered about the extent to which the recent liberalization in the regulation of foreign investment might play a more important role in providing financing from abroad and in contributing managerial, marketing, and technical expertise. In that connection, he welcomed the recent foreign investment measures, although he noted that one element of the new regulations consisted of an undesirable export requirement.

During 1984, his chair had expressed some concern about the adequacy of exchange rate policy in Malaysia, Mr. Templeman recalled. Recently, the authorities had been following a more market-oriented policy, and the ringgit had depreciated in real effective terms against the Singapore dollar and the U.S. dollar to a rate that had prevailed during the latter part of 1983. However, the 1983 rate had been the product of substantial real effective appreciation during the 1981-82 period; hence, he agreed with the staff that exchange rate policy might be used more actively in support of other elements of the adjustment effort in Malaysia.

The fundamental changes occurring in the Malaysian financial system, the staff's endorsement of the shift in focus from narrowly defined monetary targets to broader ones, and the potential impact of those changes on broader macroeconomic objectives, all suggested that the authorities should monitor monetary developments closely, Mr. Templeman said.

Finally, Mr. Templeman observed, the Fifth Malaysia Plan would be directed toward alleviating the following problems: a significant increase in the size of the public sector since 1979, a slackening of private investment, the increasing strain on the balance of payments and the increase in external debt, the decline in agricultural productivity, and the narrow production base of manufacturing. The authorities had stated that the primary objectives of the Plan were further to consolidate fiscal adjustment, restructure public sector investment, and reduce the external current account deficit. Toward those ends, the authorities would be implementing policies to improve the investment climate and encourage more dynamic expansion of the private sector. They should be commended for their overall strategy--including their privatization policy--which should be sustained or expanded.

Mr. Nimatallah noted that the Malaysian economy had performed well during 1982-84, the authorities having made good progress in reducing domestic and external imbalances. Real growth had increased, inflation and the fiscal deficit had diminished, and the external current account deficit had narrowed substantially. However, more needed to be done. Large imbalances were likely to persist even under fairly optimistic assumptions about future developments, a prospect that called for strong measures to consolidate and strengthen the momentum of domestic adjustment. In taking the necessary measures, the authorities might have to scale down their overall economic growth targets from those of recent years in order to lay the foundation for sustainable noninflationary growth over the medium term. They might also need to review public investment priorities carefully and implement only those projects that guaranteed an expansion of productive capacity. Aware of the problems, the authorities had been working closely with the World Bank to review public investments, including those of public sector enterprises. One helpful measure was to postpone less essential projects, a step that should also contribute to a reduction in the overall fiscal deficit.

Whenever possible, the growth in public sector expenditure should be contained through strengthened monitoring and control procedures, Mr. Nimatallah continued. In that regard, the authorities might have to resist pressures to raise wages and salaries, particularly given that domestic inflation had been contained at a low level. On the revenue side, efforts to improve and modernize the tax system should be intensified. It was reassuring to have heard from Mr. Jaafar that the overall fiscal deficit for 1985 was currently projected to be lower than had been indicated in the staff report.

The overall objectives of monetary policy seemed broadly appropriate, Mr. Nimatallah continued. However, assuming that the needed adjustment effort entailed a lower rate of economic growth in 1985 than the 5.1 percent currently projected, he wondered whether there was room for somewhat slower growth in domestic credit to the public sector. The steps taken by the authorities to reform the financial system were welcome, and he encouraged the continuation of such reform efforts in order to ensure the strength and integrity of the system.

The outlook for the external sector in 1985 was less than satisfactory, Mr. Nimatallah considered. The projected current account deficit, at 7 percent of GNP for 1985, remained high; under less favorable assumptions relating to uncertainties in the oil market, the deficit would widen over the coming four years to a magnitude that was clearly unsustainable. To reduce the deficit to 5 percent of GNP would require additional efforts to promote exports and reduce imports. In that regard, he took note of the program drawn up by the authorities with the assistance of the World Bank to promote exports of manufactured goods, and he commended the policies aimed at promoting foreign private investment. Of course, sound domestic adjustment policies themselves were a good incentive to attract foreign investment into Malaysia.

He agreed with Mr. Jaafar that Malaysia's debt was not excessive by international standards, and he shared the authorities' view that the level of debt and its servicing must be kept in a range consistent with medium-term external viability, Mr. Nimatallah said. The authorities would be wise to pursue cautious debt policies, particularly at a time when the balance of payments was projected to be under pressure. In sum, the impressive recent gains in the Malaysian economy needed to be reinforced through the continuation of appropriate policies in a number of areas so as to ensure sustainable growth with a viable external position. He had been reassured by Mr. Jaafar's confirmation that the authorities were aware of the problems and determined to sustain their adjustment efforts.

Mr. Doe observed that the efforts of the Malaysian authorities to reduce domestic and external imbalances in the economy since mid-1982 had been largely successful. The revival of growth of real GDP in 1983 had accelerated in 1984, mainly through higher mining and manufacturing output; the rate of inflation, after slowing in 1983 as a result of restrained domestic demand and lower import prices, had remained moderate in 1984; the overall budget deficit had declined somewhat in 1983 and further in 1984, mainly owing to increased revenue collection from the oil sector and further cutbacks in development and operating expenditures, including the elimination of the remaining subsidies on petroleum products. With those efforts and a generally supportive fiscal policy, the external current account deficit had narrowed substantially in 1984.

The authorities deserved commendation for their determined efforts to maintain good economic performance during the past two years, Mr. Doe continued. Unfortunately, the outlook for 1985 and the medium term gave cause for concern. The rate of economic growth in 1985 was expected to slow as a result of weak external demand, particularly for oil and manufactured goods; the balance of payments would continue to be under pressure; and the outstanding external debt was expected to increase in 1985 and beyond. The authorities recognized the worrying trend and had indicated their commitment to strengthening domestic and external adjustment policies in order to counter it. In that respect, the emphasis placed on further fiscal adjustment in the Fifth Malaysia Plan and the effort to achieve a continued reduction in the current account deficit were welcome. The thrust of fiscal policy for 1985--which stressed continued restraint on development expenditures despite the possible adverse consequences of such restraint on the economy's growth prospects--was appropriate. Further "rationalization of expenditure priorities and a reassessment of government functions in economic development" aimed at encouraging the privatization of public enterprises were also welcome developments that should contribute to a reduction of the fiscal burden. He could endorse the staff's recommendation that, despite the limited scope for further expenditure restraint, the authorities should persevere in their effort to attain a further reduction in total expenditures as a proportion of GDP. The ongoing effort to increase revenue should also be intensified, particularly through a broadening of the sales tax base, a reduction in exemptions, and improvement in tax administration.

The steps taken by the authorities to define more clearly the boundaries of the public sector and to monitor and control its investment expenditure were welcome, Mr. Doe commented. Thus far, those steps had led to a sharp reduction in the rate of growth of investment in the major enterprises; the increase in the number of enterprises subject to immediate monitoring, reporting and investment review should result in additional improvements. The Malaysian authorities should continue progress toward controlling the operations of the public enterprises in order to lessen their impact on the balance of payments and the economy's external debt position. In conclusion, it was to be hoped that the efforts being made to reduce domestic imbalances and minimize the rapid accumulation of external debt would succeed in establishing the conditions for a viable external payments position in the medium term. In that regard, he welcomed the inclusion of a section in the staff report outlining the active assistance of the World Bank in the Malaysian adjustment effort, especially in public investment, external debt monitoring, and domestic resource mobilization and development strategy.

Mr. Clark agreed that the Malaysian economy had performed well in many respects during 1984, with high growth, low inflation, and further reductions in the fiscal and current account deficits. He was particularly encouraged to note the steps taken by the authorities to improve control of public sector enterprises. Despite the progress made, the imbalances in the economy remained quite large. The figure projected for the fiscal deficit could in fact have been even larger if it had covered the entire public sector; moreover, the medium-term balance of payments position, while manageable, was dependent on a number of assumptions--including those regarding the price of oil--that recent data suggested might be optimistic. For that reason, it was somewhat disquieting to note that no further progress in reducing the fiscal deficit was expected in 1985 and that, even without a reduction in the oil price, the current account deficit was likely to deteriorate significantly. He encouraged the authorities to review their targets in the light of such external prospects and, if necessary, to tighten fiscal and monetary policies accordingly.

On specific points, Mr. Clark considered, first, that the authorities should work toward improving the monitoring of off-budget agencies in Malaysia as a way of strengthening fiscal policy. Second, on a related matter, he would be interested in hearing from the staff or Mr. Jaafar any estimate of the overall public sector deficit. Third, on the monetary side, he had noted the continued strong expansion of credit to the real estate sector, representing 32 percent of new commercial bank lending and 40 percent of credit from other financial institutions. Such expansion was of particular concern, especially given the prospects of an emerging property glut, and underlined the importance of maintaining or reinforcing prudential supervision. On structural policy, he supported the aims of the Fifth Malaysia Plan, particularly the emphasis on reducing the size of the public sector and encouraging export-oriented industries, and looked forward to the publication of the overall industrial plan in the near future. On the external side, he welcomed the recent relaxation in the rules for foreign direct investment, which should prove helpful in strengthening the balance of payments, given Malaysia's intrinsic attractiveness to foreign investors.

He presumed that the relatively low ratio of debt amortization to the stock of external debt was due in part to the fairly rapid increase in the stock itself as well as to the authorities' prudent policy of refinancing debt at longer maturities, Mr. Clark said. He would be interested in hearing some indication of how the average maturity of external debt had changed in recent years. It was clear that if developments in the oil market, for example, proved less favorable than currently expected, the authorities would have to make an effort to compensate elsewhere, and he wondered whether a more active exchange rate policy might not play a more active role in that compensation effort.

Mr. Wang observed that impressive improvements in the Malaysian economy had been registered over the past three years, following the adoption of adjustment policies in mid-1982. Both the fiscal and current account deficits had been significantly reduced; at the same time, growth had been maintained at a high rate, and domestic inflation had been kept moderate. The implication was that economic adjustment was proceeding satisfactorily, along the lines of the original plan of the Malaysian authorities.

The current policy stance also appeared broadly consistent with the medium-term adjustment targets, Mr. Wang continued. Fiscal policy remained aimed at moderation in public expenditure growth and a narrowing of the public sector investment-savings gap. Moreover, stringent measures had been taken to bring the activities of the off-budget agencies under stricter control. Like other Directors, he believed that further fiscal improvement must come from the operations of the nonfinancial public enterprises.

Monetary policy was, in general, in line with the overall policy stance, as indicated by the rise in interest rates and the decline in the consumer price index, Mr. Wang commented. For the future, he understood the authorities' concern over the impact that continued restrictive monetary policy could have on domestic investment. Indeed, private investment had declined for the past two years, while public investment had borne the brunt of the reductions in the fiscal deficit. For sound economic growth in the long run, it was essential to restore an appropriate level of investment; on the other hand, given the fundamental changes that the financial system was undergoing, the authorities should watch carefully the effect of various monetary aggregates so as not to undermine the basic adjustment objectives.

On the external side, the situation in Malaysia remained a matter of concern, Mr. Wang remarked. The current account, while much improved, was vulnerable, while demand in international markets had slackened as a result of a deceleration of growth in the major industrial countries and a rise in trade protectionism. The increase in net exports since 1983 had already begun to taper off toward the end of 1984 and might slow further in 1985 and the following year if the slackening of growth in the industrial countries were not reversed. In addition, although Malaysia's external debt was not excessively high, the rate at which it was increasing was ominous. In the circumstances, and despite the impressive progress already achieved, the Malaysian authorities should continue the adjustment effort.

Mr. Romuáldez commended the Malaysian authorities for the further progress made in 1984 toward ensuring that domestic policies were consistent with medium-term balance of payments viability. Containment of the federal deficit to the equivalent of 7.5 percent of GNP--a figure 3 percentage points lower than that for 1983 and nearly 10 percentage points lower than that for 1982--had surely been a major achievement. The authorities had also been successful in bringing investment expenditures of the nonfinancial public enterprises under control. Those successes, together with some tightening in monetary conditions, a modest depreciation in the real effective value of the ringgit in the fourth quarter of 1984, and the upturn in the world economy had brought about a sizable reduction in the external current account deficit, from nearly 12 percent of GNP in 1983 to less than 6 percent in 1984. By acting decisively, the Malaysian authorities had been able to stave off a sharp deterioration in the external debt position, a development that would have been inevitable unless domestic policies had been adjusted.

Of course, the authorities' success should not lead them to be complacent; while some progress had been made, the current position was still barely viable, as reflected in the staff's "alternative" medium-term debt projections, Mr. Romuáldez continued. Indeed, even under the baseline scenario, the burden of interest on external debt would absorb an average of more than 5 percent of GNP in the years 1986-89. That prospect alone should perhaps provide a sufficient incentive for the authorities to aim for a smaller increase in external debt in the years ahead than currently seemed likely. In that regard, an alternative to domestic adjustment might be to attract foreign direct investments; in fact, the authorities had announced some moves to encourage such investment, although he had missed any indication in the staff paper about the relative contribution that that form of financing might be able to make in Malaysia's case.

Bearing in mind the need to sustain or strengthen the adjustment process in Malaysia, Mr. Romuáldez said, he found it disappointing that an increase in the fiscal deficit, albeit a small one, was projected for 1985, especially given the absence of any provision in the projections for a likely public sector salary increase. Surely, any dissipation in 1985 of the fiscal gains made in 1984 would not be consistent with the stated policy of "maintaining persistent adjustment efforts in the medium term." The latest fiscal projections for 1985 were somewhat more reassuring than those in the staff paper; however, he had the impression that the authorities saw only limited scope for achieving future reductions in the fiscal deficit beyond 1984/85 levels. He would appreciate some indication from Mr. Jaafar of what the authorities considered an appropriate fiscal deficit/GNP ratio for the medium term.

It was encouraging to see that emphasis in future would be given to "greater rationalization of expenditure priorities and a reassessment of government functions in economic development," Mr. Romuáldez commented. Clearly, the earlier strategy based on government-sponsored major investment projects had not been successful, as evidenced by the burden of those projects on the budget and the need for substantial protection over a prolonged period for certain recently established heavy industries. Less clear was the extent of the reported shift in the Government's development strategy. References to "selected tax incentives" and "enlarged export refinancing facilities" and to measures to promote tourism, national shipping, and insurance services left him wondering whether the new strategy would still depend on the ability of the authorities to select successful undertakings.

While the Malaysian authorities were in the best position to assess the appropriate balance between specific measures to promote and support particular industries or sectors and more generalized measures, which left it to the market to establish the pattern of development, he hoped that they would give thought to the use of the exchange rate, a crucial instrument, Mr. Romuáldez remarked. Malaysia had been able thus far to maintain the competitiveness of its manufacturing industries, as rising labor costs had been offset through productivity gains; however, if those gains had been largely cyclical and if world demand for Malaysia's manufactured exports were to fall, productivity and competitiveness could be eroded. Moreover, it seemed that the gains in productivity had been dependent on investment incentives, which in a sense were a fiscal proxy for a more competitive exchange rate. Those considerations, together with the continued substantial imbalance in Malaysia's external accounts, led him to support the staff's view that "exchange rate policy could be used more actively in support of other elements of the adjustment effort." In any event, an exchange rate that was managed flexibly and was responsive to changes in competitiveness and in the external accounts should be less prone to speculation than one managed in a more rigid fashion.

Mr. Jayawardena agreed with others that strong adjustment had taken place in Malaysia following the emergence of imbalances in the early 1980s. Like other countries, Malaysia had reacted to the world recession and weakened external demand with expansionary fiscal policies, financed mainly through external borrowing. The subsequent corrective action required had been primarily in the fiscal area, and fiscal adjustment had indeed been impressive.

Following the most recent Article IV consultation, the Malaysian authorities had intensified fiscal cutbacks and tightened monetary and credit policies, Mr. Jayawardena continued. Monetary policy had been eased somewhat toward the end of 1984, a decision that he was however inclined to support as a way of counterbalancing the sharp adverse effects of the fiscal retrenchment on economic growth and investment. The results of the overall corrective policy stance were evident in the sharp moderation of the fiscal and balance of payments deficits since 1983; moreover, exchange rate policy had been more flexible. The recent Malaysian adjustment could be described as a successful example of Fund surveillance in a developing country, with the perspectives of the Fund and the national authorities coinciding and leading to a determined and successful adjustment effort.

Despite the achievements of the authorities, attention must be drawn to certain disquieting features of the Malaysian economy, Mr. Jayawardena commented. The balance of payments position was under pressure, and a debt service of ratio of about 16 percent through 1989 was envisaged. While those projections did not appear excessively burdensome, the recovery was not assured, and uncertainties existed in Malaysia's oil market. In the circumstances, caution was appropriate. In addition, a cloud hung over the economy's fiscal performance in the form of off-budget agencies. Over the past ten years, the authorities had been examining ways of more closely monitoring and controlling public sector enterprises, and he was puzzled that they had not been more successful in their efforts. He welcomed the recent measures undertaken to restrain the off-budget agencies, and the proposals for their privatization seemed reasonable in the context of Malaysia's policies. However, Malaysia was an open economy, and expenditures by public sector enterprises were nearly three times the direct development expenditures of the Federal Government. Hence, even under privatization, the off-budget agencies might need to be monitored if the fiscal imbalance were to be resolved.

Another of Malaysia's problems concerned exchange rate policy, Mr. Jayawardena considered. Given the relative openness of the economy, the authorities had experienced some difficulty in conducting exchange rate policy, particularly in the context of expansionary domestic conditions. He wondered whether the apparent real effective appreciation of the ringgit through 1984 had affected Malaysia's competitiveness and had placed the burden of adjustment too heavily on the fiscal side. Perhaps a more flexible exchange rate policy would have eased the country's adjustment needs, thus minimizing the adverse impact on economic growth and helping to ensure a better allocation of resources. The market preference for investment in real estate--which of course was to be expected at times of high inflation--did not augur well and reflected an incentive structure that could be improved. In any event, he welcomed the greater flexibility recently evident in the conduct of exchange rate policies; if the approach were continued, it should help to improve external performance and attract foreign investment.

On the whole, the Malaysian authorities should be commended for the timely and resolute adjustment measures that they had undertaken, Mr. Jayawardena said. Their achievements in relation to growth, inflation, and domestic savings mobilization were considerable, although the road ahead remained difficult because export-led growth strategies depended crucially on a more robust world economic recovery and a greater commitment to open trade, and he was not particularly optimistic on either count. In the circumstances, Malaysia should be prepared to adopt contingency measures as warranted.

Mr. Abdallah remarked that during the past three years Malaysia had weathered some difficult economic times. It had moved toward fiscal and external balance while attaining a reasonable rate of real growth as a consequence of strong adjustment measures pursued since 1982. Accepting that many problems remained, he would limit his remarks to the financial system, where developments had been taking place that were deserving of particular attention by the authorities.

The essence of the problem in the financial system was related to the shift from commercial banks to nonbank financial companies, Mr. Abdallah continued. During the past two years, the nonbank financial institutions had increased their deposits by 68 percent, achieving a rate of growth of nearly twice that attained by the commercial banks. That rapid growth had occurred partly as a result of aggressive deposit mobilization techniques, such as higher deposit rates, and partly because of the opening of new branch offices, which currently totaled 303, or nearly 45 percent of the number of commercial banks' branch offices. The aggressiveness of the nonbanks had already led to a reduction in the proportion of demand deposits within the system, from 23 percent to 20 percent, and an increase in fixed deposits of one to three months, from 25 percent to 33 percent. Those changes had given an upward push to the money multiplier; as a result, the authorities had been forced to shift their focus on monetary targeting from M-1 to the broader definitions of M-2 and M-3.

The strong growth of nonbanks was not peculiar to Malaysia; it had been occurring in many fast-growing developing countries, Mr. Abdallah continued. Wherever there had been rapid growth of government expenditures and a strong and innovative private sector, a noticeable tendency had emerged for some prosperous businessmen to form their own banks or financial institutions. Those financial intermediaries were established in the expectation that economic growth would continue and that resources as well as investment outlets would always exist. Unfortunately, the international environment had changed, and many of the new institutions were finding that domestic resources were stagnant or shrinking and that many of the activities they had once financed were no longer attractive. In the circumstances, instead of becoming a source of strength, the newly established domestic banks and financial intermediaries often became a source of concern.

During recent Board consideration of a consultation report on the United Arab Emirates, Directors had taken note of the remedial measures that the authorities had been taking to strengthen the financial system by encouraging mergers, issuing new accounting regulations, and intensifying physical inspections of lending institutions, Mr. Abdallah recalled. The Malaysian authorities had also issued new accounting regulations on how to treat nonperforming loans, and they were monitoring the activities of the entire financial system. Regulatory measures should in his view be intensified in order to protect depositors, many of whom were not particularly sophisticated. In Kenya, for example, some nonbank institutions had been established by those primarily interested in financing their own private businesses. Most of the lending of those institutions tended to be granted to the construction and real estate subsector in which key shareholders of the finance house held an interest; all commercial banks had tended to set up their own finance houses and to manage them as part and parcel of their own operations. The only difference occurred when a client applied for a loan and the bankers processed all the papers even though the loan was granted by the finance house, which of course charged a higher rate of interest.

By their nature, nonbank institutions had to rely on the wholesale market for their deposits, Mr. Abdallah noted. It was easy for them to bid up deposit rates; however, if confidence in any of the institutions were to be shaken, all of them would immediately come under heavy pressure, and rescue operations would need to be mounted. Furthermore, while the institutions might open branches in semirural areas, those served in fact as channels for transmitting rural savings to urban areas rather than for injecting funds into rural projects. Hence, in countries such as Malaysia and Kenya--where governments had defined priority areas that needed to be supported--the nonbank financial institutions tended to negate flows to preferred sectors. In concluding, he urged the Malaysian authorities to allow the exchange rate fully to reflect the forces of supply and demand, especially given the strong speculative pressures that had erupted in October 1984.

The staff representative from the Asian Department observed that Malaysia had suffered large losses equivalent to perhaps US$1 billion through speculation by one of the country's largest commercial banks. More recently, a bank owned by private Malaysian citizens but not related to the Malaysian banking system had failed in Hong Kong; recent public accounts of the failure suggested that irregular lending by senior officers of the bank had been at the root of the problem. Those difficulties highlighted the need to strengthen supervision of financial institutions.

It remained to be seen whether extensive property development--particularly in the Kuala Lumpur area--and the expected substantial oversupply of new office space in the near future would place strains on individual financial institutions of the sort that could potentially impair the conduct of monetary policy, the staff representative continued. That concern was shared by the Malaysian authorities. Although it might already be too late to quash the emerging problem, the staff was not in a position to forecast specific difficulties beyond stating that there would be tight liquidity in some institutions. Bank Negara had recently required some banks to restructure their portfolios where lending for property development had been overly concentrated.

As observed by a number of Directors, the period since 1979 had been marked by sharply expanding public sector investment expenditure, the staff representative commented. Unfortunately it was difficult to categorize that expenditure on the basis of whether or not the investments had been productive. Malaysia had experienced a strong rate of growth in the period, albeit not commensurate with the investment effort; it was that inconsistency that had prompted the Government after 1983 to reverse the course of public sector expansion set in motion in 1979. The strategy was explicitly revealed in the first chapter of the review of the Fourth Malaysia Plan, presented in Parliament in early 1984, which stated in part:

> The ultimate objective of privatization is the reduction of the size and presence of the Government and, conversely, the need to expand the role of private enterprise in the economy. A progressive reduction in the size of the Government in the economy is desirable, as its sizable presence has increased its command over the resources of the economy, raising wider allocative and efficiency issues.

The staff was unable to provide for Mr. Templeman an estimate of what part of the bulge in capital spending in Malaysia might prove to be uneconomic, the staff representative remarked. It could only be surmised from the macroeconomic statistics that the proportion was large, a fact that should have encouraged the authorities to move rather decisively in the beginning to restrain such spending. While they had chosen not to violate the integrity of existing contracts, the authorities had nonetheless been able to cut out many new projects and pare existing ones. Similarly, the staff had been unable to provide a fair estimate of the overall public sector deficit in Malaysia, although the authorities were working closely with staff from the Bureau of Statistics to establish a clear economic definition of the public sector and to work on the design of statistical reporting systems that would permit better monitoring and measurement of economic aggregates in that sector. Recently, the Minister of Finance had announced a substantial shift in policy on private investment under which a larger share of foreign participation would be permitted, linked to export performance. The shift was aimed at addressing the authorities' concern that the private sector had been relatively sluggish in its investment activities--except in property development--over the past three or four years. The staff was not in a position to assess quantitatively what the shift in policy might mean for the balance of payments and external financing in the second half of the 1980s, although he did not expect that that shift alone would have a significant impact.

Among the other areas to be addressed by the Malaysian authorities was the regulatory environment within which private sector investment must take place, the staff representative observed. The authorities would be closely reviewing that environment in collaboration with the World Bank. The Fifth Malaysia Plan might well be the vehicle through which the authorities could make further changes in the administrative and regulatory environment affecting private business operations. Such changes in conjunction with the liberalization of foreign investment ownership were necessary if a markedly different performance in private investment were to be achieved in the second half of the decade.

On monetary and credit policies, the staff representative recalled, some Directors had questioned whether the authorities might not be going too far in deregulating interest rates and had wondered whether Malaysia would not be better off employing some official guidance, perhaps in the form of upper limits on interest rates. That query in particular had been raised in the context of the wide fluctuations in the interbank rate in 1984. In his view, the experience of 1984 showed that upper limits on interest rates were not necessary: the sharp increase in the interbank rate in October had been intentionally caused by the authorities to terminate speculation when one major bank had taken a short position against the ringgit on the basis of what it had seen as signals of a shift in exchange rate policy. In that respect, interest rate developments in the interbank market could be viewed more generally as the result of efforts by the authorities to deal with speculation, efforts that had to be made successful if the authorities were to be able to free up exchange rate policy to permit the value of the ringgit to move down slowly and flexibly. The authorities had made the move toward more flexible use of the exchange rate as early as August 1984; except for the one severe bout of speculation, they had been pleased with the conduct of exchange rate policy since that time.

In response to a question by Mr. Nimatallah, the staff representative observed that there was perhaps scope for greater restraint on monetary and credit expansion, especially in the light of the slowdown in growth in the economy in 1985. However, as the authorities continued to restrain public sector activities, they wanted the private sector to become more forthcoming in taking investment initiatives. It seemed only fair to characterize the authorities' approach as one of moving on two fronts: they were attempting to simplify and streamline the regulatory environment which private investment took place while at the same time adopting a stance of monetary policy that would accommodate more private investment. Whether such an approach would lead to a realization of their goals remained to be seen. He understood that recent efforts to reduce the base lending rate did not constitute a signal of a more relaxed stance of monetary and credit policy but rather should be seen as a move to encourage the banks to overcome the downside "stickiness" of interest rates that had been apparent since the upward move in late 1984. The authorities would be monitoring monetary and credit developments quite carefully, but they were concerned about the extent to which banks had already made commitments under term lending agreements to disburse more resources in property development and real estate lending. In that respect, there appeared to be some rigidities in the structure of credit that limited the ability of the banks to exercise greater restraint even when such an objective was deemed necessary. Obviously, that fundamental problem would have to be addressed in the future.

With regard to the maturity profile of Malaysia's external debt in recent years, the staff representative from the Asian Department noted, Malaysia continued typically to borrow at ten-year maturities, including five-year grace periods. In that respect, there had been no shift in the maturity profile of external debt; however, an important shift in terms of the stock of debt outstanding had been occurring. Malaysia was still in the period of building a "mature" stock of debt with relatively stable relationships between principal payments and interest payments. As time went on, the share of principal payments would continue to rise, reflecting the expiration of grace periods on amounts borrowed in the first half of the 1980s. That change in the relationship between principal and interest payments helped to explain why Malaysia's debt problem would persist well into the 1990s.

Mr. Fujino asked for some elaboration on domestic resource mobilization in Malaysia, particularly with respect to the prospects for household savings.

The staff representative from the Asian Department replied that an effort to deal with a fiscal imbalance by forcing an already high national savings rate--27 percent of GNP in 1984--still higher might not be successful. The Malaysian authorities recognized that one element of the imbalance was the level of investment expenditure, but felt that it was more important to improve the quality of such expenditure than to reduce the overall level. In the public sector, the authorities felt that tax policies should not be directed so much toward raising aggregate revenues in relation to GNP as toward improving the quality of the tax system and its administration. The major adjustment effort must be made on the expenditure side.

Household savings in Malaysia historically reflected the importance of certain primary commodities--palm oil and rubber--in the export structure, the staff representative continued. Palm oil and rubber production was labor intensive, so that when those two commodities were strong, either in export volume or price, savings in the household sector increased initially and, with a lag of 9-12 months, were formally translated into higher consumption expenditure in the private sector. It remained to be seen whether the exceptional strength in palm oil prices in 1984 and the higher savings rate in the private sector would translate in 1985 into a stronger than estimated surge in private consumption expenditure.

Mr. Fujino said that he remained somewhat unclear about how a change in Malaysia's terms of trade could so strongly affect household sector savings.

Mr. Jaafar replied that the palm oil and rubber industries had seen a major change in terms of trade; three fourths of the output of palm oil came from smallholders rather than the corporate sector, a fact that might help to explain the rise in household savings referred to by the staff.

Many countries, including Malaysia, had faced large and growing deficits in 1982 as economies had begun to emerge from the deep recession, Mr. Jaafar observed. Higher international interest rates at the time had aggravated the situation, and Malaysia had suffered a current account deficit in 1982 of nearly 13 percent of GNP. The share of government spending had also climbed rapidly to nearly half of total GNP, with the fiscal deficit at a record 19 percent of GNP. Those deficits had been unsustainable, and the turnaround had not materialized in as short a time as had occurred following the mini recession of 1975; instead, global stagflation had occurred. Following a comprehensive review of the economy in 1982/83, decisions had been taken at the highest level to pull back from the original long-term plan for economic development in Malaysia. As Directors had already observed, the burden of the cutback had fallen most on development expenditure, which had been reduced on average by 20 percent each year from 1982 to 1985. The gains made over the period would not be lost through complacency; indeed, continued restraint was a feature of the Fifth Malaysia Plan to be announced in 1986.

Responding to those who had questioned whether the fiscal deficit projected for the medium term would be sustainable, Mr. Jaafar observed, the intention was to reduce the deficit to 5 percent of GNP or even less by 1989. Painful cuts had already been made in projects aimed at alleviating poverty in rural areas, where three fourths of Malaysia's population lived. If the objectives of the current economic policy stance were to be realized by the end of the decade, a GNP growth target of 5 percent per annum would appear necessary over the next five years. However, the authorities in Kuala Lumpur recognized that external constraints made it imperative that the new economic policy objective be temporarily compromised somewhat in the interest of stability. The Fifth Malaysia Development Plan would reflect that recognition. Of course, cuts in development expenditure of the magnitude made over the past three years could not be taken indefinitely, as they would bring about hardship and minimize the impact of the development momentum thus far achieved. For both political and social reasons, the authorities would not permit those developments to occur; hence, for the future, development projects would be looked at closely with attention to quality and efficiency that was consistent with stability. In that regard, external financing would continue to be required, although at a sustainable level.

Measures were also under way to rationalize the tax structure and strengthen tax administration in order to complement tight control over public sector expenditures, Mr. Jaafar commented. In the interest of efficiency, and in order to minimize the role of government in the economy, most public sector enterprises would be shifted into private hands. The objective of privatization in the Fifth Malaysia Plan was clear cut: to place in the private sector those services that could best be provided by that sector and to improve the profitability and efficiency of certain enterprises.

The new credit target for 1985 and the reduction in the base lending rate should be seen as moves to support private sector activity rather than as a relaxation in the monetary stance, Mr. Jaafar considered. If growth and investment were to be sustained at the projected rates, it was important to turn public opinion around. With negative inflation in the most recent quarter and an expected overall low rise in the consumer price index for 1985, real interest rates nonetheless remained quite high. As Malaysian rates were also significantly higher than international rates, a lowering of the rates and various other moves meant only a loosening of the too tight monetary stance that had prevailed in the final quarter of 1984 rather than a general change toward easier monetary policy.

The Chairman made the following summing up:

> Endorsing the thrust of the staff appraisal in the report for the 1985 Article IV consultation with Malaysia, Executive Directors commended the authorities for their vigorous adjustment efforts during 1983-84, particularly the significant restraint in government expenditures, which had contributed to the substantial reduction in the external imbalance. They took note of the robust recovery in economic growth, led primarily by exports and further moderation in domestic inflation. Neverheless, Directors observed, the current account deficit remained large; as a consequence, external debt and the debt burden had risen rapidly during the past two years.
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> While taking note of the latest projections for the fiscal position in 1985, due in part to the welcome efforts to monitor and control the activities of the nonfinancial public sector enterprises, Directors were nonetheless concerned that, in contrast to the marked fall in the fiscal deficit during the previous two years, only limited fiscal adjustment was envisaged for the remainder of 1985 and beyond, reflecting weakening oil

revenues and the narrow scope for further reduction in development expenditures. They urged stronger fiscal adjustment through close scrutiny of government spending programs, including restraint in the wage bill, and improved tax administration together with a widening of the tax base.

Directors noted the slowdown in investment expenditures by nonfinancial public enterprises during 1984 and the decline envisaged in 1985. They welcomed the recent creation of a high-level interagency committee to monitor and control the activities of public sector entities. They also welcomed efforts to improve information on and monitoring of investment spending and operations of these entities, while noting the need for further statistical work in this area. Serious concern was expressed about the generally poor financial return on public sector investment. Directors stressed that the large volume of fiscal lending and public sector borrowing to finance such investment projects had contributed greatly to the emergence and persistence of the large imbalances in the government accounts and in the balance of payments.

Directors commented favorably on the gradual tightening of monetary policy during 1984, which had helped to limit the expansion in credit to the private sector. Directors generally supported the stance of monetary policy envisaged for 1985 and, to that end, urged the close monitoring of domestic credit developments. They were in general agreement that rigorous measures should be taken if credit expansion should prove unduly robust in the face of continued weakness in the balance of payments. They noted the importance of maintaining market-determined interest rates. Directors welcomed the recent steps to limit excessive concentration of lending by financial institutions and to strengthen supervision over them, including improvements in accounting requirements for interest accrual on nonperforming loans. The intensification of steps to improve and safeguard the soundness of the financial system was strongly advocated.

Directors expressed concern about the outlook of the balance of payments in 1985 and over the medium term, noting that the current account deficit was forecast to remain in excess of 5 percent of GDP for the remainder of the decade. Their concern was heightened by the recent further softening in the international oil market, which in their view added an element of vulnerability to Malaysia's balance of payments outlook. Directors shared the staff's view that further adjustment efforts would be essential to strengthen the external payments position over the medium term. While agreeing that Malaysia's external debt was not currently excessive, Directors were concerned about its rapid increases in recent years and about the forecast increase in the debt burden in the medium term. They urged the authorities to exercise great caution in the area of debt management.

In the pursuit of external adjustment, the authorities were encouraged to improve the efficiency of resource use. In that context, Directors supported restructuring of public sector investment and promotion of private sector investment conducive to the deepening of the export-oriented industrial base. They considered that the World Bank should play an active role in the crucial task of assessing investment priorities. Directors welcomed the recent liberalization of foreign direct investment policy. The liquidation or privatization of certain public sector entities was also viewed as a matter of great importance. Directors noted the recent change in the stance of exchange rate policy and encouraged the authorities to keep exchange rate policy under close and active review so as to maintain competitiveness and efficiency of the export sector over the medium term.

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

2. LIBERIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Liberia (SM/85/188, 6/28/85). They also had before them a report on recent economic developments in Liberia (SM/85/191, 7/8/85).

Mr. Mtei made the following statement:

Since September 1980, the Liberian authorities have been working closely with the Fund in their attempt to find solutions to their economic problems. The intervening years have seen successive stand-by arrangements concluded with the Fund, lending credence to the adjustment program of the Government. In EBS/84/234 (11/19/84), the staff summed up the efforts of the authorities thus: "The Liberian authorities persisted in their economic adjustment programs supported by Fund resources.... The adjustment measures have been associated with a reduction in costs, both in the private and public sectors, so that the Liberian economy is in a position to benefit from the current recovery in world markets for its products."

However, developments since last December, when the Board considered the stand-by arrangement, have served to emphasize that the problems remain difficult. The debt service burden continues to be a major constraint on the ability of the Government to stabilize its financial position, and a chronic liquidity squeeze precipitated by capital outflows and the decline in economic activity have complicated the task of economic management, while leading to a decline in the standard of living. The present situation leaves no doubt in the minds of the authorities that economic stabilization could only come about with the implementation of corrective policies over an extended period of time. This was the basic idea behind the 1984/85 program, which was intended to consolidate the gains of the previous year and to continue with efforts aimed at improving the allocation of resources and the diversification of production.

Performance during 1984/85 for the most part fell below expectations, as many of the key assumptions of the program did not materialize. On the one hand, part of the problem was due to exogenous factors: the continuation of depressed demand in the markets for Liberia's iron ore and timber exports, the sharp decline in foreign grants, and rising interest payments on external debt. On the other hand, the authorities recognize that part of the shortfall in revenue stemmed from the fact that tax measures intended to be implemented early in the fiscal year did not come on stream as envisaged, while there was a misjudgment with regard to the time frame that would be appropriate for achieving the projected reductions in expenditure with minimal social and economic disruptions. In order to finance the budget deficit the Government had to exceed the ceiling on borrowing from the banking system, which, together with the accumulation of external arrears, rendered the stand-by arrangement inoperative. However, a 2.3 percent growth rate after four years of declining output and an inflation rate of 2.5 percent were among the encouraging developments in 1984/85.

Efforts aimed at restructuring and improving efficiency in public corporations continued in 1984/85 in cooperation with the World Bank. A Bureau of State Enterprises was created with the principal function of monitoring and evaluating the performance of all such enterprises. Meanwhile, the Government is committed to a comprehensive reform with the basic objectives of reducing the size of the public enterprise sector through divestiture and/or liquidation, making remaining enterprises financially viable, and establishing the institutional framework that would guide the relationship between the Government and public enterprises. Three concrete steps have already been taken in connection with the reform program. First, the Liberian Petroleum Refining Corporation (LPRC) has been transformed from a refining company to one limited to importing and distributing refined products. Second, the operations of the National Iron Ore Company (NIOC), which required subsidies from the Government estimated at $10 million in 1984/85, have been terminated. Third, 50 percent of the Liberia Timber and Plywood Company has been sold to a private company, which will also provide management.

The authorities have continued to implement policies aimed at strengthening the agricultural sector, a major aspect of the Government's diversification program. The intention is to increase production of crops such as coffee, cocoa, and palm products. In this connection, a program geared toward improving the productivity of small farmers is now in place, supported with technical and financial assistance from the World Bank. Key elements of the program include the provision of feeder roads and irrigation facilities, together with the introduction of improved farming techniques. An increase in rice production through the expansion of acreage and improved productivity is an important goal of the Government, particularly in the context of the medium-term objective of reducing pressure on the balance of payments, since a large amount of rice has to be imported to meet increasing demand.

A major concern of the Liberian authorities in 1985/86 is the size of the budget deficit, and they are fully aware that significant changes in fiscal policy are required in order to bring the economy back onto the original path of adjustment. Accordingly, steps are being taken to enforce the 10 percent increase in import duty that became effective on May 1, 1985 and the collection of the gasoline tax, which has been raised from $1.25 to $1.50 per gallon. Expenditure is projected to decline by 9 percent, with a greater emphasis being placed on appropriations for development. The wage bill is programmed to be reduced by $8 million, and unallocated and extrabudgetary expenditures are to be eliminated. Reflecting these developments, the budget deficit is estimated to be reduced by about one half relative to GDP, from 15.2 percent to 7.8 percent. In order to strengthen control over expenditure, the authorities intend to implement several measures, including procedures to record all expenditure commitments and the establishment of monthly minimum revenue targets to act as trigger points for offsetting expenditure cuts. The Government has requested technical assistance from the Fund in this effort.

In monetary policy, the Government has decided not to create money for the purpose of financing the budget deficit. This means that the National Bank of Liberia could issue new coins only to commercial banks against their excess reserves held at the National Bank. Lending rates have been reduced from 25 percent to a level equivalent to the New York prime rate plus a spread of 4 percent. Moreover, the required reserve ratio has been reduced from 30 percent to 22 percent. These steps are intended to encourage activity in the private sector and greater diversity in bank lending. Deposit rates continue to be highly positive in real terms, given the further decline in inflation.

Liberia's external payments position will remain under severe pressure in 1985/86, with a financing gap in the budget of $164 million and the increase in the debt service burden. The situation points to the need for an increased inflow of concessional financing, without which the balance of payments

> scenario will worsen considerably. The authorities are aware that the restoration of Liberia's creditworthiness is a serious issue and are therefore taking steps to open a special account for the payment of debt service obligations, including external arrears. They have also requested technical assistance from the Fund to help in developing procedures to monitor external arrears.

Extending his remarks, Mr. Mtei observed that, as noted in the staff report, the authorities had adopted appropriate corrective policy measures, most with the concurrence of the Fund. Unfortunately, in part for reasons beyond their control, those efforts had not achieved the desired results, but the authorities remained confident that further financial discipline, more effective implementation of all remedial measures, and continued Fund support would ensure the mitigation of the problems currently facing the Liberian economy. They had asked him to reassure the Executive Board that they would not relent in their efforts to improve the current situation.

Mr. Dallara stated that it was difficult to think of an example of a Fund-supported adjustment program that had fallen further from the mark in 1985 than that of Liberia; indeed, the economic policy stance during the year could not, in his view, be fairly viewed as an orderly adjustment effort. Table 2 of the staff report provided ample detail of the fiscal shortcomings, and the staff had in several places mentioned the authorities' unwillingness to implement policies expressly agreed upon in the letter of intent. In that context, he had some difficulty in understanding Mr. Mtei's introductory remarks on behalf of his Liberian authorities. There was no question that they had made an attempt to adjust over a number of years and that some adverse exogenous developments had hampered their efforts, but he could not agree that the authorities had adopted appropriate policy measures in 1985.

It should be clear to the Liberian authorities that, in one way or another, adjustment was inevitable, Mr. Dallara continued. It was preferable that the adjustment effort should be carefully planned and implemented by the authorities with the support of the international financial community. The alternative was a continuation of the rather clear economic deterioration that had been occurring and that would in time result in a more painful adjustment for the economy and for the Liberian people than would have been necessary if appropriate adjustment measures had been adopted earlier. The large accumulation of external arrears had already caused several creditors to suspend loans to Liberia, and the import compression that had begun several years previously would probably continue in 1985, as it was highly unlikely that new financial flows would materialize in the current policy environment.

With the U.S. dollar as the medium of exchange, fiscal policy in Liberia had taken on special importance and at times had been the centerpiece of the adjustment effort, Mr. Dallara continued. The intention of the authorities to implement measures to correct the fiscal imbalances had contributed significantly to the Board's approval of the stand-by arrangement for Liberia in December 1984. Since that time, however, fiscal efforts had fallen considerably short of what was needed. The budget deficit for 1984/85 was currently estimated at 15.2 percent of GDP on a commitment basis, as opposed to a programmed target of 4.9 percent of GDP. While revenues had fallen short of expectations, expenditures had grown by 17.2 percent, against a programmed target of 4.2 percent.

Perhaps the most egregious example of noncompliance with the program was the lack of enforcement of revenue measures, Mr. Dallara observed. He wondered how the authorities could expect continued support from creditors and donors when so little effort was being made internally to generate necessary resources. Even the most recently imposed revenue measures--the increase in the gasoline excise tax--had yielded only negligible revenues. Moreover, the authorities had increasingly resorted to financing expenditures by forgiving tax liabilities, a practice that in his view could not lead to economically rational expenditure. In the case of the Liberian Petroleum Refinancing Company, excise taxes had apparently been collected but had not been passed on to the Government. He wondered whether the fact that the Government owed the Liberian Petroleum Refining Company \$18 million and was in arrears to other public and private entities had led to the lack of compliance with what appeared to be relevant tax regulations. Such a mutual lack of payment was a serious problem of administration and indicative of the critical imbalances extending into the various sectors of the economy.

As he had already noted, expenditures in Liberia had been much higher than expected, Mr. Dallara commented. Even in the wage area, where the authorities had pursued determined efforts to exercise restraint, spending had in recent years exceeded programmed targets. Moreover, the staff had estimated that \$48 million in unidentified extra-budgetary expenditures had occurred. He found it difficult to understand how an amount equal to roughly 12 percent of total expenditures could be spent without appearing on the record. Such a large discrepancy led him to doubt that the pro forma budget shown in the staff report could be implemented with determination. Indeed, even if the budgetary measures described by the staff were forcefully implemented, the budget would still show a financing gap of some \$164 million. Implementation of the described bugetary measures might free up some external resources, but it was difficult to see how sufficient financing to cover the gap could materialize at the current stage. The implication was that a much stronger adjustment effort was required than that outlined in the pro forma budget, an effort that would reduce the deficit to considerably less than 7.8 percent of GDP. While still on public sector policy, he would appreciate some further elaboration on the expected progress in rehabilitating the public corporations with World Bank assistance. In his opening statement, Mr. Mtei had described the divestiture and liquidation of some enterprises as part of the program, and he welcomed those developments. He would be interested in hearing what further progress could be expected in that area during the remainder of the year.

On the monetary side, Mr. Dallara observed, the large fiscal deficit in 1984 had led to borrowing from the National Bank of Liberia, even though no borrowing had been envisaged in the program. Tight credit should have assisted in limiting the deficit, but the authorities had chosen instead to permit a large accumulation of domestic and external arrears. Furthermore, while the program aimed at providing an increase in credit to the private sector of about 12 percent during the course of 1985, data as of end-June indicated that credit to the private sector had actually contracted by 6.5 percent. By diverting financing from the private sector to the public sector when little external financing was available, the authorities were in effect limiting the growth and development of the economy in 1985 and the years ahead. On a related matter, the financial crisis in Liberia appeared to have resulted in a significant hoarding of currency by residents, leading to a further tightening of liquidity. Such developments only strengthened the pressing need for decisive and prompt adjustment in order to restore confidence within Liberia itself and among members of the international financial community.

The use of the U.S. dollar as Liberia's medium of exchange tended to limit the flexibility of monetary policy and required that domestic costs be contained in order to maintain export competitiveness, Mr. Dallara said. However, according to the staff, it had been difficult to contain unit labor costs to the extent needed to offset the appreciation of the dollar. Moreover, the imposition of export taxes had adversely affected the profitability of the export sector; he strongly urged the authorities to consider eliminating the export tax in the context of the overall effort to strengthen revenue collection and address the fiscal deficit. The difficulties facing the export sector fueled the debate about whether Liberia should continue to use the U.S. dollar or create its own currency. Without strong action on the fiscal front, costs would no doubt be difficult to contain in the private sector, and exports could not but lose ground.

The unfinanceable fiscal deficits that had been developing in Liberia could also lead the authorities to issue a separate Liberian currency, a development that was already taking place in a way through a wider domestic use of domestic coins, Mr. Dallara noted. Such action by Liberia could lead to excessive growth in the money supply to finance the budget deficits if the issuance were to take place in the current context of fiscal imbalances, both existing and projected. While Mr. Mtei's statement that "the Government has decided not to create money for the purpose of financing the budget deficit" could be taken to mean that the authorities intended to maintain the dollar as Liberia's currency, the further statement by Mr. Mtei that "the National Bank of Liberia could issue new coins only to commercial banks against their excess reserves held at the National Bank" could suggest a further move toward a dual-currency system. It should be made clear that he was not in any way addressing the basic question of the desirability of shifting the currency base in Liberia; he was only commenting on the potential implications of such a change in the context of Liberia's current financial difficulties.

Another indicator to be monitored in Liberia was the amount of external arrears, including arrears to the Fund, Mr. Dallara remarked. The staff had observed that "foreign exchange receipts would be adequate to cover debt service payments so long as the Government did not divert these foreign resources to other uses." During the most recent Board discussion of Liberia's arrears to the Fund, the Governor for Liberia had indicated that a certain portion of external resources would be used to pay off Fund arrears. In the circumstances, he was disappointed that no payments had yet been made to the Fund; he was also puzzled about why the authorities had not yet set aside some portion of external receipts collected over recent months for use in making payments to the Fund. He would be interested in hearing the extent to which that inaction reflected the priorities that the Government attached to repayment of its growing obligations to the Fund. He presumed those matters and others would be covered in the next formal discussion of Liberia's overdue obligations to the Fund, scheduled for no later than August 26, 1985. In conclusion, he supported the proposed decision.

Mr. Taha considered that Liberia's current economic policies were inadequate to deal with the imbalances in the economy. The measures taken by the authorities as outlined by Mr. Mtei were steps in the right direction; however, given the severe imbalances in the economy, more fundamental measures were needed. For example, serious thought should be given to the desirability of continuing to peg the currency to the U.S. dollar, the appreciation of which had eroded Liberia's external competitiveness. Consideration should also be given to the fact that the burden of adjustment in Liberia was borne mainly by fiscal policy. Even if comprehensive fiscal measures were to be adopted, supportive exchange rate and monetary policy actions would be needed at the present juncture. Of course, it remained to be seen whether a tighter fiscal stance could be adopted so as to improve Liberia's ability to deal with current economic problems and service existing debts. Finally, he could support the proposed decision.

Mr. Clark remarked that it was disappointing that the stand-by arrangement with Liberia approved in December 1984 had broken down within a few days of its inception, not merely because of arrears to the Fund but also because several other end-December performance targets had been breached. Since then, the situation had deteriorated further, with fiscal policy in particular having gone out of control and external arrears--including arrears to the Fund--having increased sharply. The question to be asked of the authorities in the circumstances was whether or not they were prepared to take the severe measures necessary to ensure orderly adjustment.

A substantial improvement in public expenditure control and revenue collection was vital, Mr. Clark continued. As already noted by Mr. Dallara, nearly one sixth of government expenditure in 1984/85 had not been accounted for. The measures that the authorities intended to take were welcome, and he hoped that they would be implemented soon, with the help of requested Fund technical assistance. On the monetary side, he endorsed the staff's concern that the issuance of domestic currency was clearly not a satisfactory approach to Liberia's problems and should not be seen as a substitute for adjustment. He welcomed Mr. Mtei's assurances in that regard.

As to the current program under the stand-by arrangement, Mr. Clark considered, Executive Directors should employ some self-criticism in questioning their approval of a program encompassing a liquidity situation that had been so tight that the authorities had been unable to make a payment of $2.5 million to the Fund within two weeks of having drawn under the program. Indeed, they had managed to meet the performance criterion for the public sector enterprises only by running up substantial domestic arrears. It was to be hoped that, in the future, provision would be made for reducing that form of financing. Third, any domestic currency creation that occurred in Liberia should be included under the ceilings for net domestic assets in any future program. In conclusion, he urged the Liberian authorities to adopt a comprehensive program of measures as a matter of urgency in order to tackle the domestic economic problems and enable the repayment of arrears, particularly those to the Fund.

Mr. Goos said that he shared the concern expressed by previous speakers and the staff about Liberia's economic situation. The most striking positive feature in recent economic developments in Liberia was the low inflation rate, which unfortunately reflected underlying problems including an overvalued exchange rate and a severe liquidity shortage resulting from the erosion of confidence in Liberia's financial system. In the circumstances, and in view of the high and growing level of domestic and external arrears, including arrears to the Fund, the need for corrective action was urgent. Within existing monetary arrangements, such action must concentrate on the restoration of fiscal discipline. Against that background, the recently announced and welcome comprehensive reform program for the public enterprise sector had already produced encouraging results in cutbacks in nonproductive public expenditures.

Also welcome were the authorities' efforts to reduce the public sector deficit through various other means, as reflected in the revival of a pro forma budget, Mr. Goos continued. However, while many of the measures contemplated represented steps in the right direction, more needed to be done to restore a viable overall position and to eliminate external arrears. In that context, he had noted from the staff paper and Mr. Mtei's statement that steps were being taken by the authorities to open a special account for the payment of debt service obligations, including external arrears. He had thought that such an account had already been opened with the New York Federal Reserve Bank some months previously, and he would welcome comments from the staff or Mr. Mtei on the relationship between the two accounts and the amounts accumulated on the New York account. He would also appreciate hearing whether, in the course of the consultation discussions, the authorities had given any indication of when they intended to settle their overdue obligations to the Fund. He raised that issue not only because of the alarming pace at which arrears were accumulating but also because neither the staff nor Mr. Mtei had made any explicit reference to concrete plans or commitments by the authorities to become current with the Fund.

While sharing the staff's analysis of, and recommendations regarding, the Liberian economy, he had been surprised to note that the staff had refrained from recommending that any change in the current monetary arrangements, including a possible devaluation of the currency, Mr. Goos said. It was clear that the pace of adjustment was being restricted by the strong real appreciation of the exchange rate that had occurred in recent years and that was reflected in both the continued stagnation of export volume since 1980 and the apparent lack of any significant diversification in the export base. He was well aware that abolishing the current U.S. dollar standard would constitute a fundamental institutional change; however, such a change was perhaps already taking place in a gradual but hidden manner with the increasing circulation of Liberian coins, which he understood were currently being issued without the original restriction of 100 percent U.S. dollar coverage. The issuance of Liberian coins meant that Liberia was in fact issuing its own currency, thereby creating the potential for the authorities to pursue an independent exchange rate policy. Such a policy seemed to be indicated already by various "elements of a growing distinction between U.S. dollar notes and the Liberian currency." He wondered whether the authorities were deliberately steering such a policy course of phasing out the dollar standard and, if so, what that course would imply for the country's prospects for economic stabilization.

The financing of the balance of payments gap envisaged for 1985/86 was apparently subject to uncertainty, the more so "because the envisaged disbursements of official loans are threatened by the high level and continuing accumulation of external arrears," Mr. Goos commented. In that context, he noted that the World Bank was currently negotiating a structural adjustment loan for Liberia. While welcoming the Bank's involvement in Liberia's adjustment effort, he wondered whether and to what extent prospective lending decisions by the Bank were being affected by Liberia's external arrears, particularly by Liberia's overdue obligations to the Fund. In conclusion, he supported the staff's recommendations and the proposed decision.

Mr. Chatah said that, like others, he was disappointed in the performance of the Liberian economy since the Board's approval in December 1984 of the most recent stand-by arrangement. Although the marked deterioration in the country's external finances could be attributed in part to adverse exogenous developments, it was clear that inappropriate economic policies were largely to blame for that deterioration. In particular, large overruns in fiscal expenditures--which had raised the deficit to more than twice that of the previous year and three times the deficit targeted in the program--were indications of the degree to which policies had diverged from the adjustment effort required. In May 1985, the deficit had been estimated at 11.5 percent of GDP; the latest estimate was for a deficit of 15.2 percent of GDP.

The balance of payments tables provided by the staff and the fact that Liberia had begun to accumulate arrears to the Fund only a few days following the Board's approval of, and Liberia's first purchase under, the stand-by arrangement were indicative of the lack of adequate financial management in the economy and raised serious questions about the prospects for any improvement in Liberia's creditworthiness or for orderly financing arrangements with creditors, Mr. Chatah continued. Since he was in broad agreement with the staff appraisal and the views of earlier speakers, he did not need to detail the specific policies required to rectify the situation. However, decisive and timely action was needed in all areas of economic policy, although priority must be given to reducing the budget deficit; he could agree with the remarks of previous speakers regarding the present exchange rate arrangements. More generally, however, what was needed was a change in attitude that would translate the authorities' stated recognition of the required adjustment into actual implementation.

Mr. Polak agreed that the stand-by arrangement with Liberia was hopelessly off track and that the economic problems, including Liberia's arrears, would probably not be resolved before the November elections. All Directors could hope to do at the present meeting was to give guidance to the authorities on the direction in which their search for solutions should take.

In some ways, there was room for self-criticism about how well or badly the Fund had played its catalytic role in Liberia, Mr. Polak continued. Clearly, when a program broke down within a few days of its inception because of arrears to the Fund, some hard questions had to be asked, including questions about the quality of performance criteria, which the authorities had observed by running up domestic arrears, coining new money, and giving away the following year's taxes.

Two other major issues--the budget and the exchange rate system--were deserving of consideration, Mr. Polak commented. The staff had stated that the original budget had been revised significantly on the basis of discussions during the consultations. The staff had also included a detailed description in its report of all the measures in the budget. In the end, however, the staff had expressed its doubts about the credibility of the adjustment effort, the desirability of the balance to be struck between current and development expenditures, and the financeability of the remaining gap. The staff had gone on to call for "extraordinary measures supported at the highest political level"; he wondered whether more concrete ideas for such measures had been brought out in the discussions between the staff and the authorities.

On the exchange rate regime, the views of the staff had not been clearly presented, Mr. Polak considered. In theory, Liberia's dollar-based system should produce financial discipline, full convertibility, and no exchange restrictions, since domestic money was identical with foreign money. At the same time, the system should ensure competitiveness with a self-correcting type of balance of payments adjustment.

However, it seemed clear from the staff paper that the authorities had found ways--e.g., coining money and running up arrears--to circumvent the system. The staff had urged the re-establishment of financial discipline, but it was questionable whether that could be accomplished through a return to the old system. Was it possible, for example, once the loopholes had been discovered, to plug them in a credible way? It was also questionable whether the corrective measure of wage adjustment would work in Liberia, where slippages in financial discipline together with the overvaluation of the U.S. dollar had worked to produce a huge real effective overvaluation. More generally, in the face of those serious problems, it was questionable whether Liberia should continue to cling to its official current monetary arrangement; that question had not been carefully discussed in the staff paper. The answer was to abandon the current arrangement and focus on an appropriate alternative, making it clear to the authorities that another financial regime did not by itself relieve them of their responsibilities to adjust.

On another matter, Mr. Polak said, he had some doubts about the wisdom of the staff's decision not to construct a medium-term scenario in SM/85/188. It was not sufficient to indicate that current policies were not reliable. Of course, a predictive scenario would have been impossible, but a normative scenario might have provided some guidelines to the Liberian authorities, the Fund, and other creditors.

The Executive Directors agreed to resume their discussion of the staff report for the 1985 Article IV consultation with Liberia at 3:00 p.m.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/110 (7/22/85) and EBM/85/111 (7/24/85).

3. BOTSWANA - TECHNICAL ASSISTANCE

In response to a request from the Botswana authorities for further technical assistance in reviewing the tax system and its administration, the Executive Board approves the proposal set forth in EBD/85/180 (7/16/85).

Adopted July 22, 1985

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/85/186 (7/18/85).

Adopted July 22, 1985

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/154 are approved. (EBD/85/181, 7/17/85)

Adopted July 23, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/188 (7/19/85) is approved.

APPROVED: April 15, 1986

LEO VAN HOUTVEN
Secretary