April 2, 2020
Approval: 4/9/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/12-1

12:05 p.m., February 15, 2019

1. Malaysia—2019 Article IV Consultation

Documents: SM/19/33 and Correction 1; and Supplement 1; SM/19/34

Staff: Choueiri, APD; Gonzalez Miranda, SPR

Length: 40 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	M. Ismail (AE), Temporary
M. Raghani (AF)	
	R. Morales (AG), Temporary
	G. Johnston (AP)
	A. Maciá (BR), Temporary
	K. Lok (CC), Temporary
	A. Guerra (CE)
	M. Sylvester (CO), Temporary
	S. Benk (EC)
	A. Castets (FF)
	S. Buetzer (GR), Temporary
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
	Y. Saito (JA)
J. Mojarrad (MD)	
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	S. Evjen (NO), Temporary
	A. Tolstikov (RU), Temporary
	R. Alkhareif (SA)
J. Agung (ST)	
P. Inderbinen (SZ)	
	O. Haydon (UK), Temporary
	D. Crane (US), Temporary

H. Al-Atrash, Acting Secretary
S. Maxwell, Summing Up Officer
D. Alcantara, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: O. Brekk, N. Choueiri, R. Craig, X. Li, K. Miyachi, K. Svirydzenka. Communications Department: T. Yan. Legal Department: J. Pampolina, A. Yiadom. Monetary and Capital Markets Department: D. Grigoryan, Y. Mooi. Research Department: L. Juvenal.

Executive Director: M. Mouminah (SA). Alternate Executive Director: J. Di Tata (AG). Senior Advisors to Executive Directors: R. N'Sonde (AF), T. Ozaki (JA). Advisors to Executive Directors: K. Carvalho da Silveira (AF), U. Latu (ST), M. Mehmedi (EC), Y. Naruse (JA), A. Srisongkram (ST), C. Wehrle (SZ), S. Alavi (MD).

1. MALAYSIA—2019 ARTICLE IV CONSULTATION

Mr. Agung and Mr. Shaari submitted the following statement:

Introduction

On behalf of the Malaysian authorities, we would like to express our appreciation to the IMF team for the comprehensive and constructive dialogue during the 2019 Article IV consultation. We are encouraged by staff's positive assessment on Malaysia's economic and financial outlook as well as the appropriateness of the current macroeconomic policy setting.

In an environment of heightened uncertainty and downside risks in the global economy, resilience of the Malaysian economy is underpinned by strong macroeconomic fundamentals and a robust financial system. Appropriate policy frameworks, timely policy responses and ample buffers are in place to further reinforce the economy's resilience. Our authorities continue to be vigilant over the near-term risks while remaining committed towards medium-term structural reforms to ensure inclusive and sustainable growth.

As a highly open economy with a financial system that is integrated with the international financial system, Malaysia is susceptible to external influences and spillovers from abroad. Given this environment, our authorities remain committed to exchange rate flexibility as a first line of defense against shocks. A broad suite of policies remain available to ensure the instruments deployed are the most effective for the specific risks being managed. As conditions evolve and new challenges emerge, the effectiveness of our policies are continuously assessed to ensure overall macroeconomic conditions are conducive to growth with price stability.

Our authorities welcome staff's efforts to understand the domestic economy and country specific challenges. We are encouraged by staff's recognition of the positive outcomes from the foreign exchange measures implemented by the authorities. Greater understanding of authorities' policies and their intended outcomes are imperative for effective and balanced policy advice by the Fund. In this regard, we encourage staff to offer more constructive policy advice, such as alternative measures to better address the key challenges faced by the authorities, and to move away from rigid adherence to the Fund's prescriptive set of policy advice. Policies have to be designed in the context of the situation.

Latest economic developments and outlook

Authorities agree with IMF's assessment that the Malaysian economy continued to show resilience. In the first three quarters of 2018, the economy recorded growth of 4.7 percent. While a moderation from the 5.9 percent growth in 2017 had been expected, growth in 2018 was also marked by commodity-specific production disruptions. While there was a smooth political transition to a new Government, transitory policy uncertainty weighed down on growth in the few months after the May General Election. In 4Q 2018, growth is expected to rebound (3Q: 4.4 percent), supported partly by the on-going recovery in commodity output. Based on this development, for 2018 as a whole, the Malaysian economy is on track to expand at around the official forecast of 4.8 percent. At close to 5 percent, and amid global trade tensions and tighter financial conditions during the year, growth remains highly respectable. Headline inflation averaged at 1.0 percent in 2018, mainly reflecting the impact of the zerorisation of the Goods and Services Tax (GST) and the fixing of retail fuel prices. Labour market conditions were favourable, underpinned by firm employment and steady income growth. Importantly, the higher net employment gains were mainly driven by high- and mid-skilled workers. Malaysia's external sector remained resilient, amid a challenging external environment during the year. Malaysia's current account is expected to continue to register a surplus in 2018 (1Q-3Q 2018: 2.1 percent of GDP; 2017: 3.0 percent of GDP), with positive exports growth. As highlighted by staff, highly volatile short-term capital flows, which were driven mainly by global uncertainties, were ably intermediated by deep capital markets and broad base of domestic institutional investors.

For 2019, growth is projected to remain on a steady growth path and driven by the gradual recovery in commodities output, which would also support growth in the manufacturing sector and trade performance. In addition, the new production facilities particularly in the petrochemicals industry will lend further support to growth. On the demand side, private sector spending will remain the anchor of growth amid continued rationalisation of public sector expenditure. Private consumption is expected to normalise following the lapse of one-off factors in 2018 but remain firm underpinned by continued income and employment growth. Government measures such as the minimum wage increment, cash transfers and targeted fuel subsidy will support household spending among the lower-income household. Investment activities will remain supported by the on-going multi-year infrastructure projects and sustained capital spending by both domestic- and export-oriented firms. Inflation in 2019 is expected to average moderately higher, with the impact of the consumption tax policy on headline inflation lapsing towards the end of the year. However, the trajectory of headline inflation will be dependent on global oil prices given the resumption of the managed float fuel pricing mechanism. Nevertheless, underlying inflation is expected to remain contained in the absence of strong demand pressures. On the external front, exports are expected to record a more moderate but positive growth, in line with the expectations of slower global growth and trade momentum.

Going forward, Malaysia's economic fundamentals are expected to remain strong. The diversified export base in terms of products and markets would partially mitigate the impact from slower global growth and trade. The current account is expected to remain in surplus, driven by a sizeable goods surplus, which will be more than sufficient to offset the services and income deficits. Malaysia's deep and diversified financial markets and strong economic fundamentals will continue to intermediate capital flows. In addition, the broad base of domestic institutional investors, including banks, insurance companies, and provident and pension funds will mitigate excessive volatility in the domestic financial markets. Exchange rate flexibility with adequate levels of international reserves remain an important tool against external shocks.

Our authorities concur that risks to the growth outlook are tilted to the downside and stem mainly from external sources. As a small open economy, Malaysia will be affected particularly by the intensification of the trade conflict and slower-than-expected growth in trading partners. Notwithstanding this, the strong fundamentals and the diversified nature of the economy will enable Malaysia to continue to weather these downside risks. Macro- and micro- level stress tests conducted by the authorities and individual banking institutions affirm Malaysian banks' strong capacity to withstand extreme macroeconomic and financial shocks, hence, presenting low downside risks to growth. Vulnerabilities associated with banks' and corporates' external debt are largely contained considering the risk profile and activities underpinning such exposures. While staff assessed the household debt as elevated, authorities view that risks to financial stability emanating from household indebtedness have receded amid sound underwriting standards, risk management practices and loan affordability assessments. Household debt growth has moderated towards a more sustainable rate, lower than that of income. Consequently, the household debt-to-GDP ratio has also been declining, a trend sustained since 2015, and the increase in house prices have moderated in recent years to be in line with domestic fundamentals.

Fiscal Policy

The conduct of fiscal policy centers on strengthening the public finance position while supportive for a sustainable and inclusive economic growth. In this regard, the Malaysian authorities adopted prudent fiscal management approach that aims to build healthy fiscal buffer and to ensure debt remain at sustainable level. The authorities are also committed to instill efficient and good governance in the fiscal policy management. Towards this end, several measures have been initiated to strengthen transparency and governance aspects of the fiscal management, as well as efforts to achieve greater expenditure optimization and revenue enhancement.

The inaugural publication of the Fiscal Outlook and Federal Government Revenue Estimates in November 2018 signified the ongoing effort to promote better transparency and accountability in Malaysia's public finance management. This is complemented with the introduction of the Medium-Term Fiscal Framework (MTFF) which outlines the 3-year fiscal consolidation plan and the indicative expenditure ceiling for the 2019-2021. Work is currently underway to introduce the Fiscal Responsibility Act (FRA), by 2021 to strengthen the current fiscal governance framework. Among others, the FRA will strengthen the conduct of fiscal policy by enhancing fiscal rules and principles, transparency and accountability while ensuring macro stability in the medium and long term. In addition, the Government Procurement Act will also be introduced to enhance fiscal governance and improve efficiency of public spending. The authority also took initiative to establish Debt Management Office to enhance debt management operation as well as intensify fiscal risk assessment.

The authorities are currently undertaking a rigorous expenditure optimization exercise with the emphasis to minimize fiscal leakages while at the same time ensure public programs and projects continue to support growth. Among the key priority measures to improve spending efficiencies are streamlining the structure and functions of ministries and agencies; ceasing of low priority programs and projects with low multiplier effect to the economy; and improving Government procurement policy through strengthening the procurement processes and implementing wider use of open tender. The Public Finance Committee has been established to monitor the progress and ensure effective implementation of these measures.

On the revenue enhancement, the Tax Reform Committee has been set up to carry out a comprehensive review of the Malaysian tax system including reviewing tax incentives and exploring new sources of sustainable revenue. The main task of the Committee is to narrow the tax gap and improve tax efficiency to increase tax buoyancy. The Committee is expected to provide its recommendations to the Government for its further consideration and onwards implementation.

Monetary policy

Our authorities welcome the staff's view that monetary policy should continue to be geared towards domestic stability and that the monetary policy framework has performed well. The Monetary Policy Committee (MPC) normalised the degree of monetary accommodation by raising the Overnight Policy Rate (OPR) by 25 basis point to 3.25 percent in January 2018. The OPR was maintained for the remainder of the year, as the MPC assessed that at the prevailing level of the OPR, the degree of monetary accommodativeness is consistent with the intended policy stance. The MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth and inflation.

Adjusting to external shocks

In 2018, similar to other emerging market economies, Malaysia experienced large non-resident portfolio outflows and exchange rate depreciation pressure, driven primarily by external developments. Ongoing external uncertainties suggest that this could potentially continue going into 2019. For a small and open economy with liberalised financial markets, external developments will continue to affect non-resident investment behaviour, and periods of heightened capital flows and exchange rate volatility are inevitable. If not appropriately managed, prolonged periods of exchange rate volatility could disrupt orderly financial market activity and eventually spill over to the real economy. A key consideration therefore is to ensure that levels of volatility are not excessive to preserve orderly market conditions, public confidence and overall financial stability.

Our authorities concur with staff on the importance of exchange rate flexibility and wish to reiterate that exchange rate flexibility remains a key policy in enhancing Malaysia's resilience to capital outflows and helping the economy adjust to external shocks. Foreign exchange market operations are limited to ensuring orderly market conditions particularly during periods of large and volatile capital flows. This is complemented by a sustained focus to enhance the depth and liquidity of the onshore market, and wider efforts to strengthen the underlying fundamentals of the Malaysian economy and financial system. Better hedging flexibilities ensure that domestic financial markets players are better equipped to manage currency risks.

International reserves of USD101.7 billion remain adequate, sufficient to finance 7.3 months of retained imports and 1.0 times short term external debt as at 15 January 2019. Beyond these headline numbers, the assessment of reserve level as a measure of external resilience should however, take into account the context within which reserves are held, in this case the high degree of reserves decentralisation, including liquid external assets held by the private sector. Domestic corporates and banks account for about three-quarters of Malaysia's external assets. Our authorities welcome staff's acknowledgment that sizable external assets held by private sector entities would allow banks and corporates to manage their own external liabilities. Potential claims on reserves to meet the external obligations are therefore assessed to remain limited as the large holdings of foreign currency external assets by resident entities can be drawn upon to meet their foreign currency external debt obligations.

Authorities concur that, Malaysia's external debt remains manageable. The external debt-to-GDP ratio has declined considerably from 70.3 percent in 1Q 2018 to 65.4 percent in 3Q 2018. Despite higher external debt-to-GDP ratio than peer median countries, a set of mitigating factors accord Malaysia with resilience against external shocks. First, about one third of external debt is denominated in ringgit, lowering the exposure to currency fluctuations. Second, three-quarters of the foreign-currency external debt is subject to Bank Negara Malaysia's prudential requirements and approval framework, ensuring credible repayment capacity of Malaysian borrowers. These include requirements on liquidity and funding risk management for banks' external debt (i.e. interbank borrowings, non-resident deposits and bonds and notes), while corporate external borrowings in the form of loans and bonds and notes are subject to an approval framework to ensure that they are supported by foreign currency earnings or sufficiently hedged. Third, intercompany loans which are mostly accounted by FDI companies are generally on flexible and concessionary terms, including no fixed repayment schedules and zero or much lower interest rates charged compared to the prevailing market interest rates.

Our authorities welcome the Fund's acknowledgement of the effectiveness of the December 2016 measures in reducing volatility in the onshore market. Prior to December 2016, the negative spillover impact from the offshore NDF market resulted in heightened USDMYR 1- month implied volatility of 12.0 percent, raising the risks of market dysfunction and financial instability. The volatility has since then moderated to an average of 4.6 percent along with other regional currencies (SGD, THB, IDR, PHP, CNY) at 5.5 percent. The spillover impact of the MYR NDF market has also remained contained as observed in the subdued daily volume of USD0.6 – 0.7 billion per day, from an average of USD2.9 billion in 2016 (High: USD6.9 billion). Ringgit has also traded in line with the performance and expectations of other regional currencies. Onshore foreign exchange trading volume has risen with better balance of demand and supply. The market recorded a healthy daily average foreign exchange transaction volume of USD10.6 billion since December 2016. Domestic liquidity also improved, as reflected in the narrowed USDMYR bid-ask spread while net inflows from resident trade contributed to a more balanced foreign currency supply and demand. The measures thus succeeded in providing stability to the onshore market.

Our authorities concur with staff's view that the December 2016 measures should be gradually reviewed in line with evolving market conditions. Our authorities have indeed been proactive, as evident in the recent enhancement to the export conversion measure in August 2018. Exporters are now allowed to automatically retain export proceeds with onshore banks to meet up to 6 months' foreign currency obligations without the need to first convert proceeds into ringgit. Our authorities wish to emphasise that the streamlining of investment abroad rules is prudential in nature and not distortive, as assessed by staff. The authorities continue to support productive investment abroad, as reflected in the high-level of approvals, while being mindful of the need to ensure safeguards are in place to prevent excessive build-up of corporate debt.

While our authorities remain committed to an open environment, the review of the December 2016 measures needs to be balanced with the risks that are being addressed. Subject to on-going assessment, these measures, which are prudential in nature, may be retained for an extended period of time as long as they are effective in managing the risks to the financial system and overall macroeconomic stability. When the intermediation capacity of the domestic market reaches a mature stage in terms of its ability to absorb and counter the effect of large and volatile capital flows, further relaxation or gradual phasing out of current rules can be considered. Therefore, staff needs to view the policies in place as part of a broader toolkit, alongside foreign exchange operations to ensure orderly market conditions. In this context, it would be helpful if staff could suggest policy alternatives to meet our objectives, rather than just advising the authorities to remove these measures.

Financial Sector

Our authorities welcome the staff's assessment that the Malaysian financial sector is resilient and that risks to financial stability remain broadly contained.

We are also encouraged by the staff's recognition of the efforts undertaken to enhance operational resilience and crisis preparedness of the domestic financial system. We wish to highlight that efforts are already ongoing to strengthen the resolution framework and related facilities, including contingent resolution funding facilities, to ensure alignment with the principles set out in the Financial Stability Board's Key Attributes for Effective Resolution Regimes.

While non-bank financial institutions (NBFIs) intermediate about 50 percent of financial system assets, contagion risks, as staff noted, from the activities of NBFIs remain contained. Most of the NBFIs are regulated by BNM, Securities Commission Malaysia, Malaysia Co-operative Societies Commission, or subjected to some form of oversight by government ministries. Institutional arrangements to support inter-agency cooperation are in place to facilitate information sharing across regulators and to enhance inter-agency responses and coordination. The surveillance of more systemic NBFIs by BNM is additionally supported by strengthened reporting frameworks applied to these NBFIs. The commitment by the new Malaysian Government to institutionalise greater transparency, governance and integrity across all NBFIs will also help promote the sustainability and long-term viability of these entities.

Businesses continue to maintain healthy debt servicing capacity and liquidity positions. This has supported the expansion in overall corporate debt, which grew in line with domestic economic expansion. The overall quality of business borrowings also remains high. While some sectors, such as the oil and gas and real estate sectors continue to face persistent headwinds, risks to domestic financial stability remain limited, with losses sufficiently provisioned by banks and the quality of borrowings remaining broadly stable. Bank exposures in these sectors (excluding end-financing for property) also remain small.

The authorities affirm that credit exposures to the household sector remained manageable. Debt servicing capacity of households continued to remain intact supported by healthy financial buffers with financial assets and liquid financial assets of 2.1 times and 1.4 times of debt, respectively. Asset quality remained sound with the ratio of aggregate impaired loans to total outstanding household debt for both banks and non-banks remaining low and stable.

While we note staff's assessment on the vulnerability of the vulnerable household group (individual borrowers with monthly earnings of below RM3,000), authorities view that potential risks to financial stability emanating from credit exposures to this group are mitigated given a declining proportion of exposures to this segment to 18.3 percent of total exposures of the banking system as at end-June 2018 (2013: 25.1 percent). Underwriting practices remain sound, with the bulk of new loans approved to the vulnerable segment with prudent debt service ratios of below 60 percent. The authorities agree that significant income, interest rate or cost of living shocks could affect the ability of some households to service their debt. However, internal simulations as published in the Financial Stability and Payment Systems Report 2017[1], suggest that under stressed scenarios, potential losses to the banking system from exposures to the household sector of between RM66 billion and RM104 billion will be manageable given the high excess capital buffers of banks (RM124.5 billion).

Our authorities continue to be vigilant against risks emanating from the property market. While mortgages account for a significant portion of household debt as highlighted by staff, risks to the banking system from a sharp deterioration in house prices are mitigated by prudent loan-to-value (LTV) measures observed by banks (generally below 80 percent), and low and reducing share of investment borrowers. Sensitivity analysis further indicate that banks have sufficient capital buffers to absorb potential losses arising from up to a 50 percent decline in property prices and its spillover to business sectors that are highly dependent on the performance of the property sector.

A comprehensive set of macroprudential and fiscal measures put in place since 2010 have effectively contained risks from household indebtedness and rising property prices. These demand management measures were also complemented by the authorities' efforts to increase the supply of affordable houses, which has also helped ease upward pressure on house prices. With these measures in place, credit risks from a more generalised downward correction in house prices are assessed to be low. As such, while the authorities take note of staff's recommendation to impose sector-wide standardised LTV limits on first and second properties in the medium term, they remain of the view that current macro-prudential measures continue to be

[1] As per the Box Article on page 39 entitled 'Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households'

sufficient. This is supported by existing regulatory and supervisory measures such as the differentiated capital charges for loans with higher LTV, and the review of provisioning practices of banks which also consider LTV levels as a risk driver for setting provisions. Banks' mortgage underwriting standards have also continued to strengthen as evidenced by vintage analysis for housing loans over recent years. While the authorities have not imposed a higher risk weight on the construction sector, BNM has introduced strengthened requirements on credit risk management in January 2018, which set out expectations of banks to conduct more robust assessments of financing proposals for new property development on construction prospects. Compliance with these expectations is reviewed through BNM's supervisory activities.

Finally, the authorities disagreed with staff's recommendation to phase out the differentiated RPGT and floor price for non-residents' purchase of properties, and view that the measures remain relevant to ensure that growth in house prices are reflective of domestic fundamentals. Recent data from 2017 and the first half of 2018 has indicated some resurgence in the growth of investment property purchases by non-residents. In this regard, these measures are still considered appropriate to manage risks arising from the build-up of financial imbalances in the property market, which could spill over to the domestic financial system.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continue to be a key priority for our authorities. In regard to efforts to support anti-corruption, our authorities have reduced the reporting threshold amount for Cash Threshold Reporting (CTR) from transactions amounting to RM50,000 (approximately USD12,000) and above, to RM25,000 and above in a day. These new measures were made based on the 2017 National Risk Assessment (NRA) and recent enforcement cases that found cash is still widely used by criminals to launder illegal proceeds. In addition, Malaysia continue to remain committed towards meeting its five-year National AML/CFT Strategic Plan objectives. As at 2018, 82 percent of the 74 action and sub-action plans have been reported as either completed or currently in progress within the stipulated timeline.

Reforms for sustainable and inclusive growth

The report of Mid-Term Review of the 11th Malaysia Plan (MTR 11MP), tabled and approved by the Parliament in October 2018, outlines the medium-term strategies and reform measures of the new government, with greater emphasis on strengthening the economy, public institutions and governance.

The MTR 11MP focuses on strengthening Malaysia's economic fundamentals, premised on innovation, creativity and improving productivity, in line with the aspiration to become a developed and inclusive nation. Focus will be on strengthening sectoral growth - particularly services and manufacturing sectors - and promoting private investment, while efforts to accelerate improvement in education and human capital development will continue to be prioritised to increase productivity. The transformation of the education system will emphasise quality, equity, access, unity, efficiency and inclusivity of education. Enhancing science, technology, engineering and mathematics education, and higher order thinking skills will be the focus for basic education. Meanwhile, governance of Institutions of Higher Education and stronger industry-academia linkages will be further enhanced to improve the quality of graduates. In addition, existing programmes of Technical and Vocational Education will be continuously reviewed in collaboration with industry players to meet industry demand. Further efforts will also be taken to improve the business climate through enhancing the delivery of public services, reducing bureaucratic red tape and provision of quality infrastructure. In particular, the adoption of Good Regulatory Practices will be intensified to improve the processes and procedures in increasing productivity and competitiveness, and will be expanded to the sub-national or state level.

To ensure sustained and better enforcement of prudent public finance management, a comprehensive reform on fiscal and public finance management framework will also be implemented. Strategies to be implemented include improving the budgeting system, enhancing procurement management as well as strengthening performance management, monitoring and evaluation framework. The implementation of the accrual accounting system will also be expedited to further enhance transparency and full disclosure of government's assets and liabilities. In addition, the Fiscal Responsibility Act (FRA) and Government Procurement Act will be introduced to enhance fiscal governance and improve efficiency of public spending. The authority also took initiative to establish the Debt Management Office to enhance debt management operations as well as intensify fiscal risk assessment.

Reform initiatives are also being undertaken to improve governance and strengthen public institutions. Among the key priorities is to strengthen the check and balance mechanism at all levels. For instance, the MTR 11MP outlines the commitment to establish a select committee in Parliament. To ensure operational independence of the institutions, the select committee will endorse the appointment of key positions, among others including in the Malaysia Anti-Corruption Commission (MACC), Election Commission (EC), National Audit Department and Judicial Appointments Commission. In addition, the MACC and EC will also be made answerable directly to Parliament. The Government is also committed to execute efforts in fighting corruption effectively and efficiently at all levels. In this regard, the MACC will be transformed into a fully independent body. Furthermore, the anti-corruption legislation such as the MACC Act, Witness Protection Act and the Whistleblower Protection Act will be continuously reviewed and strengthened to ensure its relevance with current development. The Government has also launched the National Anti-Corruption Plan (NACP) 2019-2023 that covers 6 strategies, including increasing the efficiency and transparency in public procurement, institutionalize the credibility of law enforcement agencies and inculcate good governance in corporate entities.

Concluding Remark

Malaysia’s diversified economy, sound fundamentals and strong financial system have considerably strengthened the economy’s resilience to withstand shocks. A robust policy framework, underpinned by a pre-emptive and pragmatic policy approach have also minimised risks and vulnerabilities. As the external economic and financial conditions evolve, our authorities remain vigilant to adverse developments and potential risks to the Malaysian economy and financial system. In the event of adverse shocks, our authorities have adequate policy buffers to respond in a timely and effective manner to preserve macroeconomic and financial stability, and achieve sustainable and inclusive growth.

Looking ahead, the challenging global environment also necessitates the Fund, as the multilateral institution responsible to safeguard the global financial system, to play greater role in reducing the risks from disruptive cross-border spillovers that can be detrimental to member economies, including Malaysia.

Mr. Johnston and Mr. Shin submitted the following statement:

We thank staff for their well-written reports on Malaysia and Mr. Agung and Mr. Shaari for their very comprehensive buff statement. The Malaysian economy has continued to perform strongly and shown resilience even in tight global financial conditions. There has been a smooth political transition and the new administration's reform efforts are commendable. We generally agree with the staff assessment and have the following comments for emphasis and clarification.

The gradual fiscal consolidation path needs to be affirmed with an emphasis on revenue measures. We welcome the steps taken by the new government to increase transparency over the fiscal accounts, recognizing additional tax refund obligations and bringing on previously off-budget spending into the budget. Given the low level and declining trend of revenue-to-GDP (from 19.9 percent in 2014 to 15.0 percent in 2020), revenue mobilization, especially through broadening the tax base, appears to be a reasonable path to create fiscal space for much-needed social and development spending. In this regard, we welcome the comprehensive review of tax system by a high-level Tax Reform Committee and encourage the authorities to introduce additional measures to boost revenue. How does projected revenue from the sales tax compared to that from GST, and why did the authorities make this change?

Careful monitoring of, and preparedness for, capital flow volatility is warranted. Large capital outflows of non-resident portfolio investment during the second quarter of 2018, mostly driven by emerging market risk-off sentiment, showed the vulnerability of the FX market to external shocks. While agreeing that a flexible exchange rate and macroeconomic policy adjustments should be the first line of defense, we also note that decisive actions need to be employed to counter disorderly market conditions. We therefore support the staff's view that further reserve accumulation would be appropriate. In addition, the current account is closely linked to capital flows and its surplus was one of most important factors that reassured foreign investors during the market sell-off, as staff noted. Hence, we share the Malaysian authorities' concerns over the external balance assessment. In modeling the current account and external imbalances, more specific factors such as capital flow volatility and susceptibility to market disruption need to be reflected further. We also agree with the authorities that the 2016 FX market prudential measures have helped limit speculative activities and deepen onshore markets. The cost of possible distortions from these measures, if any, should be weighed against the cost of market disruptions or an FX liquidity crisis. On what basis and in what channels do staff see those measures creating distortions?

We commend the authorities' efforts to raise productivity and inclusive development, including through education and technical training, and by accelerating innovation. We also urge the authorities to further improve the business climate to generate quality jobs, and to enhance job training and matching to address skill mismatches including through active labor market policies (ALMP). We welcome the important initiatives they are undertaking to improve governance and public institutions, including by strengthening the independence of the Malaysian Anti-Corruption Commission.

Ms. Levonian, Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their useful set of papers and Messrs. Agung and Shaari for their helpful buff statement.

We commend the Malaysian authorities for their record of strong macroeconomic management over many years. This has helped Malaysia weather many shocks and achieve significant economic and social gains. However, as staff notes, the economy is facing growing risks, mainly from external sources. In this regard, advancing economic and social progress, including to achieve Malaysia's goal of advanced economy status, will require the continued implementation of credible economic policies and structural reforms. As we broadly concur with staff's overall assessment and advice, we offer the following additional comments for emphasis.

We take positive note that staff and the authorities are in broad agreement on the need for fiscal consolidation to build fiscal buffers, put debt on a clear downward path, and shore up market confidence. We welcome the authorities' clear commitment in this regard through the announcement of their medium-term fiscal consolidation plan in the 2019 budget. In this regard, we encourage the authorities to implement measures to strengthen domestic revenue mobilization and rationalize spending in line with staff's advice. Moreover, we welcome the authorities' commitment to strengthen the fiscal framework, including through improving transparency of the fiscal accounts and the planned enactment of fiscal responsibility legislation.

We urge continued constructive engagement between staff and the authorities on efforts to develop Malaysia's onshore FX market. As we have noted previously, we agree that the flexible exchange rate and macroeconomic adjustments should be the first line of defense against capital flow shocks, and as such, the existing capital flow measures (CFMs) should be phased out in a manner that preserves financial stability.

We encourage steadfast implementation of structural reforms to further support sustainable and inclusive growth. In this regard, we welcome the

Mid-Term Review of the 11th Malaysia Plan, which was tabled in Parliament last October. We are pleased that it reiterates the authorities' commitment to implement reforms to strengthen the economy, public institutions, and governance. We note positively that the specific reforms will target, inter alia, improvements in education and the faster adoption of innovation and technology.

Finally, close monitoring of financial sector risks and further advancing governance reforms should bolster financial sector stability. While we note that the financial sector has remained robust, household debt and the real estate market are potential sources of risks and should be closely monitored. We also encourage the authorities to continue to make further progress in strengthening governance and anti-corruption institutions, including to improve SOEs oversight and enhance the effectiveness of the AML/CFT frameworks.

Mr. Rashkovan and Mr. Josic submitted the following statement:

We thank Messrs. Agung and Shaari for their useful buff statement and staff for their comprehensive set of reports. We welcome staff's views that Malaysia continues to enjoy robust economic growth, largely owing to the appropriate policy mix of previous years. However, considering the fiscal risks stemming from higher public debt -particularly contingent liabilities- as well as a wide range of risks stemming from the external environment, the current momentum provides a great opportunity to continue with implementing the ambitious set of reforms. This would raise medium-term growth and speed up convergence of income levels in line with those of advanced economies. We broadly share the staff's appraisal and would like to offer the following comments for emphasis.

Gradual fiscal consolidation remains an imperative. We take positive note that the general government debt was stable, hovering around 56 percent of GDP during the last five years. However, considering the persisting fiscal deficits and estimated contingent liabilities of around 31 percent of GDP (guarantees and PPP-related possible future payment obligations), fiscal risks to public debt remain tilted upwards, which could constrain fiscal space in the future. In this context, we find the authorities' commitment to medium-term fiscal consolidation trough improving expenditure efficiency and strengthening the medium-term fiscal framework reassuring, as emphasized by Messrs. Agung and Shaari. On the revenue mobilization, we note that the tax-to-GDP ratio was significantly below the OECD average, but at the same time slightly above neighboring countries, like Singapore and Indonesia (based on OECD 2016 data). Could staff comment on the effect of the recommendation to reduce investment incentives in CIT and the overall increase in revenues on regional competitiveness.

On the external sector assessment, we note a continuing disagreement between staff and the authorities' assessment. We welcome the fact that the authorities see the recent methodological refinements to staff's external balance assessment as an improvement. However, disagreements remain. In this vein, it would be helpful if staff could provide more information why this year's assessment of the CA gap (2.2 percent of GDP) is fully explained by unidentified residuals, compared to last year's assessment when less than half of the gap (total of 2.6 percent of GDP) was explained by the residual, and a larger part was due to identified policy gaps.

We share staff's view that further efforts are needed to improve the fiscal governance and the overall anti-corruption framework. In this vein, adopting a fiscal risks management framework and publication of an annual fiscal risks statement could be a step forward. In addition, the recent corruption case points to the urgent need to improve the system of control of corruption and the strength of anti-corruption institutions. Against this background, we commend the authorities for recently adopting a five-year plan to fight corruption. This will be particularly important from the perspective of public finance, but also to boost investors' confidence.

FinTech developments in Malaysia deserve more attention. Staff rightly assigns a medium likelihood of realization as well as a medium to high expected impact of risks associated with cyber attacks. At the same time, no attention or analytical coverage has been dedicated to this topic or FinTech in general. In this vein, the PwC report from 2016 highlighted that 82 percent of Malaysian financial institutions see FinTech as a threat to their business, while 22 percent believe they could lose more than 20 percent of their revenues. Against this background, and considering that the Board has recently adopted the Bali FinTech agenda which among other issues, outlines more frequent coverage of FinTech issues in surveillance, we would like to ask staff whether they plan to cover these topics in the next consultation?

Mr. Saito, Mr. Ozaki and Mr. Naruse submitted the following statement:

We thank staff for their comprehensive reports and Mr. Agung and Mr. Shaari for their informative statement. It is encouraging that the economy continued to show resilience amid a political transition. Also, we positively note that growth is expected to stabilize in 2019 and over the medium term, supported by private consumption and investment. Having said that, the authorities need to continue their efforts to address policy gaps. We encourage the authorities to proceed fiscal consolidation, safeguard financial stability, and achieve sustainable growth. Since we agree with the thrust of the staff's appraisal, we will limit our comments as follows:

Fiscal Policy

We encourage the authorities to continue advancing revenue mobilization and expenditure rationalization to create space for additional social and development spending. On the revenue side, we note the revenue shortfall from replacing the GST with the SST due to a smaller tax base. In this context, we welcome the establishment of the Tax Reform Committee, tasked to carry out a comprehensive review of the Malaysian tax system, including tax incentives and possible new sources of sustainable revenues. Also, we expect the successful implementation of the SST. On the spending side, we commend the authorities' efforts to rationalize spending, including through the improvements in targeting social assistance and subsidies. In this regard, the Public Finance Committee should play a key role. We believe that the improvements in targeting social assistance and subsidies would also help reduce external imbalances by removing uncertainties over the future and reducing precautionary savings. Furthermore, we positively note the authorities' medium-term commitment to reducing the deficit to 2 percent of GDP. We are encouraged by the staff's analysis that this would put debt on a downward trajectory and would provide comfortable buffers. Lastly, we urge the authorities to closely monitor potential risks to public debt emanating from federal government guarantees and possible future payment obligations related to PPPs projects.

Monetary, Exchange Rate, and Financial Markets Policy

We agree with the staff's view that the broadly neutral monetary policy stance is appropriate given close-to-potential growth, underlying inflation expected to remain contained in the absence of strong demand pressures, still-supportive albeit gradually tightening financial conditions, and the real policy rate within the natural rate band. We encourage the authorities to monitor closely risks surrounding the outlook for growth and inflation and adjust the monetary policy stance if needed.

Regarding the 2016 FX measures, we note the divergence of views between staff and the authorities. While the authorities emphasize that these measures, which are prudential in nature, may be retained for an extended period of time as long as they are effective in managing the risks to the financial system and overall macroeconomic stability in their buff statement, staff say that these measures can be distortive, potentially leading to resource misallocation, and therefore may not support market development. Do staff see any evidence of resource misallocation? Furthermore, the authorities justify these measures because they helped reinforce Malaysia's long-standing policy on the non-internationalization of the ringgit. How do staff assess this long-standing policy in light of the IMF's Institutional View on capital flows? And what kind of policy measures do staff recommend deepening the onshore financial market and reduce the volatility without using the CFMs, especially in a country where the intermediation capacity of the domestic market is still at a developing stage in terms of its ability to absorb and counter the effect of large and volatile capital flows?

Financial Sector Policy

We welcome the fact that the financial sector appears resilient, but we encourage the authorities to closely monitor household debt and the real estate market. It is encouraging that banks are well-capitalized and liquid. Also, we are pleased to see that loan quality is strong, and that provisions are sizable. However, we note that the banking system's reliance on short-term external debt, as a share of GDP, increased in 2018. How do staff assess the liquidity risk of foreign currency for banks, considering BNM's prudential requirements and approval framework, including the requirements on liquidity and funding risk management for banks' external debt? Also, we are concerned that household debt remains at a high level compared to regional peers. In addition, we take note of the staff's assessment that the real estate sector represents a vulnerability. In this light, we welcome the authorities' ongoing efforts to enhance operational resilience and crisis preparedness.

Structural Reform

We encourage the authorities to continue advancing structural reforms to raise productivity and inclusive development. We are pleased to see that the new government has launched multiple initiatives, such as the establishment of the National Centre for Governance, Integrity and Anti-Corruption, to address governance weaknesses and corruption. On the other hand, we note with concern that Malaysia's total factor productivity growth slowed recently. So, we agree with the need for the policies to help lift productivity growth with a focus on improving education and encouraging innovation, technology adoption, and a move up the value chain. We also concur with the staff's view that the authorities should raise the quality of human capital, by improving the quality of teachers and design of curricula and by expanding vocational and technical training to address skills mismatches. Could staff comment on the sequence of the policies to help lift productivity growth and to raise the quality of human capital?

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the report and Mr. Agung and Mr. Shaari for their informative BUFF statement. We broadly share staff's appraisal and agree that in the current favorable environment with downside risks, policies should aim at achieving fiscal consolidation while protecting growth and supporting financial stability. We offer the following remarks on fiscal policy, monetary policy, governance, and structural adjustment.

We commend the authorities for anchoring fiscal policy by their commitment to keep the total government debt below a limit and for planning to reduce the fiscal deficit over the medium term. With debt estimated at almost 52 percent of GDP by end-2018, we note that the limit of 55 percent could be breached if downside risks materialize. In addition, staff's analysis indicates that the budget has increased its dependence on oil-related revenues which are vulnerable to oil price fluctuations. Hence, we agree that Malaysia's fiscal space could be at risk absent fiscal consolidation, and therefore welcome efforts to reduce fiscal deficits in coming years. We note that domestic tax revenues are low compared to other countries while at the same time there is a need to raise spending to meet social and development objectives. By prioritizing domestic revenue mobilization, the medium fiscal deficit target can be met without reducing non-interest expenditure in percent of GDP. We thus encourage the authorities to prioritize revenue mobilization.

We concur with the assessment that the monetary policy stance is appropriate. The output gap is approximately closed and according to staff's analysis inflationary pressures are limited. We take note of Chart 9 showing that the real interest rate has increased over the past year amid low and reduced inflation. The somewhat higher real interest rate means that the central bank has some room to maneuver should the downside risks to growth emanate. Although we recognize that an open economy like Malaysia is exposed to volatile capital flows and developments in international financial markets, we agree that the authorities should consider gradually phasing out the December 2016 FX market measures, with careful regard to market conditions.

We agree with staff's view that considerations should be given to gradually phasing out residency-based differentiation measures in the property market as systemic risks dissipate. While the financial sector appears resilient, the real estate market requires close monitoring. Authorities introduced two measures in 2014 to cool down the property market – an increase in the real property gains tax on property disposals by non-citizens and a floor price for property purchases by non-citizens. Should the activity in certain segments again threaten financial stability, the authorities may consider macroprudential measures that target the specific segments, without a differentiated treatment of non-residents.

We encourage the authorities to continue strengthening anti-corruption measures. We note that indicators suggest Malaysia performs worse than many other countries both in terms of control of corruption and strength of procurement systems. Hence, we welcome the launch of multiple initiatives to address governance weaknesses and corruption by the new government. Going forward, it is imperative that the extensive set of governance reforms – such as ensuring the independence of the MACC – will be anchored in legislation. If the authorities continue strengthening AML/CFT measures, this will probably also serve to mitigate risks from corruption.

We welcome the authorities' structural reform agenda, which aims to help reach a more inclusive economic development. Investing in human capital, increasing female labor force participation and productivity is essential. Obviously, raising female employment is key to improving inclusive growth in Malaysia. We note that these topics have also been part of IMF's advice in previous Article IV consultations with Malaysia. Could staff elaborate on the developments in female labor participation and other measures meant to enhance inclusive growth?

Mr. Inderbinen, Mr. Merk, Mr. Buetzer and Ms. Wehrle submitted the following joint statement:

We thank staff for an insightful report and Messrs. Agung and Shaari for their comprehensive buff statement. Malaysia has shown noteworthy resilience to recent pressures on emerging market economies against the backdrop of a smooth political transition. Further progress was made on a wide array of economic outcomes such as sustainable growth rates, firming labor markets, low inflationary pressure and a financial sector so far withstanding stress. At the same time, fiscal consolidation efforts remain incomplete and the budget's increasing dependence on oil-related revenues is a matter for concern. Structural policy challenges, in particular in the area of governance and combatting corruption, continue to impede private sector activity. Additionally, external risks weigh on the short- to medium-term outlook. Against this backdrop, policy priorities should focus on promoting private sector-led growth, strengthening anti-corruption institutions, and safeguarding fiscal sustainability.

We are generally pleased by the authorities' reaffirmed commitment to medium-term fiscal consolidation. We welcome the ongoing work on a Fiscal Responsibility Act that could help strengthen the medium-term fiscal framework and better ensure medium-term fiscal sustainability. At the same time, we would advocate more ambitious and front-loaded efforts in building buffers, not least in view of the risk of breaching federal debt thresholds. While consolidation efforts should aim for adequate expenditure rationalization, we encourage the authorities to explore avenues for broader revenue collection. This is all the more important given the reliance on inherently volatile oil revenues that could unduly constrain fiscal policy in periods of unfavorable market conditions.

We welcome the increased transparency of fiscal accounts. Comprehensively and reliably disclosing all fiscal accounts is instrumental in improving public financial management as well as accountability. A more transparent approach will help in monitoring the risks emanating from contingent liabilities and in applying prudence in incurring new ones. This is particularly relevant as guarantees granted by the government seem to be sizeable and could, if underlying risks materialize and the public sector is forced to assume them, place a significant burden on fiscal sustainability. We would have appreciated a deeper analysis and recommendations in the staff report regarding the share of proceeds from the oil and gas sector in the overall budget over time, which has fluctuated substantially (cf. Fig. 5), and how these are incorporated in the fiscal projections.

We take positive note of the authorities' structural reform agenda and emphasize that dedicated implementation is key. The priorities laid down appear suitable for a country at Malaysia's level of economic development with the ambition to climb up in the value chain. To this end, the strategy adequately focuses on raising the efficiency and governance of SOEs, anti-corruption measures, and creating an enabling environment for innovation. We acknowledge that Malaysia has prospered over the last decades in part thanks to its remarkable performance in integrating itself more closely into the global economy. Against this backdrop – and keeping in mind the uncertainties stemming from rising trade tensions – we encourage the authorities to promote trade integration further.

We support staff's calls to prioritize improving human capital development and increasing female labor force participation. Could staff give an assessment of the expected impact that the planned update of the foreign worker policy will have on labor supply (para 39)?

While staff's favorable assessment of financial sector stability is reassuring, we call on the authorities to exercise vigilance towards the relatively elevated level of household debt. In this context, we agree with staff on the need to phase out residency-based measures in the real estate markets and encourage the authorities to lift them in due time. For one, housing price pressures seem to have been muted recently, thus reducing the urgency for corrective action. Moreover, there seem to be alternative (macroprudential) instruments available that would be suitable to the same aim of safeguarding financial stability without the need to differentiate between residents and non-residents. We also join staff's call for continued efforts to strengthen the AML/CFT framework as well as asset declarations. Could staff give some additional information on the proposed study by the Companies Commission of Malaysia on beneficial ownership requirement (e.g. specific aims, composition, timeframe) and how its findings are planned to be fed into the political process (para 31)?

We concur with staff and the authorities that exchange rate flexibility should continue to be the first principal instrument for external shock absorption. We take comfort in the outcome of external debt stress tests that overall do not point to immediate stability concerns. We take note of staff's assessment of foreign exchange market considerations that point to overall functioning onshore FX markets but encompass distortionary features. Accordingly, we support staff's call for a gradual phase-out of such measures, undertaken with due regard to market conditions.

We call for caution in reading results of the EBA model. We reiterate that EBA estimates should not be used in a mechanical way. A closer analysis of country-specific factors and the use of judgement are necessary, especially given the weak fit of the CA regression model.

Finally, we encourage the authorities to consent to the publication of the report.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the informative papers and Messrs. Agung and Shaari for the helpful buff statement. Malaysia's solid economic performance puts the country in a good position to take on some of the medium-term challenges related to governance, anti-corruption and structural reforms set forth in the staff paper. We broadly concur with the staff assessment and would like to underscore several points.

Fiscal

We welcome the authorities' efforts to make fiscal data more comprehensive and to undertake gradual fiscal consolidation to strengthen fiscal space for the future. Bringing off-budget expenditures into the budget, and taking better account of contingent liabilities including from PPPs will strengthen Malaysia's fiscal and debt management. Can staff comment on advice they are providing regarding coverage of contingent liabilities in fiscal and debt data, and whether transparency will be reinforced in the Fiscal Responsibility Act? We note staff's finding of "fiscal space at risk" and note that recent actions such as narrowing the tax base via the SST and reintroduction of fuel subsidies limit the government's fiscal room for maneuver. We encourage the government and the newly constituted Tax Reform Committee to consider growth-friendly, base-broadening measures, in line with staff advice.

External Sector

We welcome the narrowing of Malaysia's current account surplus and greater reliance on domestic demand, though the external position remains stronger than fundamentals and desirable policies. We encourage Malaysia to take up staff advice on strengthening social protection and public healthcare, to reduce precautionary savings, and labor market reforms including to boost female labor force participation. Exchange rate flexibility, underpinned by strong fundamentals, should continue to serve as a first line of defense to absorb shocks. We found the in-depth and candid analysis in the appendix on Foreign Exchange Market Considerations to be very helpful. We welcome the authorities' efforts to deepen onshore foreign exchange markets and ease some of the restrictions on capital movements, including the liberalization of dynamic hedging. We encourage the authorities to follow staff advice to phase out FX regulatory measures that hamper market development, as well as residency-based property sector CFM/MPMs as risks dissipate.

Governance and Anti-Corruption

We welcome the authorities' commitment to enhancing governance and combating corruption at all levels, not only in public financial management but also more broadly in administration, legislation and the judicial system. The appendix on Fiscal Governance and Anti-Corruption provides helpful perspectives on Malaysia's governance challenges. We encourage the authorities to tackle areas such as infrastructure management/procurement and budget transparency where comparison to peers shows ample room for improvement.

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the comprehensive report, and Messrs. Agung and Shaari for their informative buff statement. While Malaysia's growth remains high and robust, and the near-term prospects are favorable, downside risks stemming from the high fiscal deficit, contingent liabilities, low productivity, and structural impediments weigh on medium-term growth. We encourage the authorities to continue with the planned fiscal consolidation, maintain exchange rate flexibility, and strengthen financial sector stability, while improving productivity and enhancing governance. In this context, we very much welcome the authorities' initiatives to address governance weaknesses and corruption and look forward to the prompt implementation of the governance initiatives. We share the thrust of staff's appraisals and advice and would like to provide the following comments for emphasis.

A gradual and well-paced revenue-based fiscal consolidation is essential to put debt on a firm, downward trajectory. We note that the 2019 budget law is underpinned by a modest fiscal consolidation and budgets for the full clearance of tax refund arrears, while enhancing the analysis of fiscal risks and liabilities. Given that the tax-to-GDP ratio in Malaysia is at 13.1 percent and below its peers, the re-introduction of the Sales and Services Tax (SST) in September, with a smaller tax base than the Goods and Service Tax (GST), has created a revenue shortfall and does not bode well with the authorities' intentions to raise revenue, instead increasing the reliance on oil revenues. Staff's comments regarding the rationale behind replacing the GST with the SST are welcome. Against this backdrop and given that the fiscal deficit remains elevated and public debt is high, embarking on a credible medium-term fiscal consolidation path is essential. We encourage the authorities to consider implementing, drawing on staff's recommendations, concrete revenue measures aimed at broadening the tax base, containing the wage bill, as well as rationalizing tax incentives and non-essential expenditures with the focus on subsides and transfers. At the same time, the prompt conclusion of the ongoing comprehensive review of the Malaysian Tax System would be helpful in this regard.

The fiscal framework should be strengthened to reduce fiscal risks and increase fiscal transparency. We welcome the authorities' plans to introduce a Fiscal Responsibility Act which should clearly stipulate fiscal objectives and the fiscal anchor to bolster the framework. In this context, we concur with staff's suggestion that the adoption of an expenditure rule could be considered to help prevent procyclical fiscal policy. Considering that federal government guarantees are at 18 percent of GDP and the possible future payment obligations related to public-private partnership projects are estimated at 13 percent of GDP, posing a significant risk to public debt, we call on the authorities to monitor, manage, and further integrate contingent liabilities into the debt management strategy, building on the steps taken in the context of the 2019 budget.

Exchange rate flexibility should continue to serve as a key absorber of external shocks. We concur that the monetary policy stance remains appropriate and that it should be calibrated to support growth while containing financial risks. In view of Malaysia's vulnerability to capital flow volatility, maintaining exchange rate flexibility is critical to aiding external adjustments and protecting the reserves. We appreciate the authorities' efforts aimed at developing the onshore FX market, but note that the FX measures which are classified as capital flow measures should be phased out as they are costly and are creating distortions in the market.

Risks emanating from the housing market and high household debt should be closely monitored. We take comfort in staff's assessment that the banking sector is well-capitalized, liquid, and profitable. Nonetheless, household leverage is high and mortgages represent 60 percent of the total household debt. Given banks' sizable exposure to mortgage lending and to the construction industry, a real estate market price correction could have a considerable impact on growth and financial stability. The careful monitoring of the risks associated with the housing market is therefore critical. In this vein, should housing price increases remerge, the authorities should consider introducing further macroprudential measures that target the specific segments, without a differentiated treatment of non-residents. We underscore the importance of strengthening the AML/CFT framework, specifically related to high-risk, politically exposed persons. Staff's comments on the authorities' action plan to address weaknesses in the AML/CFT framework are welcome.

The authorities' focus on tackling governance issues and bolstering the anti-corruption frameworks bodes well with their objective of improving transparency and public service efficiency. We welcome that the Midterm Review of the Eleventh Malaysia Plan has reoriented government priorities towards improving transparency and public service efficiency, while launching multiple initiatives to improve the governance framework. Nonetheless, the governance reform agenda will require legislative changes and test the new government's commitment and resolve in addressing governance issues, including on procurement, state-owned enterprises' legal framework, and reinforcing anti-corruption institutions. At the same time, reaching high-income status and broad-based growth will entail concerted efforts concentrated on enhancing the low productivity; further improving the business environment; enhancing education outcomes; and reducing the skills mismatch, including by expanding vocational training.

Mr. Di Tata and Mr. Morales submitted the following statement:

We thank staff for the informative and well-written reports and Mr. Agung and Mr. Shaari for their comprehensive buff statement.

Malaysia's economy continues to perform well, following a political transition that led to the first ruling party change since independence. Real GDP growth decelerated last year, reflecting in part the winding down of large public investment projects and delays in private investment in the face of a temporary spike in political uncertainty. The economic outlook, however, looks positive, with growth projected to pick up supported by strong domestic demand, rising electronics exports, and a gradual recovery in commodity output with positive spillovers on manufacturing and trade, as highlighted by Mr. Agung and Mr. Shaari.

We welcome the authorities' intention to return to the path of gradual fiscal consolidation and agree with staff that such commitment would have a positive impact on market confidence. The 2019 budget envisages a reduction of the federal government deficit to 3.4 percent of GDP, from 3.7 percent in 2018, owing in part to higher non-tax revenue, notwithstanding large one-off tax refunds and the incorporation into the budget of off-budget spending items, in line with efforts to improve fiscal transparency. Could staff comment on the motivation behind the decision taken last June to replace the Goods and Services Tax (GST) with the Sales and Services Tax (SST) and to what extent this decision could complicate the fiscal consolidation efforts? To offset this revenue shortfall, we encourage the authorities to promptly implement the revenue measures announced in the 2019 budget, including the increases in excise taxes, the real property gains tax, and the stamp duty on properties. Regarding expenditure, the re-introduction of some petroleum subsidies implemented last year could be reconsidered. We would also appreciate staff's comments on how to better target social assistance and subsidies to save 2.1 percent of GDP (paragraph 12).

Anchoring medium-term fiscal policy to the commitment to keep federal government debt below 55 percent of GDP would help contain the possible impact of prospective fiscal risks. Given Malaysia's relatively low tax revenue (equivalent to 13.1 percent of GDP in 2017), it would be important that the envisaged comprehensive review of the Malaysian tax system by a high-level Tax Reform Committee identify concrete measures to expand the sources of sustainable revenue. Regarding expenditure, we commend the authorities for the adoption of zero-budgeting and agree with staff that a prioritization of expenditures in line with the government's medium-term plan is needed to ensure sufficient resources for additional social and developing spending. The recently established Public Finance Committee should ensure that public finance management practices meet high standards, contributing to an improved quality of expenditure. Moreover, the introduction of the Government Procurement Act, the Fiscal Responsibility Act, and a comprehensive analysis of fiscal risks would help identify and contain the vulnerabilities associated with Malaysia's high level of contingent liabilities (18 percent of GDP in federal government guarantees and 13 percent in PPP-related contingent liabilities).

The central bank has appropriately maintained a neutral policy stance by keeping the real policy rate within the natural rate range. Inflation is expected to return to the 2-3 percent range after full dissipation of the negative inflation shocks arising from tax regime changes and suspension of a domestic fuel price adjustment in 2018. We welcome the authorities' commitment to exchange rate flexibility as the main line of defense against external shocks, which is reiterated by Mr. Agung and Mr. Shari in their buff statement. We also commend the authorities for having successfully managed volatility during the political transition by containing the impact of capital outflows on the exchange rate and domestic yields. Looking ahead, given Malaysia's sizable reserve buffers, the high acceptance of ringgit-denominated liabilities, and the smooth debt profile, consideration may be given to phasing out restrictions on foreign exchange financial operations, if market conditions are favorable.

We commend the authorities for the strong financial oversight framework and for having addressed the main gaps identified by the 2012

FSAP, namely on licensing standards, information sharing with foreign supervisors, and insurance supervision. We welcome the authorities' intention to continue enhancing financial institutions' resilience and crisis preparedness, including the efforts under way to strengthen bank resolution while gradually firming up the macroprudential framework. Given the risks related to the housing market, it would be prudent to assess the impact of the macroprudential tools adopted in similar circumstances in peer countries, which may help enhance the monitoring capabilities of supervisory authorities. Could staff indicate what tools are commonly used in comparable jurisdictions? How widespread is the use of standard LTV requirements and debt-service-to-income ratios?

We welcome the ambitious structural reform agenda laid out in the Mid-Term Review of the Eleventh Malaysia Plan. Prompt implementation of measures to encourage investment in human capital and increase productivity would translate into greater confidence and an improved business environment. Rebalancing growth would require sustained productivity gains through improvements in education, innovation, faster adoption of technology upgrades, and efforts to move up the value chain. These measures would help the economy to be better prepared in the event of a tightening of global conditions and a continuation of trade tensions, which could have a potential adverse impact on capital flows, oil prices, and growth for Malaysia.

We encourage the authorities to move ahead with reforms to the legal framework for governance, especially to ensure the independence of anti-corruption institutions. We appreciate the steps toward a stronger governance framework and increased transparency in fiscal reporting pointed out by Mr. Agung and Mr. Shaari, including the establishment of the National Centre for Governance, Integrity and Anti-Corruption (GIACC), and the anti-corruption plan launched in late January 2019. These efforts should be complemented by improving procurement and public service delivery processes and implementing pending AML/CFT measures to enhance due diligence procedures by banks and the accountability of high-public officials.

With these comments, we wish the authorities and people of Malaysia success in their endeavors.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for the informative report and Messrs. Agung and Shaari for their candid buff statement. We encourage the new authorities to build on the favorable economic momentum and to focus on prudent policy management and strengthening the quality of the institutions. Moreover, tackling structural weaknesses, including by appropriate policies to achieve a reduction of external imbalances, is essential to enhance resilience to external shocks. We broadly concur with the thrust of staff's appraisal and limit our comments to the following.

The measures classified by staff as capital flow management measures continue to remain in place. We welcome the thorough analysis made by staff on the consequences of these measures on the foreign exchange market. They appear to have achieved the intended goals of deepening on onshore foreign exchange market, reducing volatility and curtailing "speculative" trading in the offshore market; they have also been generally well received by onshore market players. However, the report cautions on the potential distortions from some of these measures. Overall, we continue to think that the same goals can be attained by using alternative and less distortive policy options, more respectful of the Fund's institutional view. The recent relaxation of the conversion requirements is an encouraging signal in this direction and we would encourage further engagement between staff and the authorities to achieve progress on this issue.

In an overall sound financial sector, some specific source of vulnerabilities deserves particular attention. The authorities should remain vigilant in monitoring risks related to household debt and from banks' exposure to the housing market, especially in regard of risks stemming from vulnerable households. This prudent approach is compatible with a gradual phasing out of the residency-based measures in real estate and their replacement with non-discriminatory macroprudential measures, such as introducing sector-wide LTVs and debt-service-to-income limits.

We take note of staff's assessment that, absent fiscal consolidation, Malaysia's fiscal space is at risk. The progress already reached in increasing fiscal transparency is encouraging and we see very favorably the ambitious reform plan envisaged to strengthening fiscal governance and transparency. The gradual medium-term consolidation path seeks to preserve debt sustainability and will help to free resources to invest in areas, like social security, that are also important for external rebalancing. The adjustment should rely primarily on the broadening of the tax base, allowing to reduce the dependence from oil revenues. The replacement of the GST with a SST goes regrettably in the opposite direction. Therefore, we encourage the authorities to consider the implementation of the fiscal measures suggested by staff in order to ensure the quality of the adjustment. Staff information on the extent of potential revenue gains from narrowing the compliance gap would be welcome.

The actions taken for strengthening governance weaknesses are steps in the right direction. Improving the efficiency of public services is essential to reduce corruption. The implementation of the reforms aimed to guarantee the independence of the Anti-Corruption mechanisms is key in this respect. We welcome the existing agreement on the need to strengthening the effectiveness and the coverage of the AML/CFT framework. The new lower limit on the use of cash is a good signal in this direction.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the well- prepared reports and Mr. Agung and Mr. Shaari for their candid buff statement.

The Malaysian economy has continued to deliver a strong performance backed overall by sound foundations and more specifically by robust demand, an improved business environment and investor confidence. With a five-year average growth rate above 5 percent, the economy is projected to grow at a more moderate pace of 4.7 percent in the medium term. An uncertain external environment, including trade tensions and slower growth in trading partners could weigh on the economy going forward. To enhance resilience, the authorities have placed a high premium on reforms and governance and are encouragingly taking sustained initiatives to build on the economic fundamentals and foster equitable growth. We broadly agree with the staff report and would like to make the following points for emphasis.

Enhancing fiscal buffers with fiscal consolidation and revenue mobilization will be central for growth and for creating space for social and development spending. Towards this end, we positively note the several measures mentioned in the buff to strengthen transparency, governance and expenditure optimization, including the Medium-Term Fiscal Framework, Debt Management Office and the upcoming Fiscal Responsibility Act. On revenue mobilization, we align ourselves with the staff viewpoint on prioritizing this and view the comprehensive reform being carried out by the Tax Reform Committee as an important process for reviewing tax incentives and developing balanced and sustainable revenue streams.

The monetary policy framework has delivered price stability and growth. We are reassured by the authority’s agility on monetary accommodation. We agree with staff that the broadly neutral stance remains appropriate in the face of supportive financial conditions and no apparent inflation pressures. Coming to the measures adopted in December 2016 and classified as capital flow management measures (CFM), we note that they remain in place and a gradual phase out has been advised by staff. Beyond the classification, staff has recognized their positive impact on reducing volatility in the onshore FX market. As noted in the buff by Mr. Agung and Mr. Shaari, key considerations in imposing these measures are to preserve orderly market conditions, public confidence and overall financial stability. On balance, we remain sympathetic to the authorities' view on a gradual review in line with evolving market conditions and see no basis for the proposition that the CFMs should be avoided in all circumstances. The staff recommendation to phase out these measures needs to be further analyzed including the application of the Institutional View on management of capital flows, considering the specific country context. We would like to hear more details from staff on a) The indicated distortions emanating from these measures and how these could be addressed by alternate measures with assured results on the onshore FX market b) Is there room for considering country circumstances while considering the policy advise on CFMs?

Bank profitability and liquidity are sound, and NPLs low. The financial sector appears resilient, and the staff had highlighted the vulnerabilities on account of household debt and the real estate market. While agreeing that household balance sheet risks require close monitoring, the authorities have underscored that the associated problems do not pose systemic financial stability risks. Specifically, divergence on staff recommendation for the sector-wide LTV ratios and to phasing out the residency-based differentiation, is notable. Does staff assess any immediate fallouts of the non-application of the staff suggested measures?

Finally, for Malaysia to fulfil its aspirations of achieving a high-income, developed nation status with inclusive development, it will need to make further advances in governance, innovation, productivity, and in improving human capital. We welcome the multiple efforts of the authorities to unlock future productivity growth, fight corruption and improve the education quality. Priority should be given to further the business climate, accelerate female labor force participation and continued strengthening of the implementation of AML/CFT measures.

With these comments we wish the authorities the best in their endeavors.

Mr. Ronicle and Mr. Haydon submitted the following statement:

We thank staff for an interesting set of papers, and Mr. Agung and Mr. Shaari for their informative buff statement.

We congratulate the Malaysian authorities on the resilience shown by the Malaysian economy in recent years. We agree with staff's assessment that the strength of Malaysia's institutions was well demonstrated by the peaceful political transition following the May 2018 elections. As Mr. Agung and Mr. Shaari point out, Malaysia's economy is highly open, with a financial system that is integrated with the international financial system, making it susceptible to external influences and spillovers from abroad. We concur with staff's broad judgment on the economic outlook and support their overall policy recommendations.

We focus our comments, therefore, on the following points:

Governance Reforms

We welcome the launch of the National Anti-Corruption Plan, and the significant focus of the new administration on initiatives to address governance weaknesses and corruption. We strongly support staff's emphasis on the importance of these reforms, and we join with staff in calling for these reforms to be anchored in legislation to ensure the independence of anti-corruption institutions and the appropriate separation of powers. Could staff comment on the importance of these reforms in enabling the Malaysian authorities to meet their wider economic objectives, including achieving high-income status by 2025?

Trade

Ratification of the CPTPP should strengthen Malaysia's trade links, boost productivity growth, and contribute to the government's objective of achieving high-income status by 2025. Staff, however, make minimal reference to the CPTPP in their report. Could staff provide an estimate for the impact of CPTPP ratification on the Malaysian economy?

Fiscal Policy

We agree with staff's assessment that the realisation of contingent liabilities could cause debt to reach the target ceiling, equal to 55 percent of GDP. This underlines the need to maintain momentum on fiscal consolidation, to ensure that there is sufficient space to respond. We welcome the authorities' commitment to enhancing their reporting of federal government guarantees and possible future payment obligations related to PPPs, as announced in the 2019 budget. We also support staff's recommended further actions: that the authorities continue to reform fiscal institutions, publish an annual fiscal risks statement, and increase the transparency of GLC operations.

External Sector

Malaysia's external debt was around 65 percent of GDP in the third quarter of 2018. Staff are comfortable with this, given that a significant proportion of that external debt is attributable to parent-subsidiary interbank borrowing. We can concur with their reasoning. Staff, however, assess that Malaysia's external funding requirement is large, and it is deemed a high risk in their Debt Sustainability Analysis. Could staff elaborate upon this judgment, and the factors behind the high external financing requirement?

Mr. Beblawi and Ms. Al-Riffai submitted the following statement:

We thank Messrs. Agung and Shaari for their detailed buff statement. Malaysia's economy has continued to perform well following a smooth political transition. Growth is moderating, though still high due to improved labor conditions and higher private consumption, and inflation fell significantly. We note that growth is expected to stabilize in 2019 and through the medium term with inflation picking up, and the current account surplus is projected to narrow. We see agreement on the downside risks to the outlook stemming mainly from rising protectionism and weaker than expected growth in trading partners, output shocks, tightening of global financial conditions, and lower than projected oil prices. We appreciate staff's comprehensive report and make the following comments for emphasis.

We commend the authorities on their demonstrated commitment to medium-term fiscal consolidation to further reduce debt and increase fiscal buffers. This is especially welcome, given the size of the current and possible future government guarantees related to PPP projects, which are estimated to be close to one third of GDP. Commitment to the debt anchor has notably contributed to overall fiscal discipline and to maintaining market confidence. We positively note the authorities' intention to strengthen the medium-term fiscal framework, as well as their plan to propose a Fiscal Responsibility Act (FRA). Staff has proposed a series of reform options, where the FRA is at the center of the reform strategy and recommends that the FRA should specify key features of the fiscal framework to ensure a lasting impact. What are staff views on whether the FRA will address these suggested reform options?

The authorities intend to accommodate additional spending needs by improving expenditure efficiency. However, staff note that further domestic revenue generation should be a priority to offset the overall impact of replacing the GST by the SST, provide more fiscal space for social spending, and avoid the increased oil dependence in revenue yields. Whilst we sympathize with the authorities' view that the SST is less regressive than the GST, we see merit in staff's view that other revenue generating measures will be needed to achieve a fiscal consolidation that also safeguards growth. To this end, we welcome the establishment of a high-level Tax Reform Committee and look forward to the completion of their comprehensive review of the Malaysian tax system.

Malaysia's financial sector is robust. Banks are well-capitalized and liquid, with capital and liquidity buffers exceeding regulatory levels, NPLs are low, and provisions are generous. However, the non-bank financial institution (NBFI) investments in equities and bonds remain a transmission channel of contagion risk to the financial sector and a potential fiscal risk, since some of the institutions are government-owned. Thus, we commend Bank Negara Malaysia's (BNM's) initiative to improve NBFI's financial reporting practices.

The housing sector could be another source of concern. The financial sector is exposed to the housing sector through both mortgages and real estate developers, where both make up 12 percent of total outstanding credit. Macroprudential measures adopted in the face of rising housing prices and falling affordability, complemented by supply side efforts, have appropriately helped curb speculative activity in the housing market. We note that staff and the authorities have differing opinions around the potential vulnerability of the banking sector to sharp adjustments in real estate prices. We invite staff to clarify the reason behind these diverging opinions, especially since BNM stress tests indicate that potential bank losses due to sharp real estate price adjustments and income, and interest rate shocks are manageable relative to banks' capital buffers.

Staff advise that as systemic risks from the housing market diminish, residency-based differentiation measures should be gradually phased out. In contrast, the authorities believe that MPMs aimed at non-residents are still necessary to encourage the re-balancing of housing supply towards more affordable price ranges and increased rental activity. We note in Tables 1 and

3 in Appendix X, that residential property transactions by nonresidents have indeed fallen and appear to have shifted away from RM250,001-RM500,000 values towards higher property values. We sympathize with the authorities' view on the role of nonresidents as potentially destabilizing to the housing market and commend them on their overall close monitoring of the housing market. In the absence of rigorous quantitative analysis on the causality of both the reduced and shifting profile of non-resident transactions, we would caution against prematurely doing away with MPM measures that have helped curtail the falling affordability of the housing market in Malaysia. We look forward to staff suggestions on alternatives that could meet the same objectives.

We wish the Malaysian authorities continued success in their goals of achieving high income status and inclusive development.

Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the excellent set of papers and Mr. Agung and Mr. Shaari for their comprehensive buff statement. The Malaysian economy has shown continued resilience in recent years, supported by a strong policy framework that has been adapting to an environment of heightened uncertainty in the global economy. As real GDP growth moderates towards potential and there are no imminent inflationary pressures, authorities should continue addressing medium-term challenges with a focus on safeguarding growth and financial stability in a context of heightened external risks. We broadly concur with the staff appraisal and will comment on some points.

We agree with staff that fiscal policy should follow a gradual consolidation path, prioritizing revenue mobilization to create savings for social and development spending. The Malaysian authorities have adopted a prudent fiscal management approach aimed to ensure that debt remains at sustainable levels and adequate fiscal buffers are built. We support the authorities' efforts to introduce the Fiscal Responsibility Act and to enhance efficiency of public spending. The authorities, as reported in the buff statement, have expressed their commitment to contain debt-to-GDP levels. In this regard, we noticed that there has been an increase in Federal Government Loan Guarantees. We would appreciate staff comments on the factors behind this increase. We take note that the authorities have put in place a Tax Reform Committee with the aim of enhancing revenues while reviewing tax incentives. In staff's view, which are the main issues that this Committee should focus on? Can staff report on the rationale behind the change from the

GST to the sales tax, and how important the impact on revenues in a medium-term perspective is?

Monetary policy has delivered broad price and output stability despite diverse economic shocks coming from abroad. We support staff's assessment regarding the monetary policy stance. Domestic economic and financial considerations should continue to guide monetary policy decisions. A floating exchange rate should continue to be the first line of defense against shocks, and we note that the authorities' interventions in the FX market were meant to ensure that levels of exchange rate volatility were not excessive and did not erode orderly market conditions.

The financial sector in Malaysia has proved to be resilient given the high capitalization levels and liquidity buffers, but risks should continue to be monitored. We concur with staff's call for continued monitoring of financial developments given the high levels of household debt and possible vulnerabilities in the commercial real estate sector. Regarding mortgage markets, we understand that the authorities have recently put in place strengthened requirements on credit risk management. Which additional prudential measures would staff recommend for mortgage credit? Regarding the residency-based policy in the property market, how does this compare to other countries, are these measures used frequently elsewhere?

Finally, we want to thank staff for the informative analysis of the SIPs in corporate savings and the medium-term fiscal framework.

Mr. Mojarrad and Mr. Alavi submitted the following statement:

We thank staff for the informative set of papers and Mr. Agung and Mr. Shaari for their candid buff statement.

Malaysia's remarkable macroeconomic stability and resilience is a testament to the authorities' pre-emptive and pragmatic policy approach, guided by the Eleventh Malaysia Plan and underpinned by a firm commitment to economic diversification and trade openness, and strong institutions. Growth remains robust at a sustainable pace, inflation is tame, and the external position is edging towards equilibrium. The authorities are to be commended for these achievements. With growth drivers rebalancing towards domestic demand, the medium-term policy focus should be on preserving macroeconomic stability and boosting productivity as Malaysia pushes forward toward high-income status and inclusive economic development. Given Malaysia's open trade and its position in the global value chain, the economy is, however, particularly vulnerable to global trade conflicts, but the ongoing growth rebalancing should help to mitigate the negative drag on growth from an uncertain external environment. We agree with the thrust of the staff appraisal and offer the following comments for emphasis.

The current policy mix remains appropriate and largely in line with the past Fund advice. On the fiscal front, we welcome the authorities' commitment to sustained medium-term consolidation to put the public debt on a firm downward path—particularly in view of upside risks to public debt associated with large contingent liabilities—create fiscal space to accommodate higher social and healthcare spending; and bolster market confidence—while safeguarding growth. In this connection, we encourage the authorities to consider the menu of options suggested by staff, and presented in the SIP, on expenditure rationalization, and particularly on revenue mobilization given Malaysia's relatively low tax-GDP ratio compared to peers. We further agree with staff that the medium-term fiscal targets need to be fully operationalized in annual budgets to ensure enforceability, and the fiscal framework should contain clear operational rules that are consistent with the debt anchor. We welcome the authorities' intention to table a Fiscal Responsibility Act and undertake a comprehensive review of the tax system, and commend their ongoing efforts to strengthen fiscal transparency and governance, and to undertake a rigorous expenditure optimization exercise.

We support BNM's current neutral monetary policy stance in an environment of close-to-potential growth and low inflation. The future course of monetary policy should be guided by domestic economic and financial considerations. We commend BNM for successfully balancing its multiple objectives without compromising price stability.

We welcome the authorities' continued commitment to exchange rate flexibility as the first line of defense against external shocks. The BNM's interventions in 2018 to smooth FX market volatility—associated with large capital outflows that also affected other emerging markets—and to prevent its spillover to the real economy were, in our view, warranted. Going forward, surges of capital inflows should be used to build up reserves, although in assessing reserve adequacy we agree with the authorities that due consideration should be given to several buffers already in place to protect against external shocks, including large holdings of external liquid assets by the private sector, as indicated by Mr. Agung and Mr. Shaari.

The financial system is stable and able to weather severe internal and external shocks, and financial supervision is robust. Banks' exposure to the real estate sector is flagged by staff as a source of potential vulnerability, but there seems to be subtle differences in risk assessment between staff and the authorities. We welcome staff comments. The 2014 residency-based CFM/MPM measures, together with prudent risk management practices by banks, have been successful to cool the housing market and could be removed gradually in tandem with dissipation of risks. In any event, close monitoring of household debt and real estate market conditions, as well as stronger micro-and macro-prudential oversight of the banking system, are imperative. We positively note that the remaining gaps in the 2012 FSAP recommendations have been addressed and welcome the authorities' ongoing efforts to enhance crises preparedness and their intention to periodically test banking system's resilience.

Malaysia is well on track to becoming a high income and inclusive economy, and the authorities' efforts to maintain growth on a sustainable path by raising productivity are well placed. Encouraging innovation, adopting digital technologies, investing in human capital and increasing female participation, as well as governance reform would greatly facilitate the transition.

We wish the authorities every success.

Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the reports and Messrs. Agung and Shaari for their comprehensive statement. Despite external headwinds and significant capital outflows, the Malaysian economy continued to perform well in 2018, supported by strong fundamentals and robust domestic demand. The smooth political transition in the aftermath of last year's election is a testament to Malaysia's present institutional strength and sends a strong massage of confidence about the country's favorable prospects to domestic and external economic agents.

Malaysia's near-term economic outlook remains favorable, reflecting its well-diversified external trade and strong domestic demand. Real GDP growth is forecasted by staff to remain around 5 percent over the medium-term, whereas inflation is expected to remain low and stable. We agree with staff that risks to the outlook are tilted to the downside, given Malaysia's highly open economy, a fact that makes the country particularly vulnerable to external developments. The ongoing trade disputes, and possible slowdown in important trade partners, can impact an otherwise benign growth path.

The authorities’ gradual fiscal consolidation approach with an emphasis on revenue mobilization is consistent with protecting pro-growth and social spending, while preserving public debt sustainability. We agree with staff that revenue mobilization should remain a priority given Malaysia’s low tax revenue as a share of GDP. Measures such as introducing capital gains tax and reducing tax incentives for corporate investment could be considered. We welcome plans by the government to strengthen the fiscal framework, including with the introduction of a Fiscal Responsibility Act.

The monetary policy stance is appropriate and exchange rate flexibility should be preserved. We agree with staff that with no evident underlying inflation pressures, the current broadly neutral monetary stance is adequate. We also agree that the exchange rate should continue to play the role of shock absorber, but given Malaysia’s openness, some intervention in situations of excessive foreign exchange market volatility may be inevitable. We take note that staff assesses Malaysia’s external position as stronger than warranted by fundamentals and desired policies. Although relatively contained, risks associated to the real estate market and elevated household debt should remain under the authorities’ scrutiny.

Malaysia has made in recent years impressive strides in reducing poverty and increasing per capita income. The challenge ahead is to maintain inclusive and sustained growth under less auspicious international conditions. In this regard, we praise the new government’s reform initiatives to improve governance, combat corruption, accelerate technical innovation, and increase productivity.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Messrs. Agung and Shaari for an insightful buff statement. We welcome the continuous good performance of the Malaysian economy since last year elections and we encourage the authorities to implement the reform package that will allow Malaysia to reach the high-income status in the coming years. We notably commend the authorities for their focus on governance and anticorruption reforms which are key to sustain high growth rates in the medium term but also to make the growth-model more inclusive. We also strongly value staff’s analysis of this issue. While we share the thrust of staff’s analysis and recommendations, we would like to emphasis the following points:

On the fiscal side, we agree with staff that domestic revenue mobilization is a priority, notably to finance enhanced public spending in the field of education, health and social protection. Given the existing low tax revenues (13 percent of GDP), there is large room for maneuver to increase public revenues without negatively impacting growth2. We note that the reduction of the base of the tax on consumption, through the replacement of the GST by the SST, has been done against previous staff recommendations. We also note from last year article IV that the rate of the consumption tax was particularly low compared to regional peers, and we wonder if staff still recommends increasing this rate (beyond the call for tax base broadening). We also support staff's recommendation to limit tax incentives and deductions for the corporate income tax and the personal income tax.

We are not sure to fully understand the underlying assumptions of the assessment of fiscal space. It is the first time that we notice that the "limited fiscal space" category has been split in two. While we are not opposed to this change, we would have appreciated a clearer warning by staff and we wonder whether this change needs to be explained more clearly in a methodological paper (to avoid confusion for people whose reference remains the June 2018 paper "Assessing fiscal space: an update and stocktaking"). On the Malaysian case, we understand that the assessment of limited fiscal space was justified only once fiscal rules were taken into account. This argument does not appear in the discussion of this year assessment which we find quite confusing. Additionally, given the limited level of tax to revenue ratio, it seems that Malaysian authorities would have some room to react should the debt to GDP ratio comes closer to the limit sets by the fiscal rule. Could staff elaborate on this issue and clarify its reasoning behind its assessment of fiscal space being at risk.

We particularly thank staff for its analysis of the corporate sector net saving and its impact on the current account surplus. As we requested several times in the past such a sectoral break-down of the drivers of the current account surplus of Malaysia, we are particularly pleased by the work done in the Selected Issue Paper which confirms the importance of the corporate sector in explaining the high CA surplus (notably in the past). We also thank staff for the tentative policy recommendations based on this preliminary analysis. As for other countries where large current account surpluses are explained by high net corporate saving, it seems necessary to deepen further the analysis, notably by integrating the role of the exchange rate regime, wage

[2] See for instance the recent research results on the role of the initial level of taxation on tax multipliers by Gunter, Riera-Crichton, Vegh and Vuletin, "Policy Implications of Non-linear Effects of Tax Changes on Output", World Bank Policy Research Working Papers, Juanary 2019

dynamics, competition and other potential factors of the high level of corporate saving. On a separate item concerning the balance of payment statistics, could staff comment on the very high level of errors and omissions and whether staff recommend potential improvements in BoP data collection.

On structural reforms, we are strongly supportive of the ambitious measures undertaken by the authorities to tackle governance issues and we support staff's recommendations to improve human capital and enhance innovation. Improvement in these last two fields will warrants some public financing and hence our support to enhanced domestic resources mobilization. On human capital, we encourage the authorities to focus on universal access to high-quality early childhood care and education and improving learning assessment systems. Addressing child stunting (which still concerns one-in-five children) is paramount and economically beneficial notably to prevent constraints on learning, cognition and hence productivity in the long-term. More broadly, we support staff's call for providing adequate social protection through social welfare programs to enable households to invest in human capital.

Finally, the authorities should facilitate trade integration and encourage foreign investment, notably in the context of the current reshuffling of value-added chains in the region. In this regard, could staff elaborate on the ongoing review process of the CPTPP?

Mr. Jin and Ms. Lok submitted the following statement:

We thank staff for the set of informative reports and Mr. Agung and Mr. Shaari for their comprehensive buff statement. We take positive note that the Malaysian economy has continued to perform favorably amid an uncertain global environment. With risks to the outlook tilted to the downside, it is important for the authorities to maintain sound macroeconomic management to safeguard the economy against potential shocks. We broadly share staff's appraisal and would like to make the following comments for emphasis.

We welcome the authorities' fiscal consolidation plan, which will help place the federal government debt on a downward path over the medium term. Efforts to mobilize revenue should be complemented by expenditure rationalization, particularly in light of the revenue shortfall created by replacing the GST with the SST. We note that a high-level Tax Reform Committee has been established to review the Malaysian tax system and explore possible new sources of sustainable revenues, while the Public Finance Committee has been set up to monitor the progress in, and ensure the effectiveness of, expenditure optimization. The successful implementation of revenue and expenditure measures under the guidance of these committees would help free up fiscal space for increased social and development spending, which would contribute to achieving sustainable and inclusive growth. Could staff shed light on the considerations behind the authorities' decision to zero-rate the GST and introduce the SST?

We take positive note of the authorities' steps to increase fiscal transparency and governance and look forward to the completion of the ongoing review of major infrastructure projects. Going forward, we believe efforts to improve public project governance and management would help reduce the chance of disruptions to important projects that could weigh on businesses and growth.

As an open economy, Malaysia is exposed to possible external shocks. We support the continued use of exchange rate flexibility as a first line of defense, with foreign exchange interventions limited to preventing disorderly market conditions. Malaysia's external debt is currently assessed as manageable, but external financing vulnerabilities are higher than that of the median peer. We take comfort from the buff statement that the external debt-to-GDP ratio has declined in the third quarter of 2018, and various mitigating factors are in place. That said, we encourage the authorities to closely monitor developments in this regard and continue to strengthen the resilience of the financial system, including through measures to further develop and deepen the domestic financial market.

We take positive note of Malaysia's healthy financial sector and the BNM's robust financial oversight. The ongoing efforts by the authorities to monitor risks and adopt mitigating measures are also welcome. Although the elevated level of household debt is on the decline and the associated vulnerability mainly lies in the lowest income group, we believe continued vigilance is warranted. The authorities pointed out that the potential risks to financial stability arising from credit exposures to the lowest income group may not be significant. Could staff comment on the potential social implications of an interest rate shock on these low-income households, if any?

We welcome the various reform initiatives under the new government to enhance governance, tackle corruption, and increase public services efficiency. At the same time, we support the prioritization of inclusive economic development in the Mid-Term Review of the Eleventh Malaysian Plan and look forward to further progress in the authorities' structural reform agenda.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for well-focused set of reports and Mr. Agung and Mr. Shaari for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

It is encouraging to note that despite the challenges, the Malaysian economy continued to show resilience, thanks to the prudent policies undertaken, reinforced by ample buffers and robust financial sector. The medium-term outlook is broadly positive, as growth is expected to converge to potential, underpinned by strong domestic demand, and inflation will remain subdued. We also take note that policies have been largely in line with the Fund's past advice. That said, risks to the growth outlook are to the downside, mainly stemming from external shocks given that Malaysia is a highly open economy. Therefore, we appreciate the authorities focus on preserving macroeconomic and financial stability and would like to emphasize that fiscal consolidation and structural reform efforts should be sustained going forward.

We welcome the authorities' commitment to fiscal consolidation under the Medium-Term Fiscal Framework (MTFF), supported by revenue mobilization and spending rationalization efforts. This is important to put debt on a firm downward path and to enhance the fiscal space to expand spending on priority areas. Indeed, creating fiscal space to expand social safety nets and increase health spending would be appropriate. Separately, the authorities' stride to improve fiscal transparency under the 2019 budget are also welcome.

We continue to note the authorities' reservation on the limitations of the external sector assessment analytical framework, despite the refinement. This is pertaining to the weak explanatory power of the current account regression model in the Malaysian context as explained by the authorities. Here, we would welcome staff elaboration on the reasons behind the persistency of this issue.

We take positive note of the assessment that the financial sector remains resilient and well-positioned to withstand shocks. banks are well-capitalized and liquid, with low NPLs and sizable provisions. We also take positive note of the authorities' macroprudential efforts to contain household NPLs and agree on the importance of closely monitoring household balance sheet risks in light of the elevated household debt. On a separate note, the authorities' commitment towards continuing to strengthen the AML/CFT framework is welcome.

Finally, we welcome the authorities' emphasis on further reforms. In particular, we take positive note of their efforts to improve the quality of education and reduce skills mismatches. We also welcome the authorities' efforts to improve infrastructure, and further enhance the business environment to boost investment.

With these remarks, we wish the authorities further success.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for a set of well-written reports and Mr. Agung and Mr. Shaari for their informative buff statement. We commend the Malaysian authorities for a steady implementation of sound economic policies, which underpinned healthy performance of the Malaysian economy despite volatile external environment. Growth prospects are solid and commitment to medium-term fiscal consolidation remains clear. While some pockets of vulnerability remain in the real estate sector and the financial system, Malaysia maintains strong buffers, risks are manageable and gradually receding. As we broadly agree with the staff assessment, we would provide a few comments for emphasis.

The authorities' fiscal policy is appropriately aimed at increasing fiscal buffers and ensuring debt sustainability. We take note that some widening of the fiscal deficit in 2018 is a one-time event related to efforts to increase fiscal transparency. Revenue mobilization remains the key for fiscal consolidation, and we welcome recent steps to perform a comprehensive review of the Malaysian tax system and find new sources of sustainable revenue. The planned adoption of the Fiscal Responsibility Act and accrual accounting would further strengthen the medium-term fiscal framework and improve transparency of the fiscal system.

After some tightening in 2018, monetary policy remains on hold, as growth is gradually decelerating towards potential, and there is no evidence of inflationary pressures.

Large capital outflows in the second quarter of 2018 were successfully managed by the authorities but reminded about potential vulnerability to external shocks. The December 2016 FX measures have reduced onshore FX market volatility. At the same time, we agree that exchange rate flexibility should remain the first line of defense against volatile capital flows, while some reserve accumulation may be desirable in case of capital inflows.

The Malaysian financial system remains sound and resilient to shocks. Banks are well capitalized, liquid and NPLs are low at 1.5 percent. Household debt is elevated, but is declining, and high household financial assets mitigate vulnerabilities. We, therefore, tend to agree with staff that housing policy measures discriminating non-resident housing market participants could be gradually removed as systemic risk dissipates. At the same time, risks from the housing market should be closely monitored.

Continued implementation of structural reforms is needed to ensure sustainable and inclusive growth and transformation into a high-income economy. The 11th Malaysia Plan is appropriately focused on improving human capital, boosting creativity and innovation, and enhancing business climate. We also welcome the steps undertaken in the anti-corruption area, which should be further anchored through the legislative process. They should be supported by public financial management reforms aimed at enhancing efficiency and transparency of budget management and procurement procedures.

With these remarks, we wish the authorities further success.

Mr. Raghani, Mr. N'Sonde and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for the informative set of papers and Mr. Agung and Mr. Shaari for their insightful buff statement.

We commend the Malaysian authorities for implementing sound macroeconomic policies and building strong institutions which have helped to maintain a robust and steady growth momentum over the years. Growth has continued to pace at close to 5 percent in 2018 while inflation has decreased on account of temporary factors such as the pause in fuel price adjustments and the zero-rating of the good and service tax. This coupled with increases in social expenditures and the bringing on budget of some off-budget spending, has brought the fiscal deficit significantly above its programmed level. On the external front, we note that the country's position remains strong albeit recent capital outflows, thanks to rebalancing towards domestic demand.

Looking forward, the authorities are encouraged to focus their efforts on growth-friendly fiscal consolidation, governance reforms and preserving financial stability while long-term priorities should be geared at structural reforms to reinforce productivity and facilitate growth rebalancing. While the outlook is for continued expansion and further external rebalancing, downside risks are largely related to an unfavorable external environment (protectionist pressures, tightening financial conditions, global growth slowdown). Moreover, there is a need for the authorities to address domestic vulnerabilities, notably by streamlining contingent liabilities and reducing fiscal deficits, closely monitoring real estate price movements, and keeping households' indebtedness under control, with the view to safeguard financial stability and growth. Advancing governance reforms is also required to preserve confidence while structural reforms should aim at raising productivity and potential output.

Bolstering revenue mobilization in a growth-friendly manner remains critical to sustain medium-term fiscal consolidation plans. While significant efforts should be made to rationalize non-essential expenditures including by better targeting subsidies and improving procurement, priority should lie on raising the tax revenue-to-GDP ratio well above its current level. We welcome the authorities' renewed emphasis on fiscal transparency and consolidation under the 2019 budget. Given the revenue underperformance, it is encouraging to note the recent steps taken to review the tax system and boost revenue mobilization with the newly created Tax Reform Committee. Could staff comment on the timeline for the planned tax system review? The plan to create a Fiscal Responsibility Act and introduce accrual accounting is well appreciated and, in this area, staff should stand ready to support the authorities' agenda through adequate advice and technical assistance.

Monetary policy should continue to focus on maintaining price stability while supporting the more sustainable growth path. We share the view that, at the current juncture, the neutral policy stance is broadly appropriate. Exchange rate flexibility continues to serve this economy exposed to external shocks quite well. We also share the view that FX interventions can be helpful and should be limited to prevent excessive price movements and disorderly market situations. We take positive note of the recent measures implemented to assist with the efficient functioning and resilience of FX markets.

Significant policy actions have been taken to address financial stability risks, but continued vigilance is warranted. Although the financial sector is broadly sound and resilient, the high household debt, real estate market developments and the related supply-demand mismatch can still pose significant risks to financial stability. We see the current market conditions as a good opportunity to enhance the macroprudential toolkit and see merits in considering sector-wide loan-to-value (LTV) limits on first and second properties in the medium term beside those LTV observed by banks. As underscored in Mr. Agung and Mr. Shaari's buff statement, the measures to phase out residency-based differentiation are essential to ensure that growth in house prices reflect domestic fundamentals. The progress made in strengthening and implementing the AML/CFT framework should be maintained going forward. As Malaysia has just completed the 3-year cycle since the Financial Action Task Force (FATF)'s 2015 mutual evaluation, could staff provide an update on the progress achieved in addressing compliance deficiencies in the Enhanced Follow-up Report? Additionally, could staff provide comments on the regulatory landscape for Fintech and crypto assets in the country?

The authorities' initiatives to address vulnerabilities in governance and combat corruption at all levels are timely. These reforms should be enshrined through legislative actions. We appreciate the recent steps taken to create institutional bodies and special committees to support the Government's anti-corruption plans and reforms, notably the National Centre for Governance, Integrity and Anti-Corruption (GIACC), the Malaysian Anti-Corruption Commission (MACC) and the Economic Planning Unit. Additional attention should also be given to financial oversight of SOEs and avoidance of tax refund arrears. Moreover, we see merit in the establishment of the Special Investigation Committee on Governance, Procurement and Finance to review existing procurement contracts.

The authorities' ambitious strategy to enhance potential output, foster inclusive growth and help the country reach the high-income status is noteworthy. Implementation of the reform agenda envisaged in the Mid-Term Review of the Eleventh Malaysia Plan should focus on boosting productivity and female labor market participation by improving education and training and fostering innovation and technology. Moving up the value chain as innovations increase productivity and the sophistication of goods exports is equally important.

With these remarks, we wish the authorities of Malaysia every success in their future endeavors.

The Acting Chair (Mr. Furusawa) remarked that the Malaysian economy had shown resilience and continued to perform very well against the backdrop of a smooth political transition. The outlook remained positive, though downside risks from external sources have persisted. Gray statements highlighted the importance of a gradual fiscal consolidation and neutral monetary stance, together with continued exchange rate flexibility. Directors also emphasized the need to safeguard financial sector stability by closely monitoring risks and advancing structural reforms to raise productivity, improve governance, and support inclusive growth.

The staff representative from the Asia and Pacific Department (Ms. Choueiri), in response to questions and comments from Executive Directors, made the following statement:[3]

> I wanted to share some information with the Board that has become available since the issuance of the staff report, but it has no material implications on the staff's appraisal.
>
> The first piece of information is that Bank Negara Malaysia has had a monetary policy committee meeting at the end of January. The decision was to maintain the policy rate unchanged at 3.25 percent, which is consistent with the staff's advice, as laid out in the staff report.
>
> The other piece of information is that yesterday, there were a few data releases on national accounts and on the balance of payments. These show that growth for the full year was 4.7 percent, as estimated in the staff report, and that the current account surplus was 2.3 percent of GDP, which is also in line with what we estimated in the staff report, which was 2.2 percent of GDP.

Mr. Agung made the following statement:

> Let me use this opportunity to highlight some issues raised by the Directors, as well as to update the Board on new developments.
>
> The challenging global environment necessitates a continued emphasis on further strengthening Malaysia's economic resilience. Besides ensuring that the economy is always supported by strong macroeconomic fundamentals and a robust financial system, the calibration of macroeconomic management will continue to focus on the adoption of an appropriate policy framework, timely policy response, and the availability of ample policy buffers. In this regard, the growth-friendly fiscal consolidation, accommodative monetary policy, a flexible exchange rate policy, and strong supervision of the financial system will remain the thrust of macroeconomic management in Malaysia.

[3] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

The Malaysian authorities are also steadfast in implementing a number of structural reform initiatives, with the new government placing a greater emphasis on strengthening the economy, public institutions, and governance. I would like to elaborate on our authorities' policy priorities.

First, on fiscal policy, the authorities remain committed to medium-term fiscal consolidation and a gradual reduction of the debt level. The higher level of fiscal deficit targeted in 2018-2019 is temporary and meant to accommodate the new policy direction. It also addresses short-term adjustment, as well as the authorities' efforts to improve fiscal transparency and governance, especially bringing off-budget spending and allocation for tax refunds.

The authorities will resume their consolidation trajectory in 2019 and onward. The authorities also reiterate their commitment to lower the fiscal deficit to 2 percent of GDP over the medium term and strengthen their medium-term fiscal framework.

On monetary policy, the monetary policy committee of Bank Negara Malaysia concluded on January 24, 2019, that the current degree of monetary accommodation remained appropriate and decided to keep the policy rate unchanged. The committee also reiterated its stance to continue monitoring and assessing the balance of risks surrounding the outlook for domestic growth and inflation. Exchange rate flexibility continues to be the first line of defense against external shocks, and reserves remain adequate.

Our authorities welcome the staff's acknowledgement, that sizable external assets held by private sector entities would allow banks and corporates to manage their own external liabilities.

Our authorities welcome the staff's and a few Directors' acknowledgement of the effectiveness of the foreign exchange market committee measures announced in December 2016 in reducing volatility in the onshore market. These measures have also provided stability to the onshore market, as reflected by improved domestic liquidity.

Our authorities wish to highlight that the decision to gradually review the measures needs to consider the risks that are being addressed. In this context, it would be helpful if the staff would suggest policy alternatives to meet our objectives, beyond advocating for the removal of these measures.

Malaysia's financial sector is robust, underpinned by a strong balance sheet, asset quality, and capital buffers. Stress test results demonstrate that the Malaysian banking system remains resilient to major macroeconomic shocks. Our authorities take note of the concerns raised by many Directors on Malaysia's rising household debt levels. However, our authorities would like to highlight that risks to financial stability emanating from household indebtedness have receded amid sound underwriting standards, risk management practices, and loan affordability assessment. Corporate leverage continues to be supported by sound debt servicing capacity and hedging practices. The imbalances in the property market are not widespread and are effectively contained, following a comprehensive set of macroprudential and fiscal measures put in place since 2010. In this regard, our authorities view that the current macroprudential measures (MPM) that have been implemented are sufficient.

My Malaysian authorities would like to convey their appreciation for the staff's efforts to further understand the domestic economy and country-specific challenges, but they also feel that there is room for more constructive policy advice—particularly if the staff could suggest alternative measures that would meet our authorities' intended objectives. We note that a few Directors also requested the staff to suggest potential measures that the authorities could implement in place of capital flow management measures (CFM) and CFM/MPMs.

Mr. Raghani made the following statement:

We thank the staff for the responses to the many questions raised by Directors, including our inquiries on the timeline for the authorities' tax system review and the update on the progress that has been made in addressing compliance deficiencies in an enhanced follow-up process.

As laid out in our gray statement, we broadly agree with the staff's assessment and policy recommendations and wish to make the following points for emphasis.

First, we commend the Malaysian authorities for establishing strong institutions that have helped to maintain macroeconomic stability and robust growth and sustain the aspiration to achieve high-income status. Notwithstanding the positive developments, both domestic and external risks can still undermine growth prospects. As clarified in the staff's responses, the authorities are showing a strong commitment to macro and financial stability and to governance reforms. We encourage them to pursue these efforts while also addressing structural bottlenecks to reinforce productivity and promote growth.

Second, enhancing revenue mobilization in a growth-friendly manner remains important to support fiscal consolidation efforts and to keep public debt at sustainable levels. In this respect, we welcome the establishment of the tax reform committee to review the tax system and explore new revenue streams.

Like Mr. Rashkovan and Mr. Josic, we would have expected more attention to be given to fintech-related issues, including crypto assets, in line with the recently adopted Bali Fintech Agenda. We look forward to discussions on this topic in future consultations with Malaysia. We encourage the authorities to continue to strengthen their regulatory framework for fintech, including Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), while creating a supportive space for innovation.

Mr. Saito made the following statement:

As we have issued a gray statement, I would like to limit our remarks to the foreign exchange market policy.

First, we take note of the authorities’ statement, saying that Malaysia is susceptible to capital flows and exchange rate volatility as an open economy with liberalized financial markets. Against this background, we welcome the authorities’ view, that exchange rate flexibility should continue to be the first line of defense against external shocks.

Second, on the 2016 foreign exchange market measures, we note the staff’s assessment that the measures have reduced volatility in the onshore foreign exchange market but can create distortions. Given the difference of views regarding the distortion, we encourage the staff to continue collaborating with the authorities to assess the costs and the effectiveness of the measures on an ongoing basis. If the costs are judged to be larger than benefits, we encourage the authorities to replace the 2016 foreign exchange market measures with less distortive alternative measures. On this front, we support Mr. Agung’s request to the staff to provide alternative measures to effectively achieve the authorities’ objectives.

Third, in terms of the timing, pace, and sequence for removing foreign exchange market measures, we support the staff’s recommendation that the 2016 foreign exchange market measures should be gradually phased out with due regard to market conditions. We encourage the staff to discuss with the authorities the sequence, the pace, and the timing of phasing out the measures so that they do not undermine financial stability. More generally, as the Institutional View does not make clear the appropriate pace of removing CFMs, developing more granular and practical guidance on the removal of CFMs would help foster a common understanding on the application of the Institutional View and ensure the staff's evenhanded assessment.

Finally, we take note from the staff's answers to our technical questions that Malaysia's longstanding policy of non-internationalization of the ringgit is not at odds with the Institutional View because the level of openness is chosen by the authorities, depending on the economic objectives. In this regard, is Malaysia still in the process of the capital flow liberalization, and at what stage? More specifically, are the 2016 measures defined as the needed imposition of CFM in the process of the capital flow liberalization because the liberalization has to outpace the capacity of the economy?

Mr. Castets made the following statement:

We commend the authorities for the continuous good performance of the Malaysian economy. As we have issued a gray statement, we will just focus on four points.

First, like Mr. Raghani, we commend the authorities for the impressive improvement of the governance framework and the numerous measures that have been undertaken by the authorities to fight corruption. It can have a substantial impact on the medium-term growth prospects and it could also set a positive example for countries in the region. We welcome the staff's analysis of this issue in the Article IV report. We broadly support the recommendations provided to improve the fiscal and financial governance framework. When these reforms are fully implemented, we also encourage the staff to thoroughly evaluate them and draw lessons from this experience.

Second, as Mr. Raghani alluded to, with regard to domestic revenue mobilization, there is a clear case, as also advocated by the staff, for increasing public revenues since the level remained quite low compared to GDP. At this level of development and given the still substantial need to invest in human capital and public infrastructure, the Malaysian state's financing capability remains quite low. We encourage the authorities to consider the base broadening measures advised by the staff and maybe to go beyond that.

My third point regards the fiscal space assessment. While we thank the staff for the answer to our question, we are still not entirely clear on the reasoning used in this specific case. We would appreciate if the staff could confirm that Malaysia is assessed as having fiscal space at risk because of the existing fiscal rule and that, without taking into consideration the fiscal rule, the staff assessment would have been that Malaysia has some fiscal space. It is not entirely clear how the tax potential is taken into consideration.

My fourth and last point is to reiterate our satisfaction with the staff's analysis of the role of corporate savings to explain the Malaysian current account dynamics. We encourage the staff to pursue this work in Malaysia and in other countries that have high current account surpluses, and to keep building on the External Sector Report's (ESR) good work on persistent external account surpluses. In that sense, it would be helpful to broaden the factors that could explain high corporate savings to include wage dynamics, exchange rate levels, corporate tax rates, and product market competition.

Mr. Psalidopoulos made the following statement:

In our gray statement, we commended the authorities for their sound policy mix, aimed at preserving the positive growth momentum by building further financial buffers while strengthening the institutional framework. We find as particularly positive the comprehensive reform agenda that the authorities intend to implement in the areas of fiscal reforms, including revenue mobilization and spending efficiency, as well as to ensure the independence of anti-corruption institutions.

We have supported the staff's recommendation to gradually phase out the CFMs currently in place and to consider replacing them with alternative policy options that do not potentially distort resource allocations or not discriminate on the basis of residence. We would like to stress the risk that possible developments of market conditions, in terms of their capacity to absorb large and volatile flows—which, according to the authorities, is warranted before fully phasing out the current rules—could actually be slowed by the same application of these measures. For instance, as the staff reported in the written answers, exchange rate volatility is needed to some extent to help deepen foreign exchange markets.

As we stated at the previous Article IV consultation, preserving the strong fundamentals that the Malaysian economy currently enjoys and maintaining a floating exchange rate regime, where the use of interventions is limited to disorderly market conditions, should be the primary tool to handle capital outflow pressures in line with the Fund's Institutional View. In this respect, we feel reassured that the authorities consider that adequate policy buffers are in place to respond in a timely manner to shocks that can endanger macroeconomic and financial stability.

Mr. Alkhareif made the following statement:

Like other Directors, we commend the authorities for their strong macroeconomic management, which led to solid economic performance. We agree with the staff that the outlook remains positive. However, there are downside risks to the outlook.

On the fiscal front, we welcome the authorities' commitment to the fiscal consolidation under the medium-term fiscal framework. This is important to put debt on a firm downward path and to enhance fiscal space to expand spending on priority areas, as mentioned by Mr. Castets. In particular, creating fiscal space to expand social safety nets and increase health care spending would be appropriate going forward.

On the external sector assessment, we appreciate the staff's answers to our technical question, No. 4. We agree that the refinement of the External Balance Assessment (EBA) model continued to have residuals due to country specificity, including in the Malaysian case. Therefore, we agree that having the right judgment would be helpful to reach a final conclusion. When formulating the staff's judgment, it is important to engage with all stakeholders, including the authorities, themselves.

With these remarks, we wish the authorities continued success.

Mr. Guerra made the following statement:

While supporting the overall staff appraisal and the policy advice, we have a more nuanced opinion regarding the consideration of these measures on real estate investments by foreigners, that is closer to what has been stated by Mr. Agung. We had a discussion on housing markets, and the idea is to have this portfolio of measures, this flexibility. The authorities should have this flexibility to impose these different policy measure, MPMs and CFMs, if that is the case. We believe that we should have a more nuanced opinion on that front. In that respect, we share the view of Mr. Agung.

The staff representative from the Asia and Pacific Department (Ms. Choueiri), in response to further questions and comments from Executive Directors, made the following additional statement:

> I thank Directors for the additional comments and questions. We take note of the request for further work on fintech and further discussions of the phasing out of the capital flow measures. We will take these on board.
>
> There was a question from Mr. Saito about whether Malaysia is still in the process of liberalization. Yes, this is the case. One of the longstanding policies of the Malaysian authorities is the non-internationalization of the ringgit. This translates into the fact that they are somewhere on the path of full liberalization, and they are not quite there.
>
> At what stage? It is hard to say. I do not think that we have a gradual measurement, and we have not ranked the countries, to my knowledge.
>
> The 2016 measures, there were three of them. There was one forbidding the banks to interact on the non-deliverable forward market. This was reaffirming a longstanding policy and therefore tightening it. Phasing out this measure will need to take the time that the authorities choose on this path of liberalization. Our advice is more focused on the other two measures, which is the conversion of export proceeds and the limit on outward investment for residents with ringgit borrowing. These are the two measures that we are advising the authorities to gradually phase out, with due regard to market conditions.
>
> We are aware that there has to be a plan. We have not discussed any specific plan with the authorities yet. This would take a lot of time and work to prepare. We would be happy to do that if the authorities would be ready to work with us on that.
>
> On the issue of alternative measures for the foreign exchange market CFM, we took a close look at that over the past year. During the staff visit, we had an expert from the Monetary and Capital Markets Department (MCM) with us on the visit—and he was the main author of the appendix on foreign exchange measures—to take a deep look at the market and see what other measures would be needed to further the authorities' objectives of developing the onshore market.
>
> At this stage, our assessment, which is in that appendix, is that the authorities have done all the right things for the onshore market, in the sense of providing hedging instruments, extending hours, the pricing, the exchange

rate fixing mechanism. On these technical measures, we do not have any further advice to give to them. What we believe is that the market will continue to deepen, and the instruments will continue to be created as the authorities see the need for them or as market participants see the need for them as they are facing exchange rate volatility and they have to hedge against this volatility. At the end of the day, the main instrument now for furthering onshore market development is exchange rate volatility.

On the question on the fiscal rule and the fiscal space. The assessment of fiscal space takes into consideration current policies and current rules. The potential for further tax revenues as policies change is not taken into consideration. However, without the fiscal rule, could they have more space? The main fiscal rule that is now on the table is the debt rule, the debt ceiling. We believe that this is a useful rule to have. If they did not have it, we would have to look at what other rules would they need to have a strong framework. If there is not an anchor for fiscal policy—like this debt anchor—then maybe there is more space to spend. But that assessment cannot be on its own without asking whether this is the right framework and the right anchor. If they did not have this debt anchor, they may have more space. But then the question would be: Is that the right thing to do?

Mr. Castets made the following statement:

I would like to clarify my question. We understand that the fiscal space approach has two steps. The first step is to measure the fiscal space without taking into consideration the fiscal rule. The second step is to integrate the fiscal rule, and it is constrained.

Based on that, my question was: Is it true that, without taking into consideration the fiscal rule, we would have judged that there is some fiscal space? The second part of the question is: In the case of Malaysia, there is something like a 51 percent of debt-to-GDP ratio, which means they are below their own anchor. We are not discussing the fact that it is good to have an anchor. We understand that the staff believes that 55 percent is good for Malaysia. We are just trying to understand how the staff approaches this issue of fiscal space since it has changed a bit recently.

The staff representative from the Asia and Pacific Department (Ms. Choueiri), in response to further questions and comments from Executive Directors, made the following additional statement:

Part of the confusion could be related to the fact that last year we said that there was some fiscal space without the fiscal rules. What I should have specified in my answer is that, last year, there were two fiscal rules that we were taking into consideration, which is the debt ceiling and the balanced budget over the medium term. The assessment was, without the balanced budget over the medium term, there would be some fiscal space. However, there is some fiscal space also with the debt ceiling. But this year, given that the deficit has increased compared to the previous year, the situation has changed. That is why even without this specific rule, the balanced budget over the medium term, they still have limited space. But the new category for them is fiscal space at risk. We do not have the "limited" category anymore. This assessment that fiscal space is at risk is with and without taking into consideration the debt rule.

Mr. Agung made the following concluding statement:

On behalf of my Malaysian authorities, I would like to express my appreciation for the Directors' insightful comments and constructive suggestions, which I will convey to my authorities.

Going forward, the authorities will remain vigilant of the downside risks to the economy. In responding to possible adverse shocks, the authorities will always strive to respond in a timely and effective manner through the adoption of a practical and flexible policy approach that could preserve the stability of the Malaysian economy. In addition, our authorities wish to propose for the Fund to play a greater role in reducing risks from disruptive cross-border spillovers that can be detrimental to member countries, particularly in the current challenging economic environment.

In conclusion, I thank the Article IV team, headed by the mission chief, Ms. Choueiri, for the candid and constructive discussions with our authorities during the mission. The Malaysian authorities highly value the inputs provided and look forward to their future engagement with the Fund.

The Acting Chair (Mr. Furusawa) noted that Malaysia is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the resilient performance of the Malaysian economy over recent years, noting that growth was solid, without signs of inflationary pressures. Directors concurred that, while the medium-term outlook remains favorable, risks are tilted to the downside stemming primarily from the external environment. They encouraged the authorities to continue implementing credible macroeconomic policies while safeguarding growth and financial stability, and undertaking structural reforms to boost sustainable, inclusive growth.

Directors agreed with the planned gradual pace of fiscal consolidation in 2019 and over the medium term to support debt reduction and strengthened fiscal buffers. They encouraged the authorities to embed the medium-term fiscal path in a strengthened fiscal framework that would rely on credible revenue and expenditure measures. Noting Malaysia's low tax revenue ratio, Directors emphasized that revenue mobilization should be a priority, not only to support medium-term consolidation, but also to help finance needed expenditure to achieve government priorities identified under the Mid-Term Review of the Eleventh Malaysia Plan. They welcomed continued efforts to increase fiscal transparency.

Directors supported the broadly neutral monetary policy stance. Going forward, domestic economic and financial conditions should continue to guide monetary policy decisions, with exchange rate flexibility the first line of defense against shocks. Directors noted that exchange rate flexibility should help further financial market deepening. A number of Directors encouraged the authorities to phase out the 2016 FX market measures with due regard to market conditions. Some Directors were of the view that such measures could be helpful in preserving overall financial stability.

Directors agreed that the financial sector appears resilient, with sound profitability and liquidity indicators and low NPLs. They encouraged the authorities to continue close monitoring of risks stemming from large household debt and the real estate market, noting that household debt is high compared to peers, with a large share of mortgages and with pockets of vulnerability among lower-income groups. A number of Directors agreed that the measures related to the residency-based differentiation in the property market should be gradually phased out as systemic risks dissipate. A few Directors suggested a more cautious approach should be taken in phasing out these measures. Directors commended the authorities' ongoing efforts to enhance crisis preparedness noting that they could be strengthened by a comprehensive review of the overall framework.

Directors commended the authorities' initiatives to improve governance and strengthen anti-corruption institutions and emphasized the importance of anchoring them in appropriate legislation, particularly to help secure their independence. Directors encouraged continued strengthening of the AML/CFT framework.

Directors agreed with the authorities' emphasis on raising productivity and achieving inclusive and regionally balanced development. They encouraged prioritizing human capital development and increasing female labor force participation and productivity, including through improving education; accelerating innovation and technology adoption; and encouraging a move up the value chain.

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

APPROVAL: April 9, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Could staff provide an estimate for the impact of CPTPP ratification on the Malaysian economy?***

- Staff believe that by ratifying the CPTPP, Malaysia's economy will benefit not only from further FDI and trade resulting from the deal, but also from enhanced accountability and transparency under its provisions. However, it is challenging to develop a quantitative, forward-looking assessment of the impact of the CPTPP. This is partly because, given Malaysia's integration into the global supply chain, an up-to-date assessment must factor in the latest development in global trade, as well as the spillover effects from other nations that have ratified the CPTPP. Staff believe that, as more countries ratify the treaty, the opportunity cost of not ratifying it will be increasing. At this stage, the staff's baseline does not factor in this ratification, nor does it include any impact from other possibly ongoing negotiations on trade agreements.

2. ***Could staff elaborate on the ongoing review process of the CPTPP***

- The CPTPP is currently under review by the Malaysian authorities. Malaysia is unlikely to ratify the CPTPP during the first half of 2019, given (i) the time needed to complete the ongoing review and (ii) the significant number of laws the government would have to amend, pursuant to the treaty's ratification.

3. ***On a separate item concerning the balance of payment statistics, could staff comment on the very high level of errors and omissions and whether staff recommend potential improvements in BoP data collection.***

- Malaysia registered increasingly large E&Os in the BOP accounts, associated with a discrepancy between the accumulation of CA surplus and the change in NIIP. Market participants have been more aware of the large, negative E&Os in recent years as Malaysia's CA surplus has been narrowing. Staff highlighted the large E&Os during the most recent Article IV mission and the availability of technical assistance through STA to help the authorities resolve this issue. The authorities expressed interest in working with the Fund on this issue. We hope there will be progress in resolving this issue in the period ahead.

4. ***We continue to note the authorities' reservation on the limitations of the external sector assessment analytical framework, despite the refinement. This is pertaining to the weak explanatory power of the current account regression model in the Malaysian context as explained by the authorities. Here, we would welcome staff elaboration on the reasons behind the persistency of this issue.***

- While refinements to the EBA methodology carried out last year led to an improvement of the EBA current account model fit, along with a better conceptual grounding, residuals remain large in some cases, including Malaysia. These residuals reflect either policy distortions or fundamentals that are not captured by the EBA model, often due to data limitations. As such, assessments must continue to be complemented by analytically-grounded judgement and insights. More work is underway to help with these insights. For example, work is underway to better understand the drivers of rising corporate saving (which is highly relevant for Malaysia) and whether these reflect policy distortions.

5. ***In this vein, it would be helpful if staff could provide more information why this year's assessment of the CA gap (2.2 percent of GDP) is fully explained by unidentified residuals, compared to last year's assessment when less than half of the gap (total of 2.6 percent of GDP) was explained by the residual, and a larger part was due to identified policy gaps.***

- The change in the contribution of policy gaps to the excess CA surplus compared to last year is driven by two main factors. (1) This year's assessment is based on the new EBA model, which has a higher coefficient for the change in reserves variable (proxy for FX intervention). (2) With this higher coefficient, the large change in reserves in 2018, in addition to the more expansionary fiscal policy in 2018, contribute to a much larger reduction in the excess CA surplus. This CA reduction, coming from both factors, compensates the excess surplus driven by another policy gap present in Malaysia and represented by public health expenditure (which is used as a proxy for household precautionary savings). Therefore, in the 2018 CA assessment, policy gaps offset each other.

Fiscal Policy

6. ***How does projected revenue from the sales tax compared to that from GST, and why did the authorities make this change?***

7. ***Staff's comments regarding the rationale behind replacing the GST with the SST are welcome.***

8. ***Could staff comment on the motivation behind the decision taken last June to replace the Goods and Services Tax (GST) with the Sales and Services Tax (SST) and to what extent this decision could complicate the fiscal consolidation efforts?***

9. ***Could staff shed light on the considerations behind the authorities' decision to zero-rate the GST and introduce the SST?***

10. ***Can staff report on the rationale behind the change from the GST to the sales tax, and how important the impact on revenues in a medium-term perspective is?***

- Staff estimates that the revenue shortfall from replacing the GST with the SST amounts to around 1.4 percent of GDP—subject to future revision based on the actual SST revenue in 2019 as well as the GST related tax refunds to be verified and audited.

- Abolishing the GST was one of the main campaign pledges of the Pakatan Harapan (the ruling party of Malaysia that won the 2018 elections) in the 2018 general election with the aim of reducing household tax burdens—tax burdens of low income households in particular. In addition, the 2019 budget speech highlighted that replacing the GST with the SST would lower the compliance cost for small and medium enterprises. Even though the authorities seem to be aware of the disadvantages of the SST (e.g., narrower tax base and cascading effect), the above reasons led to the authorities' decision to replace the GST with the SST.

11. ***Staff information on the extent of potential revenue gains from narrowing the compliance gap would be welcome.***

- The authorities have been enhancing tax compliance, including through increased information sharing between agencies. The 2017 staff report expected a moderate revenue gain of 0.1 percent of GDP from improving compliance in corporate income tax. Separately, as highlighted in the 2017 staff report, the GST was helpful in this respect by providing an incentive for businesses to register so as to reduce input costs. Given the GST abolishment, however, we have not included additional gains from improving tax compliance in the fiscal projections. Nevertheless, tax compliance remains a priority to enhance the efficiency of revenue mobilization and prevent the widening of informal economic activities following the abolishment of the GST.

12. ***Could staff comment on the effect of the recommendation to reduce investment incentives in CIT and the overall increase in revenues on regional competitiveness.***

- According to the 2019 Fiscal Outlook, less than 20 percent of the 14 million-strong workforce and 1.1 million business establishments are paying income/corporate tax.

Against this backdrop, staff assesses that there is room for raising revenues through broadening the tax base without undermining regional competitiveness.

- According to BNM's analysis (The BNM Quarterly Bulletin, third quarter 2017. "Rethinking Investment Incentives"), there are more than 100 types of tax incentives mainly related to pioneer status, investment and reinvestment incentives. The corporate tax revenue foregone from tax exemptions and allowances is estimated to be 0.8-1.3 percent of GDP. In addition, the analysis also mentioned the possibility of tax redundancy by quoting a survey conducted by the World Bank—four out of five firms surveyed in Malaysia indicated they would have invested also in the absence of incentives. Staff understands that the Tax Reform Committee will carefully review the effectiveness of tax incentives in order to streamline without undermining Malaysia's regional competitiveness.

13. ***We would have appreciated a deeper analysis and recommendations in the staff report regarding the share of proceeds from the oil and gas sector in the overall budget over time, which has fluctuated substantially (cf. Fig. 5), and how these are incorporated in the fiscal projections.***

- The staff report highlights the increased dependency on oil revenues in the budget in paragraph 12. To give additional perspective on this issue: the share of oil and gas revenues substantially declined from 30 percent of the total revenue in 2014 to 16 percent in 2017, supported by the authorities' fiscal reforms. The share is estimated to increase to 22 percent in 2018 amid higher-than-expected oil prices and the abolishment of the GST. In 2019, the share will further increase to 31 percent, also due to one-off transfers from Petronas (2 percent of GDP) to finance one-off tax refunds (2.4 percent of GDP). Over the medium-term, the share of oil and gas revenues is projected to be at around 20 percent in the absence of additional tax reforms.

- As mentioned in the staff report, lower-than-projected oil prices could complicate the authorities' fiscal consolidation efforts. In general, a US$10/bbl decrease in oil prices is estimated to decrease the oil related government revenue by about 0.2 percent of GDP.

14. ***We would also appreciate staff's comments on how to better target social assistance and subsidies to save 2.1 percent of GDP (paragraph 12).***

- Expenditure rationalization measures to save 2.1 percent of GDP are already included in the 2019 budget. Concrete measures include: targeting fuel subsidies; better targeting cash transfers for low-income households to those in need; and rationalizing supplies and services as well as grants to statutory bodies.

- Regarding fuel subsidies, the authorities have reintroduced in 2019 a managed-float fuel price and will limit the fuel subsidies for individual car owners with engine capacity of 1,500cc or less and motorcycle owners of 125cc or less with the aim of benefiting low-income households. On other social assistance, the cash transfers for low-income households previously provided to both households and individuals are now targeted to households, since individuals are typically not facing poverty issues (such as students living alone who receive transfers from their parents).

15. ***Can staff comment on advice they are providing regarding coverage of contingent liabilities in fiscal and debt data, and whether transparency will be reinforced in the Fiscal Responsibility Act?***

- The authorities already produce Government Finance Statistics (GFS) for the budgetary central government on a cash basis. The authorities also collect and publish data on other subsectors of the public sector. Going forward, the reporting of public sector data, government guarantees, and public private partnerships should be integrated in the GFS. In addition to the cash-based information, accrual-based information is critical to capture the comprehensive picture of the public-sector balance sheet. To this end, the STA has been conducting technical assistance and training missions on GFS.

- While the details are yet to be seen for the Fiscal Responsibility Act, fiscal transparency is included in the authorities' fiscal reform agenda and should be reinforced in the Act.

16. ***Staff has proposed a series of reform options, where the FRA is at the center of the reform strategy, and recommends that the FRA should specify key features of the fiscal framework to ensure a lasting impact. What are staff views on whether the FRA will address these suggested reform options?***

- While the details for the Fiscal Responsibility Act are yet to be seen, staff is encouraged by the authorities' comprehensive reform agenda laid out in the 2019 Fiscal Outlook. The main areas of fiscal reforms are governance, revenue mobilization, and expenditure rationalization. In the context of fiscal governance, the authorities highlighted responsible fiscal principles, medium-term fiscal targets and high standards of fiscal reporting. Staff is in touch with FAD on possible technical assistance to the authorities to help with preparing the Fiscal Responsibility Act.

17. ***In this regard, we noticed that there has been an increase in Federal Government Loan Guarantees. We would appreciate staff comments on the factors behind this increase.***

- Like most other countries, the authorities make use of government guarantees as a complementary fiscal tool for accelerating economic development by facilitating public entities' undertaking of development projects. The authorities are aware of associated fiscal risks and noted the increase in guarantees in recent years, which could be associated with the relative weakness of the related governance framework. The authorities have initiated a review of the process of granting guarantees and have tightened conditions associated with the process, including by imposing a fee on government guarantees for riskier projects. Nevertheless, the authorities' risk management framework still needs to be further upgraded in line with best practice. For example, the authorities could explore the introduction of numerical rules for government guarantees as discussed in the Economic Report 2017/2018. In addition to these policy developments, staff was informed during the mission that the granting of new government guarantees was put on hold amid a comprehensive review of infrastructure projects.

18. ***We take note that the authorities have put in place a Tax Reform Committee with the aim of enhancing revenues while reviewing tax incentives. In staff's view, which are the main issues that this Committee should focus on?***

19. ***Given the revenue underperformance, it is encouraging to note the recent steps taken to review the tax system and boost revenue mobilization with the newly created Tax Reform Committee. Could staff comment on the timeline for the planned tax system review*?**

- Staff is of the view that a comprehensive approach is critical to enhance the tax system and strengthen tax revenues to help meet the authorities' medium-term fiscal objectives. In addition, as indicated in the text table (page 10 in the staff report), streamlining investment incentives should also help raise tax revenues. Staff understands that the Committee will conduct the review in advance of the formulation of the 2020 budget in order to reflect their recommendations in that budget.

20. ***We also note from last year article IV that the rate of the consumption tax was particularly low compared to regional peers, and we wonder if staff still recommends increasing this rate (beyond the call for tax base broadening).***

- Staff does not rule out the option of raising tax rates but is of the view that broadening the SST coverage should be a priority, since the authorities introduced a sales tax rate of 10 percent for some items vis-à-vis the standard GST rate of 6 percent.

21. ***We are not sure to fully understand the underlying assumptions of the assessment of fiscal space. It is the first time that we notice that the "limited fiscal space" category has been split in two. While we are not opposed to this change, we would have appreciated a clearer warning by staff and we wonder whether this change needs to be explained more clearly in a methodological paper (to avoid confusion for people whose reference remains the June 2018 paper "Assessing fiscal space: an update and stocktaking"). On the Malaysian case, we understand that the assessment of limited fiscal space was justified only once fiscal rules were taken into account. This argument does not appear in the discussion of this year assessment which we find quite confusing. Additionally, given the limited level of tax to revenue ratio, it seems that Malaysian authorities would have some room to react should the debt to GDP ratio comes closer to the limit sets by the fiscal rule. Could staff elaborate on this issue and clarify its reasoning behind its assessment of fiscal space being at risk.***

- Last September, some adjustments to the categories for the bottom-line fiscal space assessments were implemented. The change and the rationale were explained to the Board as per the attached Note on Fiscal Space Framework, circulated by the Secretary to the Board on November 7, 2018***. This change in categories was in response to concerns by some Directors, which had expressed that the existing categorization of space (Limited, Some, Substantial) gave the impression that the framework was biased towards finding space and Management agreed to revisit this issue. The revision thus split the previous category of "limited fiscal space" into two new categories of "no fiscal space" and "fiscal space at risk."*** Cases where fiscal sustainability and market financing are patently in question, or market financing is already prohibitively expensive, would be categorized as having no fiscal space. Countries where there are clear, but not imminent, risks to fiscal sustainability and at most marginal fiscal loosening is possible compared to the baseline, would be categorized as having fiscal space at risk.

- This change implied that about 13 pilot countries assessed to have limited fiscal space had to be re-categorized into one of the two new categories. The categories of some and substantial fiscal space would remain unchanged.

- As mentioned in the staff report, Malaysia's fiscal policy is anchored by a commitment to keep the federal government debt below 55 percent of GDP. Malaysia's fiscal space is assessed as "at risk" absent fiscal consolidation, because the debt anchor could be breached if downside risks materialize. In other words, in the absence of fiscal consolidation, at most marginal fiscal loosening is possible compared to the baseline. On the other hand, the authorities' medium-term fiscal consolidation would provide welcome buffers vis-à-vis the debt anchor and enhance fiscal space.

- In the 2017/2016 pilot results (included in the June 2018 paper "Assessing Fiscal Space: An Update and Stocktaking"), staff regarded both the above-mentioned debt anchor and the medium-term fiscal balance target (which was, at that time, achieving a near balance over the medium-term) as fiscal rules. It concluded that there is some fiscal space if the authorities are not constrained by the medium-term fiscal balance target, as slower fiscal consolidation path could also satisfy the debt anchor. In fact, the authorities have reset their fiscal consolidation path in the 2019 budget, given a higher deficit outcome in 2018.

Monetary, Exchange Rate, and Financial Markets Policies

22. ***On what basis and in what channels do staff see those measures [the 2016 FX market prudential measures] creating distortions?***

- The December 2016 FX measures create distortions by introducing administrative costs (costs involved in complying with the regulations, including associated paperwork), and by affecting economic agents' desired resource allocation. For example, limits on FX investments by residents with domestic ringgit borrowing complicates the management of FX risks across companies within a group in cases where one company may earn the bulk of the export proceeds while others may import. BNM welcomes applications seeking approval in those cases, however the process adds bureaucracy and paperwork. Also, the narrow interpretation of domestic borrowings that can activate limits on foreign currency investment (e.g. company credit cards) has resulted in some companies moving regional treasury units outside of Malaysia, which was not an optimal outcome for these companies.

23. ***Regarding the 2016 FX measures… staff say that these measures can be distortive, potentially leading to resource misallocation, and therefore may not support market development. Do staff see any evidence of resource misallocation?***

- The overall quantitative impact of distortions highlighted in our response above is difficult to measure. Private sector participants that staff met with on mission gave specific examples of the distortions, as noted in the answer to Q22, on the basis of which staff is confident that such distortions do exist.

24. ***Staff, however, assess that Malaysia's external funding requirement is large, and it is deemed a high risk in their Debt Sustainability Analysis. Could staff elaborate upon this judgment, and the factors behind the high external financing requirement?***

- In the public debt sustainability analysis, the external financing requirement is defined as current account balance plus amortization of total short-term external debt at remaining maturity, which is estimated to be 38 percent of GDP for Malaysia. The heat map (page 49 in the staff report) automatically generates the risk rating based on the threshold of early warning benchmarks—15 percent of GDP. However, as described in the staff guidance note for public debt sustainability analysis in market-access countries, the heat map does not produce an overall debt rating, calling for a granular analysis. In the context of public debt sustainability, staff is of the view that risks associated with the relatively high share of government debt held by foreigners are mitigated by the existence of a large domestic institutional investor base. Instead, the key challenge is to build fiscal buffers vis-à-vis the federal government debt anchor. From the external sector perspective, as discussed in the external sector DSA, risks are manageable via a variety of migration measures.

25. ***How do staff assess this long-standing policy in light of the IMF's Institutional View on capital flows? And what kind of policy measures do staff recommend deepening the onshore financial market and reduce the volatility without using the CFMs, especially in a country where the intermediation capacity of the domestic market is still at a developing stage in terms of its ability to absorb and counter the effect of large and volatile capital flows?***

- The IMF's Institutional View (IV) does not prescribe full capital account openness to all countries at all times. Rather it recognizes that the appropriate degree of liberalization at any time would depend upon the country's circumstances and overall economic objectives. The IV recommends that liberalization be well planned, timed and sequenced with other supporting policies and each country's institutional and financial development to ensure that its benefits outweigh the costs. Staff is mindful of the level of openness chosen by the authorities and therefore, Malaysia's long-standing policy of non-internationalization of the ringgit is not at odds with the IV. On further deepening onshore FX markets, as noted in Appendix IX, there are no specific measures that need to be taken today, rather this deepening should continue to take place organically as market participants, faced with daily exchange rate fluctuations, make use of available derivative instruments to hedge. Exchange rate volatility is needed to some extent to help deepen FX markets.

26. ***The staff recommendation to phase out these measures needs to be further analyzed including the application of the Institutional View on management of capital flows, considering the specific country context. We would like to hear more details from staff on a) The indicated distortions emanating from these measures and how these could be addressed by alternate measures with assured results on the onshore FX market b) Is there room for considering country circumstances while considering the policy advise on CFMs?***

- On (a), please see answers to Q22, Q23 and Q25 above. On (b), the IV provides a framework for consistent assessment and advice to all members on policies related to capital flows, while fully taking into account their specific circumstances and domestic macroeconomic settings. As a result, seemingly similar measures may be assessed differently across countries if circumstances differ, or in the same country over time when and if circumstances change.

Financial Sector

27. ***Against this background, and considering that the Board has recently adopted the Bali FinTech agenda which among other issues, outlines more frequent coverage of FinTech issues in surveillance, we would like to ask staff whether they plan to cover these topics in the next consultation?***

- Given limited resources and the priorities of topics to cover in detail in this year's consultation (including fiscal issues, FX market issues, and governance issues) we had to prioritize. Staff will consider broader coverage of FinTech related issues in future consultations.

28. ***Given the risks related to the housing market, it would be prudent to assess the impact of the macroprudential tools adopted in similar circumstances in peer countries, which may help enhance the monitoring capabilities of supervisory authorities. Could staff indicate what tools are commonly used in comparable jurisdictions? How widespread is the use of standard LTV requirements and debt-service-to-income ratios?***

- Macroprudential tools commonly used in comparable jurisdictions include sectoral capital requirements (risk weights), limits on loan-to-value (LTV) ratios, and caps on debt-service-to-income (DSTI) or loan-to-income (LTI) ratios. Evidence shows that these tools can be effective in increasing the resilience of borrowers and the financial system to house price or income shocks.

- The use of LTV ratio caps across countries is quite common. Based on the annual IMF survey on macroprudential policy, as of end-2016, 56 countries maintain at least one LTV restriction (including 6 countries that implemented both LTV limits and limits on bank's exposures to loans with high LTV). 39 countries reported at least one DSTI restriction.

- In addition, DSTI caps are gaining popularity, with a number of countries having introduced such caps recently (e.g., Czech Republic, Portugal, and Romania).

29. ***How do staff assess the liquidity risk of foreign currency for banks, considering BNM's prudential requirements and approval framework, including the requirements on liquidity and funding risk management for banks' external debt?***

- Banks maintain prudent net foreign exchange positions, as mandated by BNM. Having said that, FX liquidity risk is very much present in Malaysia as it is in every other emerging market country. In this respect, the recent US Federal Reserve's more dovish stance on the interest-rate (against the previously signaled more rapid increase in rates) should help alleviate that risk.

30. ***We note that staff and the authorities have differing opinions around the potential vulnerability of the banking sector to sharp adjustments in real estate prices. We invite staff to clarify the reason behind these diverging opinions, especially since BNM stress tests indicate that potential bank losses due to sharp real estate price adjustments and income, and interest rate shocks are manageable relative to banks' capital buffers.***

- The authorities and staff agree that there are risks in bank's balance sheets associated with the real estate sector. As highlighted in Appendix X, linkages between housing market and the financial sector are significant, both through household mortgages and the (residential and commercial) real estate developers. BNM stress testing shows that the financial sector is resilient to a direct hit caused by a property market decline of plausible size. Hence both staff and the authorities deem the risks to be manageable. However, staff views that a financial exposure of this magnitude could be difficult for banks to fully ringfence in case of large combined shocks (e.g., housing market decline accompanied by a large shock to the households' ability to service debt because of, say, a recession).

31. ***Banks' exposure to the real estate sector is flagged by staff as a source of potential vulnerability, but there seems to be subtle differences in risk assessment between staff and the authorities. We welcome staff comments.***

- Please see answer to Q30.

32. ***Divergence on staff recommendation for the sector-wide LTV ratios and to phasing out the residency-based differentiation, is notable. Does staff assess any immediate fallouts of the non-application of the staff suggested measures?***

- At present, risks appear to be contained and no short-term fallout of the non-application of proposed measures is expected. Staff's advice regarding these measures is aimed at strengthening the underlying framework over the medium term and, in the case of residency-based differentiated measures, it is aimed at removing a distortion in line with the Fund's Institutional View.

33. ***We sympathize with the authorities' view on the role of nonresidents as potentially destabilizing to the housing market and commend them on their overall close monitoring of the housing market. In the absence of rigorous quantitative analysis on the causality of both the reduced and shifting profile of non-resident transactions, we would caution against prematurely doing away with MPM measures that have helped curtail the falling affordability of the housing market in Malaysia. We look forward to staff suggestions on alternatives that could meet the same objectives.***

- Staff recommends a gradual phasing out of these measures, as systemic housing market risks dissipate. Carefully calibrated changes to the measures may help reduce the excess supply of high-end housing where nonresident buyers are concentrated and therefore the probability of a sharp downward price correction. Alternative measures that would meet the same objectives without a differentiated treatment of non-residents could include, for instance, tax-based measures that differentiate properties according to price segments, as well as taxes on property value gains and taxes on vacant properties, but without differentiating between residents and nonresidents.

34. ***Which additional prudential measures would staff recommend for mortgage credit? Regarding the residency-based policy in the property market, how does this compare to other countries, are these measures used frequently elsewhere?***

- Staff has recommended introduction of LTVs on the second and first mortgages (limits on 3+ properties are already in place), which would provide for an additional buffer and reduce the riskiness of future mortgage lending. On the residency-based property market measures, while they are not commonly used in other jurisdictions (in fact they are rare), some examples of their use can be found in Australia, Canada or Singapore.

35. ***Could staff comment on the potential social implications of an interest rate shock on these low-income households, if any?***

- Based on BNM's analysis (using 2016 data), the impact of interest rate shock (modeled as a 50 basis points hike in the lending rate) is small. The share of all borrowers with negative financial margin (FM; defined as disposable income less debt service and expenditures on necessities) only increases by 0.7 percent compared to the baseline scenario. While the share of households with negative FM for the group earning less than RM3,000 per month is the greatest among all groups, the *impact* of the interest rate shock on this group is the smallest since half of their total debt is in the form of fixed-rate products.

36. ***Could staff give some additional information on the proposed study by the Companies Commission of Malaysia on beneficial ownership requirement (e.g. specific aims, composition, timeframe) and how its findings are planned to be fed into the political process (para 31)?***

- The Companies Commission of Malaysia is planning to conduct the study in 2019. The study will cover the implementation of beneficial ownership[4] requirements by companies and limited liability partnerships registered under its relevant laws. Results of the study will be used to develop a framework to streamline the implementation of the requirements by these entities. A guide will be issued to assist them to implement the requirements in line with the Companies Act 2016 and international standards.

37. ***Staff's comments on the authorities' action plan to address weaknesses in the AML/CFT framework are welcome.***

38. ***As Malaysia has just completed the 3-year cycle since the Financial Action Task Force (FATF)'s 2015 mutual evaluation, could staff provide an update on the progress achieved in addressing compliance deficiencies in the Enhanced Follow-up Report?***

- The Malaysian authorities continue to make progress in addressing the shortcomings identified in the 2015 Mutual Evaluation Report. In particular, the report identified challenges by financial institutions and other reporting entities in identifying domestic politically exposed persons (PEPs), their family members and close associates as well as their sources of funds. The authorities continue to make progress in ensuring effectiveness in the implementation of these measures and have issued guidance on the identification of PEPs and application of enhanced customer due diligence measures. Further legislative amendments are needed to ensure compliance with the FATF standards, including with respect to the transparency of legal persons and legal arrangements. Malaysia remains under the FATF's enhanced follow-up process and will periodically report back to the FATF on progress made to strengthen implementation of AML/CFT measures.

[4] Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement. (The Financial Action Task Force Guidance on Transparency and Beneficial Ownership)

39. ***Additionally, could staff provide comments on the regulatory landscape for Fintech and crypto assets in the country?***

- The consultation did not focus on FinTech issues. Please see answer to Q27.

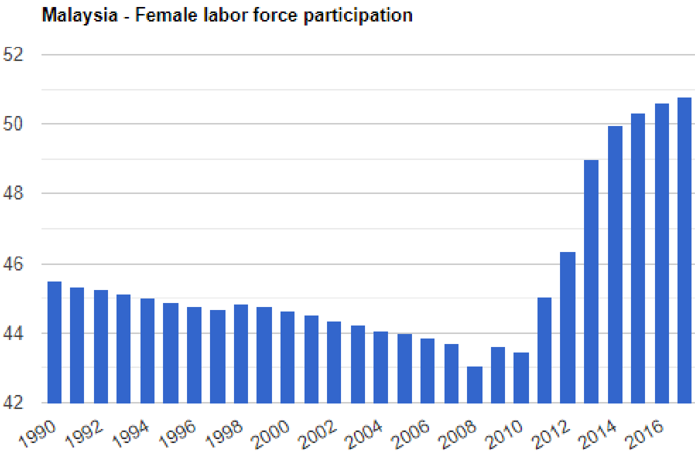
Structural and Governance Reforms

40. ***Could staff comment on the sequence of the policies to help lift productivity growth and to raise the quality of human capital?***

- To achieve high income status, boosting productivity growth is key. In the recent decade, Malaysia has gradually lost some of its competitiveness in labor intensive industries to neighboring countries, while foreign firms with high R&D-content stayed. This indeed provides an opportunity for Malaysia to upgrade its industries by promoting the use of digital technology and automation. In terms of sequencing of reforms, institutional reforms should be prioritized, which would help boost confidence and promote private consumption, investment, and potential growth. The authorities have rightly emphasized governance reform as first priority in the Review of the Eleventh Malaysia Plan. In addition, the authorities should continue to prioritize human capital development, with intended reforms focusing on improving labor efficiency and productivity, enhancing access to quality education and training as well as fostering stronger industry-academia linkages.

41. ***Could staff elaborate on the developments in female labor participation and other measures meant to enhance inclusive growth?***

- Average female labor participation has seen a substantial increase since 2010 (see graph below, data source World Bank). We looked at the developments in female labor participation closely during last year's Article IV consultation, and found that during 2010–16, the contribution of female workers to employment and economic growth was strong, outpacing that of male workers. Based on a growth accounting exercise with human capital formation, we found that the contribution from female employment to real GDP growth had more than trebled. Female employment growth had more than doubled over 2010–16, compared to 2000–09, and was also higher than male employment growth. Moreover, the gender gap in average years of schooling had shrunk, providing additional contributions from female human capital formation. Despite this progress however, the analysis found that there was still scope for additional improvement as the relative female labor participation rate remained low compared to some regional peers and to OECD average. (See Appendix IX of the 2018 Article IV Staff Report for Malaysia for details).



- The authorities' structural reform agenda includes several reforms to enhance inclusive development, with an important focus on raising the income and purchasing power of the Bottom 40 households and empowering minorities. Key initiatives for B40 households include enhancing access to quality education and skills training at all levels, providing comprehensive and integrated entrepreneurial development programs as well as promoting the adoption of modern technology and best practices. Regarding minorities, priority will also be given to increase intake of minority students into skills training institutes. Other initiatives aim to uphold the needs and interest of children, nurture the potential of youth, enhance the role of women in development, enhance the living environment for the elderly, and empower persons with disabilities.

42. ***Could staff give an assessment of the expected impact that the planned update of the foreign worker policy will have on labor supply (para 39)?***

- The progressive multi-tiered levy on foreign labor employment is expected to reduce firm demand for foreign workers, with implications for domestic labor. At this stage, staff is not able to give a quantitative assessment, as the details of the multi-tier levy system have not been announced.

43. ***Could staff comment on the importance of these reforms in enabling the Malaysian authorities to meet their wider economic objectives, including achieving high-income status by 2025?***

- Governance reforms would help enhance transparency and accountability, strengthen public trust, and improve the efficiency of fiscal spending. The latter would help create space for additional spending needed to promote inclusive and balanced regional development, invest in human capital, enhance environmental sustainability, and strengthen economic growth to reach high-income status.