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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 20/15-2

10:30 a.m., February 7, 2020

2. Malaysia—2020 Article IV Consultation

Documents: SM/20/29, and Cor. 1, and Cor. 2, and Sup. 1; SM/20/30

Staff: Choueiri, APD; Gonzalez, SPR

Length: 49 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	M. Ismail (AE), Temporary
	M. Alle (AF), Temporary
	R. Morales (AG), Temporary
	N. Heo (AP)
	P. Fachada (BR)
	K. Lok (CC), Temporary
	A. Guerra (CE)
L. Levonian (CO)	
R. Kaya (EC)	
A. Buisse (FF)	
	S. Buetzer (GR), Temporary
S. Bhalla (IN)	
	A. Ribeiro Mateus (IT), Temporary
	K. Kuretani (JA), Temporary
	C. Sassanpour (MD), Temporary
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
	R. Alkhareif (SA)
A. Mahasandana (ST)	
P. Inderbinen (SZ)	
	A. Clark (UK), Temporary
	P. Pollard (US), Temporary

S. Bhatia, Acting Secretary
H. Malothra, Summing Up Officer
D. Al-Jarbou / B. Zhao, Board Operations Officers
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: N. Choueiri, G. Ganelli, X. Li, C. Marchini, D. Nyberg, J. Schmittmann. Independent Evaluation Office: R. Pedraglio Florez. Legal Department: A. Yiadom. Monetary and Capital Markets Department: J. Zhou. Research Department: L. Juvenal. Strategy, Policy, and Review Department: R. Cartaxo Mano, M. Gonzalez, S. Hassan, N. Sheridan. World Bank Group: K. Sjetnan. Executive Director: T. Tanaka (JA).

Alternate Executive Director: L. Palei (RU), P. Rozan (FF). Senior Advisors to Executive Directors: J. Damgaard (NO), Z. Mahyuddin (ST), L. Marek (EC), S. Senich (US). Advisors to Executive Directors: V. Djokovic (SZ), P. Mooney (CO), D. Susiandri (ST), S. Yoe (ST).

2. MALAYSIA—2020 ARTICLE IV CONSULTATION

The staff representative from the Asia and Pacific Department submitted the following statement:

The information below has become available following the issuance of the staff report (SM/20/29). It does not alter the thrust of the staff appraisal.

On January 22, 2020, Bank Negara Malaysia (BNM) reduced the Overnight Policy Rate (OPR) by 25 basis points to 2.75 percent. In its monetary policy statement, the BNM stated that "the adjustment to the OPR is a pre-emptive measure to secure the improving growth trajectory amid price stability." The statement also indicates that BNM continues to expect growth to be within its projected range of 4.3-4.8 percent in 2019 and to gradually improve in 2020. Nonetheless, the statement mentions downside risks to growth including trade- related uncertainty, geopolitical risks, weaker-than-expected growth in major trade partners, heightened volatility in financial markets, and domestic factors such as weakness in commodity-related sectors and delays in the implementation of projects. Analysts have portrayed the main motivation for the rate cut as buying insurance against the downside risks.

Staff Assessment: Staff support the rate cut in view of the recent drop in inflation expectations seen in the January consensus forecasts. The cut is consistent with staff advice that monetary policy should remain data dependent. With the recent drop in inflation expectations, the cut implies that monetary policy remains appropriately broadly neutral according to staff's assessment. The rate cut also helps bring risks to the outlook, assessed in the staff report to be to the downside, closer to balance.

Implications for the Staff Report: The rate cut does not alter the thrust of the staff appraisal.

Ms. Mahasandana and Mr. Mahyuddin submitted the following statement:

Introduction

On behalf of the Malaysian authorities, we wish to express our appreciation to the IMF team for the comprehensive report and constructive dialogue during the 2020 Article IV consultation. We are encouraged by staff's positive assessment on Malaysia's economic and financial outlook, as well as acknowledging the appropriateness of the current macroeconomic policy setting and the progress in Malaysia's reform agenda.

Amidst heightened uncertainty and considerable downside risks in the global economy, the Malaysian economy moderated in 2019. Growth was underpinned by a diversified economy, the flexibility accorded by a floating exchange rate and healthy external balance. The Malaysian authorities continue to be vigilant over near-term risks and remain committed towards medium-term governance and structural reforms to ensure sustainable and inclusive growth.

Given its highly open economy with a financial system that is integrated with the international financial system, Malaysia remains susceptible to external developments and cross-border spillovers. In managing these risks, the necessary policy frameworks that enable timely and targeted policy responses and adequate buffers are in place to cushion the impact of these external spillovers and address specific risks confronting the economy and the financial system. As risks and challenges become more complex, especially under the "low for long" interest rate environment in a number of advanced economies, we welcome the Fund's greater recognition of the need for an expanded policy toolkit and an integrated approach to policy formulation, and urge the Fund to expedite its ongoing work on the integrated policy framework.

Latest Economic Development and Outlook

Authorities broadly agree with the IMF's near-term assessment of the Malaysian economic growth and risks. The Malaysian economy grew by 4.6% in the first 3 quarters of 2019, supported by firm private consumption spending and positive net exports. Investment activity, however, remained modest, due to weak capital spending by both the private and public sectors. In 4Q 2019, unanticipated supply disruptions in the commodities sector and a contraction in net exports are expected to weigh on growth. Headline inflation averaged lower (2019: 0.7%; 2018: 1.0%), mainly reflecting the extension of domestic retail fuel price ceilings and the lapsed effect of the changes in the consumption tax policy[1]. Meanwhile, core inflation was broadly stable (2019: 1.5%; 2018: 1.6%).

In 2020, the authorities expect gradual improvement in growth, supported by continued household spending amid stable labor market conditions. Key Government initiatives from the 2020 Budget such as the higher minimum wage in urban areas, targeted fuel subsidy and cash transfers

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[1] Refers to the combined impact of the zeroization of the Goods and Services Tax (GST) rate and the implementation of the Sales and Services Tax (SST) in 2018.

are also expected to lift disposable income. Investment activity is expected to record a modest recovery, underpinned by the realization of approved investment projects and resumption of large infrastructure projects. In line with the expected improvement in global growth and trade, Malaysia's exports are expected to experience a broad-based recovery. E&E exports (37.8% share of Malaysia's total exports), in particular, is poised to benefit from the pickup in the current global technology cycle given Malaysia's position as the 6th largest semiconductor exporter globally. Headline inflation is expected to average higher than in 2019 but remain modest. The trajectory of headline inflation will be dependent on global oil and commodity price developments and the timing of the lifting of the domestic retail fuel price ceilings. Underlying inflation is expected to remain broadly stable, reflecting the continued expansion in economic activity and the absence of strong demand pressures.

Our authorities concur that risks to the growth outlook are tilted to the downside. These include the uncertainty surrounding trade tensions, slower-than-expected growth in major trading partners, potential tightening of global financial conditions as a result of heightened risk aversion towards emerging markets and implications from prolonged Coronavirus outbreak. On the domestic front, weakness in commodity-related sectors and delays in the implementation of projects may pose further risks to growth.

However, several factors will help mitigate these risks. Exchange rate flexibility with adequate levels of international reserves will continue to buffer against external shocks. Malaysia's diversified export base reduces reliance on any single product or market. Deep financial markets, supported by demand from large domestic institutional investors and a sound banking system, will continue to intermediate capital flows during risk-off periods. The Malaysian Government's commitment to ensure timely implementation of public projects and continued efforts to provide policy clarity will help cushion the downside risks to growth.

Fiscal Policy

The authorities embarked on a holistic fiscal reform program that focuses on strengthening of the governance and fiscal policy management while continuing to remain supportive of sustainable and inclusive economic growth.

The authorities continue to promote greater transparency and accountability through its second annual publication of the Fiscal Outlook and

Federal Government Revenue Estimates. The report, among others, highlights the Medium-Term Fiscal Framework for the next 3 years and includes a comprehensive reporting of fiscal risks and liability exposures, including Government Guarantees and other liabilities such as those related to public-private-partnerships. A comprehensive assessment of debt management and an internal Debt Sustainability Analysis suggest that Malaysia has relatively manageable level of debt and financing needs. This is consistent with staff's findings that the debt level is expected to gradually decline to a debt-to-GDP ratio of below 50% in the medium term. The authorities are establishing a Debt Management Office, for a more holistic assessment of total debt and liabilities and more prudent debt management. The Government Procurement Act will likewise further promote the credibility and efficiency of public finance while the enactment of the Fiscal Responsibility Act in 2021 will further enhance fiscal discipline.

The authorities have remained steadfast in their commitment towards fiscal consolidation and are confident in achieving further deficit reduction over the medium term. The authorities undertook a rigorous exercise to minimize fiscal leakages by improving spending efficiency, strengthening the procurement processes and ceasing low priority projects with low multiplier effects. The authorities will also gradually reduce the broad-based fuel subsidy and move towards more targeted assistance through the implementation of the Targeted Fuel Subsidy Program. The better spending efficiency created the required space for higher expenditures in health and education as well as other spending to support longer-term structural reforms.

The authorities are committed to enhancing its revenue base by reducing the tax gap and improving tax efficiency through various initiatives. This includes rationalizing tax incentives, minimizing tax leakages and enhancing tax compliance through effective auditing. Excluding the one-off PETRONAS special dividend payout in 2019, higher revenue collection is expected in 2020. More progressive personal income tax structure, higher chargeable income criteria for corporates to benefit from the reduced tax rate for SMEs and new Digital Services Tax are among the key measures expected to enhance the revenue base in 2020. The Tax Reform Committee (TRC) undertook a holistic review of the national tax system to broaden the tax base while supporting sustainable and inclusive growth. Recommendations from the TRC will be incorporated in the Medium-Term Revenue Strategy (MTRS). Support from the Fund in formulating and implementing the MTRS and other fiscal initiatives are most welcomed.

Monetary Policy

Our authorities welcome staff's view that Malaysia's monetary policy framework has performed well in delivering its objective of price stability and growth. The authorities concur with staff's assessment that the monetary policy stance is appropriate. The Monetary Policy Committee (MPC) lowered the Overnight Policy Rate by 25 basis points to 2.75% in January 2020. The adjustment was a pre-emptive measure to secure the improving growth trajectory amid price stability. The MPC will continue to assess the balance of risks surrounding the outlook for domestic growth and inflation.

Exchange Rate Policy and Reserves Adequacy

Our authorities wish to emphasize that Malaysia is committed to exchange rate flexibility to enhance Malaysia's resilience against volatile capital flows and external shocks. Two-way foreign exchange market operations are undertaken to ensure orderly market conditions, particularly during periods of large and volatile capital flows. This ensures that the domestic financial markets continue to effectively play its role in intermediating funds and supporting economic activity. This is complemented by wider efforts to strengthen the underlying fundamentals of the Malaysian economy and further deepen and strengthen the domestic financial markets.

While Malaysia remains committed to exchange rate flexibility, staff's view that in some cases the exchange rate can act as a shock amplifier rather than a shock absorber is also in line with that of our authorities. Efforts are being undertaken to better understand conditions under which exchange rate can be a shock amplifier. In this regard, the authorities welcome the analyses and insights provided by the IMF, including through future collaborative work. Lessons from these efforts can help further refine the IMF's view and policy advice on managing external spillovers.

At the current juncture, the authorities believe that existing foreign exchange market operations are sufficiently transparent and effective. International reserves data is published every fortnight and is deemed as adequate. The publication of foreign exchange intervention data would be assessed once the work on integrated policy framework is completed.

The authorities concur with the IMF's assessment of Malaysia's international reserves adequacy. International reserves remain adequate across a wide range of indicators, including the ARA metric. Reserves adequacy assessments must evolve to take into account other forms of liquidity avenues available. In particular, liquid external assets held by resident entities and the availability and use of wide-ranging financial instruments, including hedging instruments, allow resident entities to manage and mitigate external exposures more effectively. Going forward, declining external indebtedness and continued healthy current account surplus will further enhance Malaysia's reserves adequacy.

The authorities welcome the IMF's acknowledgement of the improvement of Malaysia's external debt sustainability and its manageability under a variety of shocks. A holistic and dynamic assessment is critical in simulating exogenous shocks on external debt sustainability. While the external debt will rise most under the simulated exchange rate shock, this does not necessarily imply Malaysia's healthy external debt servicing capacity will deteriorate. Given Malaysia's sizeable net foreign currency asset position, exchange rate depreciation will result in a larger increase in external assets compared to the increase in external liabilities or external debt, in domestic currency terms, thus improving Malaysia's net international investment position (IIP). This stabilizing mechanism arising from the composition of Malaysia's IIP and trade and economic structures will provide some cushion for the country against potential external shocks.

The authorities welcome the 2018 refinement to the External Balance Assessment model but note that the model's explanatory power remains weak in the Malaysian context. Malaysia's current account surplus has narrowed significantly over the last decade, reflecting both structural and cyclical factors. Nevertheless, the authorities recognize that the current account surplus reflects partly the high savings and low investment in Malaysia. In this regard, the authorities have and remain committed to implementing reforms to promote investments and ensure a more comprehensive social safety net, particularly for the vulnerable groups. We are encouraged by the IMF's acknowledgement that signs of significant undervaluation are currently not present in the economy, despite the model estimating Malaysia's real effective exchange rate (REER) to be undervalued.

Financial Market Development Policies

Our authorities welcome the Fund's acknowledgement of the effectiveness of the domestic FX market deepening initiatives, and will continue to emphasize accessibility and liquidity as financial market development objectives. Regular engagements with investors will continue to play a pivotal role in ongoing policy communication and in informing appropriate policy responses by the authorities. In 2019, the expansion of the

Appointed Overseas Office (AOO) pilot programme received positive feedback from investors, both in terms of improved ringgit liquidity and price discovery beyond trading hours. The dynamic hedging programme has also progressively gained traction onshore, with an increase from 84 investors managing an aggregate of USD30 billion registered in 2018 to 104 investors managing USD37 billion in 2019. The growing demand for investor hedging in the onshore markets will continue to support the development of domestic FX swaps and forward markets, which have seen an increase in average daily FX transactions from USD11.5 billion in 2018 to USD12.2 billion in 2019.

The existing FX market measures are prudential in nature and form part of a broader policy toolkit. The authorities will continuously review the measures' effectiveness and will determine the timeline and speed of phasing out of such measures. To this end, our authorities appreciate the ongoing dialogue with the Fund, including possible discourse to further enhance Malaysia's hedging market as well as alternative measures that are in line with our authorities' policy objectives.

Financial Sector Resilience and Prudential Measures

Our authorities welcome staff's assessment that the Malaysian financial sector remains resilient and stable. We appreciate the recognition of the authorities' policy initiatives aimed at reducing the build-up of financial imbalances from exposures to households and real estate sector, and strengthening the soundness and stability of the financial sector more broadly. We are also encouraged by staff's recognition of the efforts undertaken to better manage risks posed by climate change to the financial system to enhance operational resilience of the industry and efforts to safeguard against cyber risks.

The authorities continue to closely monitor household debt given the high level of indebtedness but affirm that potential risks to financial stability emanating from the household sector remain manageable. Asset quality remains sound with low and stable ratio of aggregate impaired loans to total outstanding household debt for both banks and non-banks. Households' debt-servicing capacity continued to be supported by income and employment growth, coupled with ample aggregate financial buffers. Internal simulations suggest that under stressed scenarios, potential losses to the banking system from exposures to the overall household sector are estimated to be manageable.

Our authorities concur that borrowings by the vulnerable household group (individual borrowers with monthly earnings of below RM3,000) warrant close vigilance. Nonetheless, exposures to this group continue to exhibit low impairment ratios and improved vintage analysis. The proportion of exposures to this segment is also on a declining trend. Most of the new loans approved to the vulnerable segment continued to be within prudent debt service ratios in line with sound underwriting practices.

Our authorities broadly agree with the need for continued vigilance on the property market. However, the effect of a sharp deterioration in house prices to the banking system are mitigated by the fact that the majority of the outstanding housing loans carry a loan-to-value (LTV) of below 80%. Moreover, the bulk of housing loans are to owner-occupants, who are more likely to maintain loan repayments in the event of negative equity compared to investors. Banks also have sufficient capital buffers to absorb potential losses arising from up to a 50% decline in property prices and the associated spillover to business sectors that are highly dependent on the performance of the property sector.

The authorities reiterate the continued appropriateness of macroprudential and fiscal measures put in place since 2010. These measures have effectively contained risks from household indebtedness and credit-fueled speculative activities in the property market. They have also been complemented by the authorities' efforts to increase the supply of affordable houses as well as several policy measures to enhance affordability (e.g. Home Ownership Campaign, stamp duty exemptions, etc.) in line with sustained demand for affordable properties. With these measures in place, coupled with continued household formation as well as continued employment and income growth, risks associated with a sharp and generalized downward correction in house prices are assessed to be low.

While the authorities take note of staff's recommendation to impose sector-wide standardized LTV limits on first and second properties in the medium term as well as imposing a debt-to-service ratio limit on all individual borrowers, the authorities maintain that current macroprudential measures remain appropriate to contain risks from household indebtedness and rising property prices. Further, in practice, the LTV levels reflect banks' affordability assessments, which are carried out in line with the Responsible Financing Guidelines that must be observed by financial institutions. Differentiated capital charges for loans with higher LTV ratios and provisioning practices provide further support to mitigate banks' credit risk. While the authorities view current policies to be sufficient at present, they have noted that should developments warrant additional limits to be introduced for LTV and DSR, such measures can be readily implemented under existing policy frameworks that have already been put in place.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continue to be a key priority for our authorities. The revised policy documents on Anti-Money Laundering, Countering Financing of Terrorism and Targeted Financial Sanctions for Financial Institutions (AML/CFT and TFS for FIs) which came into effect on 1 January 2020 emphasizes the adoption of a risk-based approach when conducting customer due diligence (CDD) in accordance to the ML/TF risk levels. The new policy document has also consolidated requirements for TFS to ensure consistency and clearer guidance for institutions to implement sanctions screening regime across all sectors.

Governance and Structural Reform for Sustainable and Inclusive Growth

The authorities welcome staff's assessment of the progress made on governance reform. The implementation of the ambitious National Anti-Corruption Plan 2019-2023 (NACP) has shown significant progress, where 22 out of 115 initiatives in the plan have been implemented in 2019, including asset declaration by members of the administration. The remaining initiatives, including those which involve amending the Federal Constitution are on track. The authorities also underscore the importance of ensuring operational independence of the Malaysia Anti-Corruption Commission (MACC). The Special Cabinet Committee on Anti-Corruption, in January 2020, has agreed on the proposal for the termination of service of the chief commissioner be made through a constitutional process by amending the relevant law. A study will be carried out on the possibility for a chief commissioner's appointment procedures to be made through a constitutional process. Furthermore, other anti-corruption legislations such as the MACC Act, Witness Protection Act and the Whistle Blower Protection Act will be continuously reviewed and strengthened to ensure its relevance with current developments. Malaysia in the latest Transparency International's Corruption Perceptions Index (CPI) 2019, has jumped 10 spots in world ranking, reflecting the significant progress made in recent years.

The remaining 11th Malaysia Plan (11MP) period will also focus 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. The focus will be on strengthening sectoral growth, particularly services and manufacturing sectors, and promoting private investment. Meanwhile, further efforts will be taken to improve the business climate through enhancing the delivery of public services, reducing bureaucratic red tape and provision of quality infrastructure. Efforts to accelerate improvement in education and human capital development will continue to be prioritized.

More recently, the Government released the Shared Prosperity Vision 2030, which outlines the longer-term policy direction that continues to focus on creating a high-value, high-technology economy as well as diversifying resources and growth potential, while ensuring an inclusive, sustainable and meaningful socioeconomic development.

The Government continued to accelerate its structural reform agenda with growth-enabling reforms as well as boosting productivity and competitiveness. Approved foreign direct investment, particularly in the manufacturing sector hit an all-time-high in 2018 and continued to record a significant increase in 2019. The establishment of the National Committee Investment in August 2019 has been successful in expediting large investment approvals. A comprehensive review and a revamp of the existing incentive framework is also expected to be ready by January 2021 to facilitate more FDIs. The authorities remain committed to continuously improve the business climate, with greater emphasis on well-functioning ports and logistics system and infrastructure support for higher investment in regional development activities. To improve SMEs' access to alternative sources of financing, the authorities are encouraging new digital financial innovation such as Equity Crowd Funding and Peer-to-Peer funding through My Co-Investment Fund and provide tax incentives to attract venture capital and angel investors.

In January 2020, an exposure draft on the Corporate Strategic Plan for the development financial institutions (DFIs) was also issued. This sets out the enhanced expectations for developing robust and forward-looking business strategies and funding plans to further enhance the development impact of DFIs in meeting the financing needs of the economy. In addition, DFIs are required to measure the effectiveness and efficiency of discharging their mandates through an enhanced performance measurement framework.

As part of measures to spur innovation and technology adoption in the financial sector while also fostering financial inclusion, the authorities issued an Exposure Draft on Licensing Framework for Digital Banks in December 2019. Up to five licenses may be issued to qualified applicants to establish digital banks in Malaysia. Such digital banks are expected to offer meaningful access to and promote responsible usage of suitable and affordable financial solutions to financial consumers, especially those in the underserved and unserved segments.

The recent 2020 Budget announcement had also highlighted the capital development spending for digital infrastructure, incentivized digital application by businesses and levelled up of human capital. Education continues to receive the largest allocation in 2020, emphasizing on quality, equity, access, unity, efficiency and inclusiveness. Meanwhile, the progress on labor market reforms, particularly in boosting female labor force participation remains on track.

Concluding Remarks

The Malaysian authorities will continue to remain vigilant in facing any adverse developments and potential risks to the Malaysian economy and financial system. Our diversified economy, the flexibility accorded by a floating exchange rate, healthy external balance and strong financial sector will continue to support the economy's resilience to withstand shocks. Adequate policy tools and buffers also allow the authorities to respond effectively in a timely manner to preserve macroeconomic and financial stability. The authorities are committed to undertake key governance and structural reforms to achieve sustainable and inclusive growth. As the global environment becomes more challenging, the Fund has a greater role to play in reducing the risks from disruptive cross-border spillovers that can be destabilizing for small and open economies like Malaysia.

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

We thank staff for the informative set of reports and Ms. Mahasandana and Mr. Mahyuddin for their helpful Buff statement. Despite domestic and external challenges, the Malaysian economy has developed steadily in recent years with robust growth and modest inflationary pressures. We encourage the authorities to press ahead with their reform agenda to create the best possible conditions for sustainable and inclusive economic growth. We broadly agree with staff's appraisal and offer the following points for emphasis.

We welcome the authorities' commitment to medium-term fiscal consolidation. The planned Fiscal Responsibility Act (FRA) provides an opportunity to revisit the public debt limit framework. We appreciate staff's detailed analysis in Annex V, which concludes that the debt limit should remain at 55 percent of GDP but should be treated more flexibly in case of negative shocks. However, while staff's analysis suggests that Malaysia could tolerate a somewhat higher level of debt and still maintain investor creditworthiness, we stress that investor confidence can evaporate very quickly in case of a global or regional shock. Therefore, we encourage the authorities to build a buffer by moving forward with their plans for gradual fiscal consolidation. We also note that the tax revenue-to-GDP ratio is low compared to peer countries and is declining. Hence, we welcome efforts to formulate and implement a Medium-Term Revenue Strategy to achieve a sustainable higher revenue level to build fiscal space and finance priority expenditure. Moreover, we welcome the establishment of a high-level Debt Management Committee (DMC) and encourage the authorities to accelerate the creation of a Debt Management Office to act as a secretariat for the DMC.

The current monetary policy stance is appropriate. The Bank Negara Malaysia (BNM) should continue to pursue a data dependent monetary policy. With a policy rate of 2.75 percent, there is still space to loosen monetary policy further should downside risks materialize. We welcome the measures to deepen the domestic FX market and take note of the differences between staff's and the authorities' view on the narrow range of FX movements. We also note that the authorities do not find the ARA assessment methodology sufficiently granular to account for the characteristics of the Malaysian economy. Could staff elaborate on the difference in opinion?

The banking sector is resilient with highly capitalized, liquid, and profitable banks. The authorities have already lowered the minimum purchase price for foreigners buying completed but unsold apartments to help reduce oversupply and avoid sharp declines in house prices. We encourage the authorities to stand ready to implement additional macroprudential measures such as LTV and DSTI limits if necessary. Regarding cyber risks, we commend the authorities for having a well-developed national strategy in place and being an early mover in this important area. Moreover, on climate change risks, we welcome the BNM's engagement in the NGFS and the newly formed Joint Committee on Climate Change with industry representation.

Robust implementation of governance reforms is important in the fight against corruption. In particular, the authorities should move forward with implementation of the National Anti-Corruption plan and enhanced AML/CFT standards. Moreover, the authorities should aim to boost potential growth by simplifying procedures to start a business, improving access to financing, enhancing education outcomes, encouraging innovation, and advancing female labor participation. Could staff provide information on any new labor market reforms aimed at increasing female labor force participation since the 2018 Article IV report?

Mr. Buisse, Mr. Rozan and Mr. Sode submitted the following statement:

We thank staff for the quality of their document and Ms. Mahasandana and Mr. Mahyuddin for an insightful Buff statement. While Malaysia's economic performance remains well-oriented, further reforms are needed for the country to reach the high-income status in this decade. As highlighted in the report, external shocks triggered by an uncertain international environment raises difficult macroeconomic policy trade-offs. Against this backdrop, we would like to emphasize the following remarks:

We agree with staff that, as long as the economy is operating at or above its potential, the authorities should pursue a gradual fiscal consolidation in order to increase fiscal buffers. While the tax-to-GDP ratio is very low compared to peers, this fiscal consolidation should be first and foremost revenue-based. The work of the Tax Reform Committee (TRC) and the work on a Medium-Term Revenue Strategy are thus welcome. We commend the authorities for their commitment to augment spending in education and health. However, could staff elaborate on the adequacy and efficiency of social spending in Malaysia?

While we commend the authorities for the significant current account adjustment over the last decade, we share staff assessment that the current account is still higher than warranted by fundamentals. We agree with staff that further reforms should be undertaken to increase private investment and reduce households' precautionary savings (notably by increasing social safety nets). Could staff elaborate on the lessons learned from the reduction of the current account deficit that could be useful to other countries whose current account surplus are largely above their fundamental value?

We take note of the policy framework used by Malaysia to address macroeconomic and financial shocks and encourage staff to further refine its empirical and theoretical analysis of this unconventional approach. We welcome the authorities' commitment to exchange rate flexibility. We support their call for additional analytical work to better understand the conditions under which exchange rates can act as a shock amplifier rather than a shock absorber. Thinking about policy measures that could reinforce the shock absorption capacity of exchange rate – such as prudential measures to limit foreign currency exposures – should be part of this analytical work. We welcome the authorities' efforts to develop the domestic FX market. Could staff elaborate on the benefit and cost of existing capital flow management measures implemented by Malaysia relatively to alternative macroprudential measures?

We commend the authorities' ambitious efforts to improve governance. We share staff's call for giving priority to legislative initiatives currently underway on procurement reform, freedom of information, and independence of anti-corruption institutions. We also stress the need to strengthen the AML/CFT framework and notably to ensure accurate beneficial ownership information. Regarding virtual assets, we fully share staff call to apply AML/CFT standards to all service providers of virtual assets.

Mr. Heo and Ms. Park submitted the following statement:

We thank staff for their well written reports on Malaysia and Ms. Mahasandana and Mr. Mahyuddin for their comprehensive Buff statement. The Malaysian economy has been resilient to domestic and external shocks reflecting continued strong macroeconomic management. Nonetheless, with a highly open economy and globally integrated financial system, Malaysia is vulnerable to external developments and cross-border spillovers. We welcome the agreement between staff and the authorities on the need for medium-term fiscal consolidation, anchoring governance reforms through legislation and boosting productivity to increase incomes and encourage inclusive growth. We confine our comments to three areas:

Continued efforts to deepen the domestic FX market are welcome and enhance the exchange rate's ability to act as a first line of defense against short-term shocks. We welcome staff's analysis of country specific features to support tailored advice in this area, including plans to do further research into the circumstances in which the exchange rate plays the role of a shock absorber or a shock amplifier in Malaysia. Careful monitoring and preparedness for capital flow volatility is warranted. We agree that ongoing analytical work on the Integrated Policy Framework has a useful contribution to make in developing policy advice on capital flow measures and foreign exchange intervention that gives due consideration to county context, policy alternatives and tradeoffs faced by Malaysia.

We agree that risks in the household and property sectors should continue to be closely monitored to safeguard financial stability. Policy initiatives aimed at strengthening the resilience of households and the financial sector are welcome. We note the authorities' assessment that the risks to financial stability from a real estate price correction or a deterioration in households' debt service is contained by prudent lending and strengthened valuation and underwriting practices. The authorities' assessment that banks would withstand a 50 percent decline in property prices is striking. Given the authorities' assessment that sector-wide LTVs on first and second properties and DSTIs for all income groups are not currently needed, and that individual LTVs are informed by affordability assessments, we would welcome more details on the benefits and costs of introducing these measures on a non-binding basis?

The analysis of Malaysia's growing fintech sector is welcome and useful from the perspective of the IMF's role in sharing good practice in this emerging area. We note staff's assessment that the authorities have struck an appropriate balance between safeguarding financial stability and consumer protection while still encouraging innovation in the emerging fintech sector. Challenges for regulators going forward include maintaining this balance and supporting the development of critical infrastructure through frequent refinements to regulations and supervision.

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

We thank staff for the informative papers and Ms. Mahasadana and Mr. Mahyuddin for the helpful Buff statement. Malaysia's stable economy keeps the country in a good position to continue to address the medium-term challenges related to governance and structural reforms. We agree with many of staff's assessments in the report; however, there were several instances where we would request clarification of staff's analysis.

Fiscal and Debt: The reduction in the budget deficit is a positive development. Still, with public debt-to-GDP levels near statutory thresholds, further deficit reduction may be warranted. We welcome the Fund's technical assistance supporting efforts to develop a medium-term revenue strategy to help increase revenue. We see the benefit for the authorities to create some flexibility in the statutory debt limit in case of an economic shock, while keeping debt on a downward trajectory over the medium-term. We also note the Debt Sustainability Analysis found that contingent liabilities pose significant risks to long-term debt sustainability, which further emphasizes the need for fiscal restraint and debt transparency going forward.

External sector: We are perplexed by the discussion of exchange rate policy in the staff report and appendices. Staff sensibly encourage the authorities to deepen the development of the exchange markets to support a more flexible exchange rate and we welcome the statement in Ms.

Mahasadana and Mr. Mahyuddin's Buff that the authorities are committed to exchange rate flexibility. However, Appendix VII paints a bleak picture of exchange rate flexibility and suggests a more prominent role for FX intervention. The possible negative outcomes of exchange rate flexibility have long been recognized but so too have been the negative effects of fixed and managed exchange rates. We would caution staff that economic history is replete with cautionary examples, both of overvalued fixed exchange rates whose ultimate collapse have resulted in deep crises, and of undervalued exchange rates where deliberate policy actions to inhibit adjustment have imposed costs both on the domestic and global economies.

We are further puzzled when considering staff's policy advice regarding FX intervention and capital flows. Staff's external sector assessment notes that the exchange rate was undervalued in 2019 and reserves are broadly adequate, while stating that FX interventions should be limited to preventing disorderly market conditions. On the other hand, the staff report notes on page 10 that, "In the event of an inflow surge, some accumulation of FX reserves would be appropriate." Indeed, as staff note in Figure 4, net reserves rose in 2019 due to an increase in the central bank's forward book.

These muddled messages make it unclear what policy advice staff is giving the Malaysian authorities and ASEAN countries more generally. Moreover, they raise concerns about how external sector surveillance may be impacted by the Integrated Policy Framework and whether the Institutional View will remain a guiding light. Are staff arguing for greater management of exchange rates or more extensive use of intervention? Are staff suggesting that in situations where reserves are adequate and exchange rates undervalued, it should be FX intervention rather than external adjustment that serves as the primary shock absorber to shifting external conditions? In the specific case of Malaysia, can staff comment on the rationale for further FX reserve accumulation?

Lastly on this issue, we agree with staff and strongly encourage the authorities to publish its FX intervention data. The authorities note that they wish to "wait for the outcome of the ongoing analytical work on the Integrated Policy Framework…" before doing so. Yet, as far as we are aware, the IPF will not address publication of FX intervention data. On the contrary, we understand that the review of data provision to the Fund is considering making FX intervention data mandatory. Staff comment would be welcome.

Reform agenda: We welcome Malaysia's progress toward implementing governance reforms and measures to improve transparency and management of public finances. As staff highlight, strengthening governance can enhance the effectiveness of the broader structural reform agenda. Such efforts are especially meaningful as Malaysia seeks reforms to boost productivity and achieve high-income status. We concur with staff that Malaysia should cement reforms through legislation on asset declaration, procurement reform, freedom of information, and independence of anti-corruption institutions to reduce the risk of retrenchment in these areas.

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

We thank staff for the reports and Ms. Mahasandana and Mr. Mahyuddin for their comprehensive statement. Despite external headwinds, the Malaysian economy performed well in 2019, supported by strong fundamentals and robust domestic demand. We commend the authorities' continued implementation of sound macroeconomic policies, which have delivered high employment, robust GDP growth and moderate public debt, while providing a solid platform to strengthen buffers against shocks and advance structural and governance reforms.

Fiscal results for 2019 were encouraging. The fiscal deficit relative to GDP declined last year, as the authorities proceed with their medium-term expenditure rationalization. Given Malaysia's relatively low tax revenue ratio, we agree with staff that revenue mobilization should be treated as a priority over the medium-term to create fiscal space. In this regard, we support IMF technical assistance to help the authorities formulate and implement a strategy in this area. We welcome current plans to strengthen the fiscal framework through a fiscal responsibility law that establishes a public debt limit. However, given Malaysia's exposure to external shocks, we agree that the debt limit should retain some flexibility.

Inflation pressures have remained subdued. This is the result of a solid monetary policy framework and the appropriateness of Bank Negara Malaysia's (BNM) current monetary policy stance. We agree with staff that monetary policy should remain data dependent and the BNM should stand ready to adjust monetary policy to ensure that inflation expectations remain well anchored. Looking forward, we encourage the authorities to continue developing FX markets and to strengthen exchange rate flexibility to further increase the Malaysian economy's shock absorption capacity and resilience.

We take note of the differences between staff and authorities regarding the assessment of Malaysia's external position. While staff indicates that the external position in 2019 was stronger than implied by fundamentals and medium-term desired policies, the authorities continue to point to limitations in the IMF's analytical framework—despite recent improvements—given the weak explanatory power of the current account regression model for Malaysia. We tend to agree with the authorities' understanding that the current account surplus fundamentally reflects the gap between savings and investments in Malaysia, which should be addresses through structural reforms that promote investment and a more comprehensive social safety net.

We welcome the authorities' reform efforts to raise productivity. Among emerging market economies, Malaysia remains at the forefront in human capital investment and adoption of technological innovations. Further, we commend the authorities for the initiatives to improve governance and strengthen the country's fiscal transparency and anti-corruption frameworks. Nevertheless, we agree with staff that recent progress should be enshrined in appropriate legislation.

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

We thank staff for their comprehensive reports and Ms. Mahasandana and Mr. Mahyuddin for their informative Buff Statement. The Malaysian economy is stable despite challenges, growth has moderated in 2019, but remains domestic demand-driven, and inflation has remained subdued. We broadly concur with staff's appraisal and would like to focus on the following issues.

We welcome the authorities' reaffirmed commitment towards improving fiscal discipline through medium-term fiscal consolidation and fiscal-structural reforms. We positively note the measures to rationalize spending, including the reallocation of savings in the 2020 budget resulting from the decrease in wage spending towards increased spending on health and education. Can staff comment on whether the authorities are monitoring the targets to assess the effectiveness of social spending? We also note that though capital outlays remain unchanged, the budget will prioritize infrastructure upgrading programs to support growth. Meanwhile, domestic revenue mobilization will be important to create the fiscal space to help achieve inclusive growth and high-income status. To that end, we welcome the Fund's TA support in formulating a medium-term revenue strategy and also see merit in undertaking structured and targeted spending reviews to identify additional savings.

Malaysia's public debt is sustainable, however, in the event of a macro-fiscal shock, staff estimates that public debt can edge closer to the threshold of 55 percent of GDP and, if contingent liabilities materialize as well, the debt ceiling may well be breached. To mitigate these risks, we welcome the planned work on a Fiscal Responsibility Act with Fund TA and see merit in updating the public debt limit framework. To that end, we appreciate the establishment of a high-level Debt Management Committee and a Debt Management Office.

We welcome the reforms undertaken towards improving the efficiency of public investment in line with the 2017 PIMA recommendations, including centralizing public investment decisions and procedures. We look forward to advancing reform efforts that take into consideration the rest of PIMA's recommendations, including developing a medium-term fiscal framework and developing an enhanced PPP framework.

The authorities' monetary policy stance has been data dependent and the underlying monetary policy framework has served the Malaysian economy well. We commend the implemented measures to deepen the domestic FX market by simplifying market regulation, enhancing FX hedging instruments, extending trading hours, and communicating with foreign investors to raise awareness of increased opportunities for onshore hedging.

We note the authorities' reservations that Malaysia's stylized characteristics are not adequately reflected in the Assessing Reserve Adequacy nor in the methodology underlying the External Balance Assessment model. The authorities highlighted that, in addition to the stock of foreign reserves, they have ready access to additional buffers to mitigate disruptive external shocks should they materialize.

Malaysia's financial sector is stable, banks are well capitalized, asset quality is sound, and liquidity coverage ratios are well above the regulatory minimum. We welcome the authorities' policy initiatives aimed at strengthening household resilience and the financial sector's as a whole. We note, however, the sector's exposure to high household debt and sizable real estate related lending, especially the potential impact of downward correction in house prices, coupled with adverse income shocks, on financial stability. We appreciate the measures implemented to increase affordability amongst the lower price segments of the housing market (where demand is strong) and others to reduce the minimum purchase price for foreigners in the higher (where there is oversupply). We see merit in closely monitoring the housing sector, including through an evaluation of the efficacy of the introduced measures aimed at addressing demand and supply imbalances across the real estate market. Can staff comment on possible vulnerabilities in the commercial real estate market?

The Malaysian authorities are at the forefront of Fintech regulation ensuring that the safety and soundness of the financial system is protected. They have managed to strike an appropriate balance between promoting innovation and safeguarding financial stability; however, rapidly evolving technology and the associated challenges warrant the authorities' continued vigilance in the sector.

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

We thank staff for the set of informative reports and Ms. Mahasandana and Mr. Mahyuddin for the useful Buff statement. We take positive note of Malaysia's ability to maintain stable economic performance and sustain progress on the reform agenda despite headwinds from both domestic and external fronts. Uncertainties and downside risks ahead call for continued sound macroeconomic policy management and steadfast implementation of structural reforms to support sustainable and inclusive growth. We generally agree with staff's assessment and limit our comments to the following.

We welcome the authorities' commitment to medium-term fiscal consolidation and fiscal-structural reforms. Fiscal adjustments in the medium term should be supported by measures on both the revenue and expenditure sides. We look forward to positive outcomes from the development of a Medium-Term Revenue Strategy with the support of Fund technical assistance and see merit in spending reviews to identify possible areas of saving. Consolidation efforts should be complemented by structural reforms to enhance public finance, debt, and investment management, such that resources can be effectively channeled to further strengthen the country's economic resilience and growth.

The Bank Negara Malaysia's (BNM) monetary policy framework continues to serve the country well. The broadly neutral monetary policy stance appears appropriate, and policy actions should continue to be data dependent. We appreciate the insight offered by staff in Appendix VII on the possibility that a flexible exchange rate can become a shock amplifier under certain circumstances. We encourage staff to conduct further study on this subject, and more broadly, on how open economies like Malaysia can cope with volatile capital flows. Meanwhile, we welcome the authorities' ongoing efforts to deepen the domestic FX market.

Various indicators suggest Malaysia's banking sector remains sound and profitable, but there are pockets of risk that warrant close monitoring. We are encouraged by the authorities' initiatives aimed at mitigating financial stability risks, particularly those related to the household and real estate sectors, and that further measures can be readily implemented should the need arise. In other areas, we note that the BNM is developing a framework to assess climate change risks to the financial sector and would appreciate more details as the framework takes shape. As for fintech, has the reduction in physical distribution networks been matched by an increased use of mobile alternatives in all age and income groups of the population? Are there any risks of financial "exclusion"?

A continued push for structural reforms is needed to facilitate sustainable growth and inclusive development. We welcome the prioritization of education and human capital development, which would in turn support efforts to boost productivity, as well as promote innovation and technology adoption. Could staff elaborate on the measures taken so far and those that are in the pipeline to boost female labor force participation? On governance reforms, we share the authorities' views that improving governance requires not only legislation but also a change in mindsets and practices, and look forward to continued progress in their reform efforts.

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

Mr. Psalidopoulos, Mr. Rashkovan and Ms. Mateus submitted the following joint statement:

We would like to thank staff for a broad-reaching set of papers and Ms. Mahasandana and Mr. Mahyuddin for their informative Buff statement. While the Malaysian economy has been stable, the authorities should continue monitoring pockets of vulnerability, implement structural reforms, foster good governance principles and enhance fiscal frameworks.

External vulnerabilities remain elevated, limiting the flexibility of monetary policy. We concur with staff that the current monetary stance seems to be appropriate and should remain data dependent looking forward. In the future, however, monetary tightening might be challenging, if external debt (currently at 62.4% GDP, of which 40% of GDP dominated in foreign currency) remains vulnerable to exchange rate and current account shocks. Given the large current account surplus, the undervalued real exchange rate, that inflation is expected to increase, and other pressing financial vulnerabilities (e.g. in the housing market), conditions might warrant a tighter monetary stance in the future.

The Funds' advice on the external sector needs to be further elaborated on. We very much appreciate staff's analysis of the role of exchange rate flexibility (appendix VII), which challenges the traditional theory of flexible exchange rates being a shock absorber and sheds light on the financial accelerator effects of exchange rate shocks such as FX liabilities. More analysis is needed to be done on these effects, as indicative evidence (e.g. Thailand's Bath appreciation in 2019 attracted speculative capital inflows) also point to exchange rate fluctuations amplifying capital flows. Until it is determined which effect dominates (the shock absorber or the shock amplifier role) for a given country, which does not yet seem to be the case for Malaysia, we would recommend cautiousness in staff advice. Also, in terms of consistency, current staff advice in the report and vulnerability exercise (exchange rate flexibility as a shock absorber) does not follow from the analysis in the appendix that concludes that this needs further study. We expect this to be also part of the undergoing Integrated Policy Framework (IPF) workstream.

In line with the Institutional View on Capital Flows, we encourage the authorities to use financial sector policies instead of maintaining CFMs, namely to mitigate vulnerabilities stemming from the housing market. Despite strengthened financial sector regulation and supervision and banks' current resilience towards (house price) shocks, high household debt leaves both households and banks vulnerable to a sharp decline in house prices. Notwithstanding decelerating loan growth and decreasing NPLs, the authorities should remain vigilant and ready to act in case risks mount. As foreign home ownership appears to be quite low, macroprudential tools could be more effective than residency-based measures in addressing financial stability risks arising from housing market pressures in a context of high domestic household debt.

We welcome the authorities' efforts for assessing cyber risks and climate-change related risks. The current economic structure, with a large financial sector and extraordinary high percentage of SMEs, and the government's commitment to grow the digital economy, makes the country prone to the risks of cyber-attacks. We welcome the initiatives taken by the BNM to identify and mitigate cyber security risks for financial institutions, such as guidelines on cyber security risk management and the created platform with the financial industry. We would welcome staff's assessment on the adequacy of the cyber strategies currently in place for the financial sector in the next FSAP.

We welcome the authorities' progress on governance reforms, but agree with staff that these should be better hinged in legislation. In particular, we consider that enhancing anti-corruption institutions' independence could foster trust in public institutions and be a steppingstone for other structural reforms aimed at increasing productivity. In this context, we also support improving the quality of education and boosting female labor force participation. Finally, we note that transparent public frameworks could help both public authorities and investors, namely in terms of fiscal risks. In terms of transparency, the main report could provide more information on the impact of fiscal risks stemming from contingent liabilities. Ensuring full coverage of debt, including local and state governments' debt, as well as acknowledging guarantees is vital for the authorities to determine their fiscal space and be able to optimize the use of fiscal policy.

Mr. Merk and Mr. Buetzer submitted the following statement:

We thank staff for their comprehensive and insightful report and broadly concur with their appraisal. We also thank Ms. Mahasandana and Mr. Mahyuddin for their helpful Buff statement.

Growth in Malaysia has remained robust, driven by healthy private consumption in an environment of low unemployment and moderate inflation. The external position as well as the financial sector appear largely sound. The relatively benign economic outlook projected by staff is nevertheless subject to downside risks, notably including fiscal risks from contingent liabilities against the background of elevated public indebtedness. We encourage the authorities to make best use of the currently rather benign economic conditions to firmly entrench stability-oriented macroeconomic policies and build on their recent progress on the structural front.

We concur with staff that continued fiscal consolidation and fiscal structural reforms remain necessary. Efforts to strengthen revenue mobilization should be pushed forward and we welcome related suggestions to improve tax administration, strengthen compliance, and broaden the tax base. These measures should be backed up by comprehensive and rigorous spending reviews as well as reforms to strengthen efficiency in public financial management, including follow-up on remaining PIMA recommendations. Reinforcing the fiscal framework by enshrining the existing commitment to a debt ceiling in law would be helpful to underpin prudent fiscal policies and thus strengthen confidence. Regarding a more flexible interpretation of the debt limit, we would stress that building buffers in good times will allow appropriate counter-cyclical policies in case of adverse shocks without undermining confidence in the debt ceiling.

We welcome the authorities' acknowledgement of the flexible exchange rate regime as the prime shock-absorber. To further enhance the working of the existing regime, we concur with staff that measures to further develop domestic FX markets should be pushed forward, while remaining capital flow management measures should be prudently phased out.

Elevated household debt and high valuations on real estate markets demand heightened vigilance. While adequately tight microprudential supervision certainly plays an important role in this regard, we concur with staff's call to complete the macroprudential toolkit and prepare to deploy appropriate measures where necessary, avoiding undue discrimination.

Determined structural reforms will be of the essence to realize the authorities' ambition to achieve high income status. While we acknowledge Malaysia's excellent outcome in the 2020 Doing Business Index, it will be crucial to further enhance the business environment and support innovation, work with regional partners to promote trade openness, improve access to financing, and raise educational quality and attainment. We second staff's call to anchor recent progress on governance reforms in legislation and to resolutely move ahead in the fight against corruption.

Mr. Kaya and Mr. Marek submitted the following statement:

We thank staff for the detailed sets of reports, and Ms. Mahasandana and Mr. Mahyuddin for their helpful Buff statement. Malaysia has been maintaining its solid growth performance, the public debt has been broadly sustainable, and the financial sector is well-capitalized and resilient. Considering potential external shocks as well as domestic vulnerabilities, particularly those related to weak revenue mobilization and real estate sector risks, the authorities should boost their reform efforts. We share the thrust of staff's appraisal and emphasize the following remarks.

Fiscal policies should create stronger buffers to contain potential downside risks. While we note that the Public Debt Sustainability Analysis' Risk Assessment for Malaysia is broadly positive, we are concerned by the elevated public debt level above 50 percent of GDP, which could exceed the government's 55-percent limit in case of a macro-financial shock. We see merit in introducing some flexibility in the fiscal framework allowing to temporarily breach the limit in case of large shocks, to enable the budget to perform a counter-cyclical function. In addition, the authorities should implement fiscal adjustment focusing on revenue mobilization, given the relatively very low tax revenue ratio below 12 percent of GDP. To this end, it is critical to improve tax administration, reduce tax leakages, and identify new sources of revenue. We take positive note of the holistic review of the national tax system undertaken by the Tax Reform Committee and encourage the authorities to incorporate its recommendations in the Medium-Term Revenue Strategy.

Fiscal adjustment should be underpinned by an improved fiscal management framework. The authorities need to enhance the efficiency of public investment through the implementation of the 2017 Public Investment Management Assessment recommendations. In particular, it is critical to develop an enhanced public-private partnership (PPP) policy framework, considering that the federal government's guarantees and PPP lease payment obligations could increase the federal government debt to about 75 percent of GDP, should they materialize. It is also critical to better align expenditure needs for public project financing with available resources through a medium-term fiscal framework. While the establishment of a high-level Debt Management Committee (DMC) is a step in the right direction, the creation of a Debt Management Office within the Ministry of Finance, acting as a secretariat for the DMC, should be accelerated.

While the monetary policy stance is broadly appropriate, vigilance is warranted about the interplay between monetary policy and financial stability objectives. We note the Central Bank of Malaysia's (BNM) most recent decision to reduce the Overnight Policy Rate, which is in line with the drop in inflation expectations. We draw the authorities' attention to the implications of monetary policy easing for financial market developments through a potential pick up in mortgage credit, in particular by the low-income household group, amid generally high household indebtedness. In addition, while we note that the banking sector is sound and has relatively strong buffers, increased demand for housing could raise already elevated house prices and exacerbate vulnerabilities in the financial sector. We share staff's view that price regulation in the housing market should be temporary and encourage the authorities to consider expanding the BNM's macroprudential framework with loan-to-value and debt-service-to-income tools. We welcome the authorities' efforts to improve the shock-absorbing function of the exchange rate through deepening the FX market, in particular by improving the access to hedging markets.

Structural reforms should focus on increasing productivity and implementing governance reforms, particularly in the financial sector. We note that the authorities should aim to further improve the business climate, including through facilitating the access of small- and medium-sized enterprises to alternative sources of financing. We positively note the authorities' initiative in this regard, in particular, providing tax incentives to attract venture capital investors as well as stimulating new digital forms of financing. The recently issued Exposure Draft on Licensing Framework for Digital Banks is a step in the right direction. Against the backdrop of expanding digitalization of certain services in the economy, it is critical to robustly implement the AML/CFT standards to mitigate emerging risks, including from virtual assets.

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

We thank staff for the informative set of papers and Ms. Mahasandana and Mr. Mahyuddinfor the helpful Buff statement. The Malaysian economy continues to perform well. The growth outlook remains solid, with activity close to potential. Underpinned by sound policies and strong fundamentals, the economy remains resilient amidst global trade tensions and uncertainties. Solid economic performance puts the country in a good position to continue strengthening resilience and policy buffers, while helping to address some of the medium-term challenges related to governance, policy uncertainty and structural reforms.

We welcome the authorities' reaffirmed commitment to continue with the budgetary consolidation over the medium term. This will create needed fiscal space—assessed "at risk" by staff—, build buffers and bolster confidence. The consolidation commitment needs to be underpinned by well-defined and credible policy measures, focused on revenue mobilization. In that context the work of the Tax Reform Committee and the forthcoming Fund TA on the Medium-term Revenue Strategy remain pivotal for formulating and clarifying the credible adjustment.

We see merit in exploring ways to modernize, and add flexibility to, the public debt limit framework. As noted by staff, this reform would benefit from further improving the medium-term fiscal framework and better monitoring the risks stemming from large contingent liabilities. Related to the latter, entrusting the high-level Debt Management Committee with a mandate to oversee state guarantees is reassuring.

The monetary policy stance appears appropriate, consistent with declining inflation expectations and the closing output gap. We note that BNM's multi-instrument policy framework has been effective and has entailed positive outcomes. We appreciate the authorities' efforts to keep monetary policy data-dependent and credible. The stepped-up efforts to deepen the domestic FX market are welcomed, and we take a good note of the authorities' view that the exchange rate flexibility will continue to be a first line of defense against external shocks. At the same time, we appreciate the discussion in Appendix VII on the potentially opposite effects of exchange rate flexibility on the domestic economy and encourage further work in that area.

The financial sector is stable and sound, but household debt and real estate market developments call for enhanced vigilance. The banking system is profitable and well capitalized, with high asset quality. The household debt is relatively high, with identified pockets of vulnerability. In that context we echo the staff advice on the need to enhance the macroprudential toolkit, by introducing tools that can be swiftly adjusted to mitigate risks to financial stability. We note the moderate systemic risks stemming from oversupply in certain segments of the real estate market and encourage the authorities to better align the real estate supply with domestic housing demand conditions.

The reforms to improve governance and fight corruption should be continued. The ongoing implementation of the National Anti-Corruption Plan attests to the authorities' willingness to tackle this long-standing macro-critical issue. We strongly encourage the authorities to heed staff's recommendations on how to improve the governance framework further, including by appropriate legislative action.

The continuous implementation of structural reforms is critical to foster convergence to higher income status. The priorities laid down in the authorities' Eleventh Malaysia Plan are appropriately geared towards lifting productivity growth and moving up the value chain. We echo staff's advice on the need to address skills gap, further promote trade integration, and boost female labor market participation, which remains low in comparison with peer countries.

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

Mr. Raghani and Mr. Alle submitted the following statement:

We thank Staff for an informative set of papers and Ms. Mahasandana and Mr. Mahyuddin for their insightful Buff statement.

The Malaysian economy is making steady progress towards achieving high-income status despite domestic and external challenges. Growth stood at a comfortable 4.5% in 2019, mainly driven by strong domestic demand, albeit in slight retreat compared to 2018. Other macroeconomic indicators were encouraging with notably inflation remaining subdued and the current account in surplus. Progress was also made on structural reforms, especially in the governance sector. The authorities' efforts going forward should focus on fiscal consolidation to ensure sustainable public finances and maintain debt in check. As well, wide-ranging structural reforms are warranted to boost productivity, improve the business climate, enhance growth and further diversify the economy. We broadly share the staff appraisal and would emphasize a few points.

On fiscal policy, we welcome the authorities' multipronged approach to achieve fiscal and debt sustainability. We see merit in the incremental steps built around a 2020 budget striking the balance between fiscal consolidation and growth, a planned Fiscal Responsibility Act which could help enshrine in law the commitment to limit federal government debt within 55 percent of GDP, and medium-term fiscal adjustment plans relying on revenue and expenditure measures. We urge the authorities to stick to their commitment under those three phases to ensure long-term fiscal sustainability and create room for maneuver in case risks came to materialize. Attention should be given to revenue mobilization, given the low revenue-to-GDP ratio. In this regard, could staff elaborate further on the consideration given by the government to revenue-enhancing measures suggested by the Tax Reform Committee? What is the potential increase one can expect in the tax revenue-to-GDP ratio, if adequate reforms were fully implemented?

We take good note of the well-performing monetary framework and the available space for the policy rate to adjust to downside risks. We also welcome efforts underway to deepen and further develop the domestic FX market for enhancing the exchange rate' s ability to absorb shocks.

As regards the financial sector, we are encouraged by the positive metrics displayed by banks, including adequate capitalization, liquidity and profitability, and sound asset quality. Going forward, the authorities should keep a close eye on household debt and developments in the real estate market, which could adversely impact the financial sector stability. The government's actions to minimize risks of a sharp decline in house prices and associated financial risks, are steps in the right direction. We support the ongoing initiatives to strengthen resilience of households and the financial sector, including the launch of a National Strategy for Financial Literacy in July 2019.

Wide-ranging structural reforms are required to sustain growth and achieve a high-income status. Growth-enhancing reforms should rank high on the authorities' agenda. Domestic and foreign investment should be equally catered in this regard. On the former, we concur with staff that policy priority should be given to improving SMEs' access to alternative sources of financing, with an emphasis on manufacturing and innovating SMEs. We take comfort in the authorities' initiatives emphasized by Ms. Mahasandana and Mr. Mahyuddin, including "new digital financial innovation such as Equity CrowdFunding and Peer-to-peer funding through My Co-Investment Fund" and "tax incentives to attract venture capital and angel investors."

Regarding foreign investment, the authorities are encouraged to accelerate reforms, which would help the economy tap the potential lying in trade and investment diversion. While the overall improvement of the business climate is warranted in this regard, specific efforts are needed in speeding up decisions on investment approvals.

We also call for further reform efforts in several other areas with cross-cutting impact. First, the authorities would be well-advised to make the appropriate investment and reforms to boost productivity, including encouraging innovation and promoting digitalization of the economy; boosting female labor participation; and enhancing the quality of and access to education through improved Curricula and expanded vocational and technical training to address skill mismatches. Second, progress made thus far on governance reforms should be locked-in while additional efforts are needed on other aspects, including transparency and institutional measures. In this vein, we support the ongoing legislative initiatives to secure procurement reform, freedom of information, and independence of anti-corruption institutions.

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

Ms. Riach and Mr. Clark submitted the following statement:

We thank Staff for the excellent papers, including the well-chosen and relevant selected issues paper, and Ms. Mahasandana and Mr. Mahyuddin for their comprehensive Buff statement. We share Staff's assessment that despite some ongoing challenges the authorities are making progress on their medium-term reform agenda. We welcome progress on implementing previous Fund advice and good overall economic performance. In order to sustain this progress over the medium-term, the authorities should focus on greater fiscal consolidation, implementing structural and governance reforms to boost inclusive growth, whilst maintaining financial stability.

Overall macroeconomic performance continues to be strong, underpinned by low inflation, a declining budget deficit, adequate reserves and a positive current account surplus. The authorities should maintain this progress and focus on medium-term fiscal consolidation, to help keep debt within the agreed limit. Implementing the planned Fiscal Responsibility Act (FRA) is an opportunity to boost market confidence and rebuild fiscal space whilst enshrining in law the commitment to debt limits. In this regard, we welcome the creation of the Debt Management Committee, but the additional planned actions should be accelerated.

This should be coupled with a credible Medium-Term Revenue Strategy (MTRS), given the declining revenue trends and that Malaysia’s tax revenue performance remains low compared to peers. Additional efforts should also be made to improve the efficiency of public expenditure in line with the recommendations that have been made under the Public Investment Management Assessment (PIMA).

Maintaining the stability of the financial sector should also remain a priority for the authorities. Risks remain especially around household debt and the real estate market and in terms of the vulnerability for those in lower income groups. In this regard we welcome the National Strategy for Financial Literacy. Expanding financial literacy and expanding household resilience will help with mitigation and help broaden the financial sector. In addition, we welcome the authorities’ commitment to updating the National Cyber Security Policy.

We strongly welcome the BNM developing a framework for assessing climate change risks to the financial sector and the BNM participation in the Network of Central Banks and Supervisors for Greening the Financial System. We support the collaborative actions that will build climate change resilience in the financial sector, especially building the capacity to assess and manage climate-related risks and how the financial sector can facilitate and help manage the transition to a low carbon economy. Given the importance of fintech to the Malaysian economy, we also welcome the detailed selected issues paper as both topical and timely. Regulators will need to focus on continued oversight whilst encouraging innovation and the development of critical infrastructure to help address both the opportunities and challenges.

Finally, sustained progress and momentum on governance and wider structural reform will be important to boost long-term growth. While progress has been made, governance reforms should focus on the legislative initiatives in procurement, the independence of Anti-Corruption institutions and full implementation of AML/CFT standards. This should be coupled with implementation of growth enhancing reforms focused on the business environment, promoting trade openness and regional cooperation and improving access to finance, especially for SMEs, to complement ongoing labor markets reforms and to boost female labor participation.

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

We thank staff for the set of well-written reports and Ms. Mahasandana and Mr. Mahyuddin for their helpful Buff statement. Notwithstanding the volatile external environment, the performance of the Malaysian economy remains solid and the authorities are making progress on their reform agenda. Fiscal policy is appropriately focused on the medium-term fiscal consolidation. The resilience of the Malaysian economy to external shocks is supported by well-diversified economy, flexible exchange rate regime, and substantial foreign reserves. While some vulnerabilities remain in the real estate sector and the financial system, strong buffers and prudent financial policies contain these risks. As we broadly agree with staff's appraisal, we would offer a few comments for emphasis.

We welcome the authorities' commitment to fiscal reforms and medium-term fiscal consolidation. As Malaysia has limited fiscal space, it is important to strengthen fiscal buffers and carry on with fiscal adjustment. In comparison to the peer countries Malaysia's tax revenue is low and declining. We, therefore, welcome the recently introduced tax measures and underscore the importance of full implementation of the Medium-Term Revenue Strategy. The forthcoming adoption of the Fiscal Responsibility Act is an opportunity to strengthen fiscal management and further enhance fiscal discipline. We also welcome the authorities' efforts to strengthen public debt management, including the establishment of a debt management office.

We agree that the current monetary policy stance is appropriate. As the output gap is closing and inflation expectations are declining, the recent decision to reduce policy rate by 25 basis points is consistent with broadly neutral monetary policy stance. We support the measures aimed at deepening the domestic FX markets and improving their functioning. We welcome the authorities' commitment to further enhance the flexibility of the exchange rate regime to strengthen resilience against external shocks.

The Malaysian financial system remains sound and resilient. Banks are well capitalized, liquid and profitable, asset quality is high. However, some risks require closer monitoring. Household debt remains high and house prices are stronger than warranted by fundamentals. We note that risks are mitigated by high household financial assets and relatively low LTV. However, the authorities are well advised to expand the range of macroprudential tools to support financial stability. It is encouraging that the authorities have a well-developed strategy to mitigate cyber risks and are moving ahead with development of fintech.

Strong implementation of structural reforms is paramount to boost productivity, ensure sustainable and inclusive growth, and transform Malaysia into a high-income economy. The authorities should further enhance the business environment and move on with their anti-corruption efforts. Growth could be further supported by the improving effectiveness of trade regime and better access to financing. Over the medium term, growth potential could be strengthened by enhancing the quality of education and boosting innovation and technology adoption.

Mr. Tanaka, Mr. Chikada and Mr. Kuretani submitted the following statement:

We thank staff for their informative reports and Ms. Mahasandana and Mr. Mahyuddin for their helpful statement. We welcome Malaysia's stable economic performance notwithstanding external and domestic challenges. We encourage the authorities to strengthen their reform efforts so as to lessen the downside risks and promote the country to reach the high-income status in this decade. As we broadly agree with the thrust of the staff's appraisal, we will limit our comments as follows:

Fiscal Policy

Building fiscal buffers by implementing medium-term fiscal consolidation should be priority. We agree with staff that the economy should focus on a credible medium-term fiscal consolidation plan to boost market confidence and build fiscal space. In this regard, we welcome that the authorities have started a holistic fiscal reform program that focuses on strengthening of the governance and fiscal policy management while continuing to remain supportive of sustainable and inclusive economic growth. We note that tax revenue is low compared to peer countries, and concur with staff that the authorities should work on well-identified revenue and expenditure measures, including revenue mobilization. In this context, we also encourage staff to support the authorities in formulating and implementing the MTRS and other fiscal initiatives by utilizing the Fund TA. In addition, it is welcoming that the country has made progress in the efficiency of public investment, such as strengthening of the gatekeeping role of central agencies, in line with PIMA. We encourage the authorities to put further efforts in this area. The establishment of Debt Management Committee (DMC) is also commendable.

Exchange Rate Policy and Reserves Adequacy

We concur with staff that the authorities should further develop FX markets to enhance the exchange rate's ability to act as a shock absorber, and look forward to continued dialogue between staff and the authorities to explore further options to deepen FX markets and how best to phase out remaining capital flow management measures. On the level of foreign reserves, we note that the gross FX reserves are increasing steadily in recent years, however, at the same time the reserves adjusted for net forwards (net reserves) appear volatile and low, and the gap between two reserve measures seem pronounced compared to the past (Figure 4, Right Middle). Could staff provide more explanation on this figure and how we should assess reserve adequacy?

Financial Sector Policy

We concur with staff that household debt and the real estate market require continued close monitoring. We welcome that the bank profitability, capitalization and asset quality are sound. Having said that, high household debt and real estate market should be carefully monitored to ensure financial stability. Regarding the real estate market risks, we would appreciate staff's elaboration on commercial real estate, especially in Kuala Lumpur.

Structural Reform

Further progress on governance reforms and boosting productivity are critical. We commend the progress on governance reform, including the

National Anti-Corruption Plan 2019-2023 and the authorities' plan to strengthen anti-corruption legislations. As staff asserts, it would be critical to continue implementing these governance reforms going forward. In addition, boosting productivity is necessary to achieve high-income status and inclusive development. In this regard, we encourage the authorities to accelerate structural reforms, especially in education and digitalization of the economy, and strengthen economic fundamentals as envisaged in the 11th Malaysia Plan and the Shared Prosperity Vision 2030.

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

We thank staff for a concise report and Ms. Mahasandara and Mr. Mahyuddin for their comprehensive buff statement. As a small, open economy, highly-integrated in the global supply chains, Malaysia is particularly vulnerable to external uncertainties and adverse shocks. The Malaysian authorities are to be commended for their able stewardship of the economy through external headwinds and for their commitment to a broad reform agenda with potentially significant medium-to-long term gains. We are in broad agreement with the thrust of the staff appraisal.

The authorities' commitment to fiscal prudence over the medium term would add fiscal space and increase the economy's resilience to external shocks, while supporting growth. We encourage the authorities to identify the mix of measures underlying their medium-term fiscal plans at an early stage and urge them to legislate fiscal policy through a Fiscal Responsibility Act, anchored by a flexible federal government debt to GDP ratio around the current limit. Staff identifies contingent liabilities as a fiscal risk. We welcome further elaboration. Revenue mobilization is a priority. The planned formulation of a Medium-Term Revenue Strategy, supported by recent Tax Reform Committee recommendations, would provide the appropriate framework for sustainable higher revenue growth going forward. On the expenditure side, we agree with staff that priorities are to upgrade the infrastructure and focus on targeted spending that help boost productivity in the longer run. We welcome the authorities' emphasis on education spending and their plans to put in place a targeted fuel subsidy program, as indicated by Ms. Mahasandana and Mr. Mahyuddin.

On the monetary front, given price stability, the pre-emptive interest rate cut in January was appropriate in view of downside risks to growth. The BNM's standing monetary policy, balancing price stability and growth objectives, should continue to be data dependent and the available monetary space should be utilized in the event of external shocks, as long as inflation expectations are firmly anchored. The BNM's exchange rate policy has served the economy well, especially in view of volatile cross-border capital flows. We take note of staff analysis on exchange rate flexibility tradeoffs (in Appendix VII) and urge the authorities to explore the issue in more depth with staff.

We agree with staff that household debt and the real estate market should be monitored closely. Notwithstanding the existing robust bank supervision and prudent bank lending practices, macroprudential tools would be a welcome addition to microprudential means, even if initially nonbinding.

Malaysia's financial sector has a large sharia-compliant component and we welcome the staff analysis (Box 4 of Selected Issues) on the potential role of FinTech in the Islamic finance space. We invite staff comments on ways that the Islamic finance institutions could help support the SMEs as financing availability is flagged as one of the issues hindering their development. More generally, given the important role of Islamic finance in Malaysia, we were expecting a deeper analysis of issues in this sector. Staff may wish to comment.

We welcome the authorities' recognition that their income and growth objectives critically hinge on structural reforms to boost productivity and commend their commitment to a comprehensive structural reform agenda. We welcome staff comments on the consistency of various plans and initiatives mentioned in ¶38 of the Staff Report. Reforms that facilitate starting business at the state level and measures that help absorb potential trade and investment diversions are likely to pay handsome return. Also important are measures to address labor skill mismatches and promote female labor participation.

We wish the authorities continued success.

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

We thank staff for the well written report and Ms. Mahasandana and Mr. Mahyuddin for the informative Buff statement.

The Malaysian economy continued to deliver stable growth averaging just under 5 percent, backed by domestic demand, a diversified economy and improved business environment. The authorities have placed a high premium on reforms and governance to foster equitable growth. Risks to the outlook remain on the downside with external headwinds from trade and the market sentiments for emerging markets. We broadly agree with the staff report and would like to make the following points for emphasis.

The growth and fiscal consolidation balance targeted in budget 2020 are crucial for creating space for development spending. We positively note the several measures mentioned in the buff to strengthen transparency, governance and expenditure optimization, including the Debt Management Office and the planned Fiscal Responsibility Act. On revenue mobilization, we align ourselves with the staff viewpoint on prioritizing this to help achieve inclusive growth and high-income status.

The monetary policy framework has delivered price stability and growth. We are reassured by the authority's agility and measures to deepen the domestic markets. We agree with staff that the broadly neutral stance remains appropriate in the face of present financial conditions and a drop-in inflation expectation. On the capital flow measures (CFMs), we note that the authorities have emphasized that they remain in place in order to preserve orderly market conditions and financial stability. The authorities have partly agreed with staff's external debt sustainability analysis but expressed reservations on the external balance assessment methodology. Could staff offer comments on this divergence as well as the positive impact of the CFMs?

Bank profitability and liquidity are sound. But the vulnerabilities on account of household debt and the real estate markets remain. We are encouraged by the policy initiatives being taken by the authorities to strengthen the resilience in this direction. Beyond this, we join staff in urging the authorities to pursue efforts to ensure that all virtual asset service providers listed in the standards are regulated for AML/CFT purposes and to implement AML/CFT measures in an effective way.

Finally, for Malaysia to fulfil its aspirations of achieving a high-income, developed nation status, advances in governance, anti-corruption, and in boosting productivity and human capital will be paramount. For this, we welcome the multiple efforts of the authorities to unlock future productivity growth, fight corruption and improve the education quality. Could staff offer more details on the progress in boosting female labor participation?

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

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

We thank staff for their useful set of papers, which highlights the continued strengthening of the Malaysian economy. As we broadly concur with staff's appraisal and recommendations, we limit ourselves to the following comments for emphasis.

Malaysia's economy continues to perform well, underpinned by sound policies and reforms. A strong record of prudent policies and reforms over many years has helped Malaysia weather many shocks and achieve significant economic and social gains. However, with risks tilted to the downside, continued credible policies and reforms will be needed to further advance the country's development goals. In this context, we welcome the authorities' strong commitment to sustaining credible policies and reforms, as highlighted in the insightful Buff of Ms. Mahasandana and Mr. Mahyuddin.

Sustained fiscal prudence will strengthen buffers and safeguard debt sustainability. We commend the authorities for the progress made in strengthening public finances. However, further efforts are needed to mitigate against shocks to fiscal and debt sustainability. Accordingly, we welcome the authorities' demonstrable commitment in the 2020 budget to pursue fiscal consolidation, while supporting growth. Furthermore, we welcome their commitment to fiscal consolidation beyond 2020. This will require continued efforts to mobilize additional revenues and improve the efficiency of spending. Also, ongoing efforts to strengthen the public finance management (PFM) framework, including through the planned enactment of fiscal responsibility legislation, will be critical. We note the authorities' request for Fund support in formulating and implementing their Medium-Term Revenue Strategy (MTRS) and other fiscal initiatives. We encourage the Fund to provide the needed support.

Close monitoring of financial sector risks is warranted. We take positive note that the financial sector has remained stable and the authorities have continued their efforts to enhance financial sector soundness and resilience. In this regard, close monitoring of risks associated with household debt and the real estate market is necessary. We are encouraged that the authorities are in broad agreement with staff on the need to remain vigilant even while asserting that these risks are currently manageable. We are also encouraged by the authorities' efforts to strengthen safeguards against money laundering and terrorism financing (AML/CFT), and cybersecurity risks.

Further progress on governance and structural reforms is critical to supporting sustainable and inclusive growth. We commend the authorities for the progress made in advancing their structural reform agenda, including on governance reforms. We encourage steadfast implementation in this regard, not least on efforts to boost female labor force participation and to promote the faster adoption of innovation and technology. Staff's elaboration on the authorities' progress on boosting female labor force participation would be welcome.

We reiterate our call for continued constructive engagement between staff and the authorities on efforts to develop Malaysia's onshore FX market. We note positively staff's willingness to work with the authorities, upon their request, to analyze the role of the exchange rate in Malaysia's economy and further options to deepen FX markets. 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.

Mr. Lischinsky and Mr. Morales submitted the following statement:

We thank staff for the set of reports and their informative follow-up statement, and Ms. Mahasandana and Mr. Mahyuddin for their insightful BUFF. Malaysia's economy remains strong and stable thanks to prudent macroeconomic policies and the authorities' commitment to structural reforms, despite external challenges.

High private consumption explains robust economic growth. Steady private consumption has offset the impact of a contraction in public investment partly due to delays in implementation of large infrastructure projects. Looking ahead, stable employment and income growth will continue supporting domestic demand, complemented by a recovery of public investment. A gradual pick up in private investment as external headwinds subside would contribute to Malaysia's convergence to its 4.8 percent potential economic growth. However, global trade uncertainty may continue to weigh on exports. Malaysia would benefit from coordinated policies to lock in gains from trade and investment diversion resulting from global trends, relying on trade promotion and clear investment policies. Besides, we agree that boosting productivity is necessary to achieve high-income status and inclusive development.

The 2019 budget deficit declined thanks to expenditure rationalization measures consistent with a zero-based budgeting. Measures included reduction in non-priority expenditure, targeting of non-fuel subsidies, and containment of the wage bill. While these measures have been sufficient to maintain the fiscal deficit on target despite de elimination of the GST, we encourage the authorities to take additional steps conducive to medium-term fiscal consolidation. In this regard, revenue measures should be given priority considering Malaysia's low and declining tax revenue's share in GDP. Forthcoming technical assistance form the Fund to formulate a Medium-Term Revenue Strategy (MTRS), building on the work of Malaysia's Tax Reform Committee (TRC) will be important. The authorities should assess proposals already submitted by the TRC on improvements to tax administration, elimination of tax leakages, and introduction of new sources of revenue. On spending, continuous review of non-priority expenditure should be complemented with measures to eliminate the overlap of social assistance programs and duplication in coverage of some government programs.

We welcome the authorities' structural reform plans to support their commitment to further deficit reduction over the medium term. The introduction of a Government Procurement Act and the creation of a debt management office within the Ministry of Finance would enhance the efficiency and credibility of public finance management in Malaysia. We commend the authorities for the comprehensive Medium-Term Fiscal Framework for the next three years, including reporting on fiscal risks and liability exposures, as highlighted by Ms. Mahasandana and Mr. Mahyuddin in their statement. We agree that fiscal reform should be complemented with a gradual move from fuel subsidies to the envisaged Targeted Fuel Subsidy Program, which would allow for additional fiscal space for priority spending on structural needs including health and education.

Inflation has remained low, and core inflation net of consumption tax changes stayed at around 1.5 percent year-on-year. Given the lower inflation expectations in January, the decision by Bank Negara Malaysia (BNM) to reduce the Overnight Policy Rate (OPR) to 2.75 percent appears appropriate. In addition, as Ms. Mahasandana and Mr. Mahyuddin explain in their statement, two-way foreign exchange market operations have helped ensure orderly market conditions during periods of large and volatile capital flows. In addition, foreign exchange market turnover has increased partly because of recent measures to deepen the domestic foreign exchange market, including repo-market liquidity enhancements, higher availability of dynamic hedging, and simplification of documentation processes. We welcome the staff's assessment of conditions under which the exchange rate could amplify shocks in Malaysia and encourage them to extend this analysis to other comparable cases.

Close monitoring of household debt is warranted given the elevated indebtedness and high house prices against macro fundamentals. We note that banks' asset quality remains sound and that borrowers' debt servicing capacity is supported by steady income and employment growth. However, we agree with staff that combined shocks to house prices and household income could have a strong impact on financial stability and confidence. Prudential measures combined with well-designed macroprudential tools would complement government initiatives such as the National Strategy for Financial Literacy and the proposed Consumer Credit Act.

We commend the authorities for recent progress on governance reforms. The National Centre for Governance, Integrity and Anti-Corruption launched a National Anti-Corruption Plan focusing on key priority areas, serving as a guide for government initiatives in this front. This has already translated into concrete measures including asset declaration by members of the administration. These efforts should be complemented by other initiatives such as procurement reform, measures to enhance freedom of information initiatives, and introduction of provisions to boost independence of anti-corruption institutions.

With this, we wish the authorities success in their policy endeavors.

Mr. Mouminah, Mr. Alkhareif and Ms. Alzamel submitted the following statement:

We thank staff for the comprehensive set of reports and Ms. Mahasandana and Mr. Mahyuddin for the useful 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 the Malaysian economy remains stable, despite domestic and external challenges, thanks to the authorities' prudent macroeconomic policies and reforms. We also note with satisfaction that policies and reforms are largely in line with past Fund advice. However, growth outlook is subject to downside risks stemming mostly from external sources as Malaysia is a highly open economy. Against this backdrop, policy priorities should focus on ensuring medium-term fiscal consolidation and safeguarding macroeconomic stability. In addition, efforts to boost potential growth and ensure inclusiveness and sustainable development should continue.

Fiscal consolidation efforts should continue in order to build buffers. To achieve this objective, sustained revenue mobilization and expenditure rationalization efforts will be crucial going forward given that Malaysia's fiscal space is assessed to be at risk. In this connection, we welcome the indication that the authorities will receive Fund TA to support the formulation and implementation of a Medium-Term Revenue Strategy (MTRS). Indeed, creating fiscal space is essential to expand social and capital spending. In this regard, we welcome the authorities' plan to increase health and education expenditure under the 2020 budget. At the same time, the planned Fiscal Responsibility Act (FRA) is a welcome step to enhance the capacity of fiscal policy to react to shocks.

We are comforted by staff's assessment that the overall financial system is stable, with well capitalized banks, low non-performing loans, and sound asset quality. The ongoing efforts to monitor and contain financial vulnerabilities from exposures to households and real estate sector need to continue. In addition, we welcome staff's analysis on FinTech in the SIP, particularly Box.4 on Islamic Fintech opportunities in Malaysia. We also welcome the National Strategy for Financial Literacy. Furthermore, priority should be given to continue strengthening governance and the AML/CFT framework.

Finally, continued implementation of the comprehensive structural reform agenda is crucial to boost productivity and economic development. This can foster progress toward achieving high-income status and inclusive growth. In this regard, we welcome the launch of "Shared Prosperity Vision 2030". Here, the authorities should be commended for the progress made in enhancing the business climate, as demonstrated by the improvement in Malaysia's rank in the World Bank's Doing Business Index. That said, more efforts are important in the area of starting a business. We welcome the authorities' efforts to promote digital economy, boost female labor participation, and enhance SMEs access to finance and encourage continued efforts.

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

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

We thank staff for the comprehensive set of reports and Ms. Mahasandana and Mr. Mahyuddin for their helpful Buff statement.

Notwithstanding internal challenges and heightened external uncertainty, the Malaysian economy continues to be resilient. As risks are tilted to the downside and Malaysia being a highly open economy, the authorities should focus on building adequate buffers, addressing medium-term challenges while safeguarding growth and financial stability, as well as implementing structural reforms to boost productivity.

A continued commitment to fiscal consolidation is needed over the medium-term. Given the country's relatively low level of tax revenues, compared to peers, revenue mobilization should be a priority in order to increase fiscal space. In this regard, we commend the authorities' efforts to enhance the revenue base by reducing the tax gap and improving tax efficiency. Although the debt sustainability analysis points to a relatively manageable debt level and financing needs, the authorities should further build fiscal buffers to better confront an uncertain external sector. The debt anchor can play an important role to guide these efforts. Can staff comment on the policy recommendation to increase flexibility of the current debt limit framework as presented in Appendix V? How does this relate to the staff recommendation of building additional buffers by reducing the debt level in the medium-term in order to reduce exposure to shocks? Can staff comment on the reasons behind the recent increase in federal government loan guarantees?

We welcome the authorities' commitment to exchange rate flexibility and further enhancement of the FX market functioning. We agree with the staff appraisal's calls for the authorities to continue deepening domestic FX markets in order to enhance the exchange rate role as a shock absorber. In this regard, we believe the conclusions expressed in Appendix VII that the exchange rate can act as a shock amplifier rather than a shock absorber may be seen by the public as contradicting, or it may weaken the policy recommendation in the staff appraisal. Can staff comment on the consistency between the staff appraisal and the conclusions in Appendix VII?

The Malaysian financial sector remains resilient and stable. This reflects the continued efforts by the authorities in implementing policies to reduce the build-up of financial imbalances and strengthening soundness and stability of the financial sector more broadly. We very much welcome the staff analysis on the real estate market and financial stability risks. This type of analysis should be part of Article IV consultations, particularly in cases of emerging market economies subject to capital flows volatility.

The Acting Chair (Mr. Furusawa) made the following statement:

The Malaysian economy has been stable despite internal and external challenges. Growth has held up, and inflation has remained subdued. The authorities are making progress on their reform agenda, particularly governance reforms. As you have noted in your gray statements, the policies ahead should focus on medium-term fiscal consolidation while safeguarding growth and financial stability. Continued commitment to exchange rate flexibility will also be important. In addition, the implementation of structural reforms to encourage investment would facilitate external rebalancing, and governance reforms will help boost productivity and achieve inclusive growth.

Those are the points you have focused on in your gray statements, and I think we can discuss these points during this session.

Ms. Pollard made the following statement:

Since the answers to the technical questions came out yesterday evening, I have been pondering staff's responses to the questions related to Appendix VII and the exchange rate policy advice, and I continue to be perplexed. I think it is somewhat disingenuous to say that Appendix VII is simply a literature review, as if it is divorced from policy recommendations, especially as much of the literature in this literature review is coming from IMF staff. Fundamentally, Article IV reports are policy reports; and whether staff sees them as policy reports, the public certainly does, and my authorities certainly do as well. These are not academic papers, and I think it will be read as a policy statement. That is certainly the way that we interpreted it and that our authorities interpreted it.

Having said that, I want to be very clear that we are not Pollyannaish, and we do not see exchange rate flexibility as a panacea. Exchange rate fluctuations do have economic impacts, and large fluctuations can have large economic impacts. I think that is clear, and literature going back over the last fifty years have recognized that.

But we also need to recognize that price fluctuations and interest rate fluctuations have economic effects. Economists and more importantly policymakers have learned over the past forty years that directly restricting price fluctuations and interest rate fluctuations cause more harm than good. Yet with exchange rates, we seem to be going the other way, and exchange rates is simply a price.

We have learned that sound policies are the key to stable prices and interest rates. What I find missing from staff's literature review is a recognition of the consequences of attempting to control exchange rates, and this is where I would encourage staff to do more research.

Mr. Heo made the following statement:

We thank staff for the thoughtful reports and Ms. Mahasandana and Mr. Mahyuddin for the comprehensive buff statement. We issued a gray statement and broadly support the staff's assessment but wanted to add to my comments about external sector, reflecting on other gray statements and on the responses to technical questions.

First, contrary to what Ms. Pollard has just said, frankly speaking, I am not perplexed at all by the staff's assessment; rather, I wanted to acknowledge the work that has been done by staff to understand how best to tailor the advice to Malaysia's specific circumstances. Appendix VII helpfully set out evidence showing that a flexible exchange rate can be a shock amplifier, rather than a shock absorber, under certain circumstances. Staff note that this collaborative work has aided the traction and that more work in this area is planned. I look forward to further constructive dialogue between staff on options to deepen FX markets and enhance the exchange rate's ability to act as a shock absorber.

Malaysia remains a very open economy and is subject to considerable capital flow volatility. Decisive actions may be needed to be employed to counter disorderly market conditions. I hope to see the Integrated Policy Framework strengthen the policy advice and the tools available to manage capital flow volatility by considering what the trade-offs are and in what circumstances different combinations of policy tools are most appropriate.

Finally, we share the authorities' reservation about the External Balance Assessment methodology, given the relatively weak explanatory power of the current account model for Malaysia. It should not be assumed that residuals are imbalanced and should be corrected, rather than omitted fundamentals.

Mr. Morales made the following statement:

We thank staff for the set of reports and Ms. Mahasandana and Mr. Mahyuddin for the useful buff statement.

Malaysia maintains solid economic performance, thanks to sound macroeconomic policies and reforms, and the authorities remain committed to pursue fiscal consolidation and make the economy more competitive to be better prepared to face external shocks in an uncertain environment. We would like to highlight the following points for emphasis.

We encourage the authorities to give a high priority to revenue-enhancing measures based on the work of the Tax Reform

Committee, complemented by the development of a Medium-Term Revenue Strategy (MTRS), ideally with technical assistance (TA) from the Fund. This effort is necessary not only to pursue fiscal consolidation over the medium term but also to enhance the fiscal space necessary for public investment and social spending. Complementary policies to improve public finance management would benefit from the prompt adoption of the Fiscal Responsibility Act.

Second, risks in lending to the real estate and household sectors need careful monitoring, and we believe that there is a case to strengthen the macroprudential framework, starting from preparing the necessary data and reporting requirements. International experience shows that the introduction of loan-to-value limits and debt service-to-income limits have contributed to better management of financial stability risks over the business cycle in a number of emerging markets. Decisions about how to introduce binding limits at a later stage could be tailored to the country's circumstances.

Finally, we welcome the authorities' efforts to increase the efficiency of social spending, including by reducing overlaps and improving subsidies targeting. At the same time, additional fiscal space will help Malaysia to bring social assistance spending to the level of peer countries. Moreover, continuous progress in raising female labor participation in the context of the Women at Work Initiative, announced in the budget 2020, will contribute to reducing poverty, increasing inclusion, and lifting economic growth.

With this, we wish the authorities success in their policy endeavors.

Mr. Inderbinen made the following statement:

In our gray statement, we welcomed the continued good performance of the Malaysian economy and noted the sound outlook, with activity close to potential and a resilience of the economy amid difficult external circumstances, which in no small part is due to sound policies and also the strong fundamentals of the economy.

We also noted the commitment of the authorities to exchange rate flexibility and to the role that exchange rate flexibility plays in maintaining resilience and enabling adjustments. We also took good note of the discussion in the staff report in the annex of the effects of exchange rate flexibility and possible amplifications. We noted this with interest. We do agree that the messaging is important and should be done cautiously in this type of report. We also note that the amplification of exchange rate adjustment is often linked to stock adjustments, which can be linked to external debt denominated in foreign exchange and also instability or possible stability concerns in the financial sector. I think both those aspects point to what Ms. Pollard was emphasizing toward the end of her intervention this morning, that it does come down to sound policies. We would agree that emphasizing this would have been beneficial in the report, and it would also support what the authorities are working on, namely, the further deepening measures in the forex market, the further strengthening of debt management capacity, as emphasized in Ms. Mahasandana's buff statement, and also the ongoing efforts to secure macroprudential policy and strengthen financial sector oversight.

On the macroprudential and the measures, we do side with staff in underlining the importance of phasing out the capital flow measures that are in place, in line with the Institutional View of the Fund.

Finally, just a word on governance. While we note the ongoing work of the authorities to improve governance and also their ambition to continue with the implementation of the National Anti-Corruption Plan, we also encourage the authorities to take the staff's recommendation under advisement on how to progress further in this.

Mr. Alkhareif made the following statement:

We have issued a detailed gray statement, in which we commended the authorities for the solid economic performance and the implementation of structural reforms, including under their Vision 2030.

Since we have issued a detailed gray statement, I will limit my remarks on the issues for discussion. I would note that many of my colleagues covered the forex exchange rate role in the economy, and I would like to add my voice. In particular, I echo Mr. Inderbinen in commending the authorities for their commitment to maintain a flexible exchange rate arrangement, which has served the Malaysian economy well.

I also appreciate the comments raised by Ms. Pollard, that the exchange rate is not a panacea to solve macroeconomic issues, and there are structural reforms and sound policies that need to be augmented when looking at the exchange rate policies. In this context, I would like to thank the mission chief, Ms. Choueiri, for addressing the exchange rate's role in a very balanced way. We sometimes tend to look at staff reports in one narrow manner, where exchange rate flexibility is the panacea to balance of payments issues. But in this case, I share the authorities' views and the mission chief's view that a broader context of looking at the exchange rate will be very important, particularly in the case of Malaysia, where sometimes excessive volatility could exacerbate and amplify the shock, rather than absorbing the shock.

In fact, I would be happy to share that the G-20 presidency of Saudi Arabia has given a particular emphasis on this issue. In particular, we, in the G-20, promote greater domestic forex market development. We believe that many countries have more of a role to deepen their financial markets, foreign exchange markets, and the role of the investor base in the domestic market to enhance the resilience of their economies. We think the staff report mentioned these issues in the case of Malaysia, including the role of fintech to improve access to finance and enhance the integrity of the financial sector. We very much appreciate the coverage on fintech issues.

Finally, we think it will be important to take into account the role of the Integrated Policy Framework. The case of Malaysia brings the attention of the Board to that. We need to take into consideration the country-specific circumstances when we look at the exchange rate policies. We look forward to a granular analysis in the Integrated Policy Framework.

Finally, we note from paragraph 20 that the staff stands ready to provide technical assistance to Malaysia to better understand the impact of the exchange rate on the economy. We advise the authorities to take this into consideration.

With these remarks, we wish the authorities continued success.

Mr. Alle made the following statement:

We would like to thank staff for the report and for the answers to our questions. We also thank Ms. Mahasandana and Mr. Mahyuddin for the insightful buff statement. We issued a gray statement, and I would like to emphasize just two points on fiscal policy and structural reform.

First, on fiscal policy, in our gray statement, we welcomed the authorities' multi-pronged approach to achieve fiscal and debt sustainability. At the same time, we are mindful that achievement in this area hinges on the effective implementation of the planned measures; notably, the reduction of the 2020 budget deficit, the possibility of the Fiscal Responsibility Act to enshrine in law the federal government debt threshold, the implementation of revenue-enhancing measures suggested by the Tax Reform Committee, and the identification of other revenue and spending measures for the medium-term fiscal adjustment plan. We would like the staff to give us the latest update on the authorities' progress on these different fronts.

Second, on structural reforms, we are very much interested in the authorities' ongoing initiative to promote access to alternative sources of financing for small and medium-sized enterprises (SMEs), especially manufacturing and innovating SMEs. As you know, countries in our constituency are exploring new ideas to diversify their economies, including around innovative SMEs. The financing issue, as you know, is a key one. We would, therefore, rely on staff to share the Malaysian experience during future Article IV consultations, especially on new digital financial innovations, such as equity crowdfunding and the peer-to-peer funding instruments that were mentioned by Ms. Mahasandana and Mr. Mahyuddin in their buff statement.

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

Mr. Tanaka made the following statement:

We thank staff for the informative staff report and Ms. Mahasandana and Mr. Mahyuddin for the informative buff statement.

We commend Malaysia for its stable economic performance with steady economic growth, stable inflation, and continuing employment improvement. As we have issued a gray statement, we would like to offer a few comments for emphasis.

First, on the fiscal policy, we concur with staff, that it is important to keep addressing medium-term fiscal consolidation to build fiscal buffers and fiscal structural reforms. In this regard, we commend that the authorities continue to seek a fiscal consolidation path without contingent fiscal stimulus, even after large projects with public investment have ended in the country recently.

Next, on the structural reforms, we share staff's view that the structural reforms are critical to reach high-income status and inclusive economic development. The staff presents examples in the report, such as education and female labor participation, which are very important for the future inclusive development foundation. But in terms of enhancing the productivity itself, we need a bit of a different angle, so we would appreciate more elaboration from staff on how to improve the productivity with other measures, in detail.

Mr. Guerra made the following statement:

We thank staff for the analysis and Ms. Mahasandana for the insightful and comprehensive buff statement.

First, we commend the Malaysian authorities for their strong policy framework.

Second, as we express in our gray statement, similar to the arguments expressed by Ms. Pollard and Mr. Inderbinen, we also appreciate the staff's answers to our questions. Related to the exchange rate, as Ms. Pollard has expressed, we believe that the appendix places kind of a confusing assessment on the role that the exchange rate can play. In particular, we see that appendix pertaining more to the realm of macroprudential policy. At the end of the day, the Malaysian corporations, as is the case in most emerging market economies, face challenges regarding the management of debt denominated in foreign currency. But we link that analysis of the appendix more to the realm of macroprudential policies, in which, the Malaysian authorities excel. So the issue is linked to communication, specifically how to communicate the IMF's policy points of view on exchange rate flexibility, to which we have to be careful.

At the end of the day, we have the same assessment, as expressed in the staff's policy recommendation, that the objective is clear, that deepening exchange rate markets is clear. Nevertheless, we would have preferred a clearer communication of the roles that both the macroprudential and the exchange rate policy play in the staff assessment.

Finally, we commend the Malaysian authorities for their commitment to fiscal prudence, to a strong financial supervisory framework, and to a very rich and far-reaching structural reform agenda.

Mr. Buissé made the following statement:

We thank staff for the excellent report and the quality of the answers to our written questions.

Malaysia's economic performance remains robust, despite the volatile international environment. We have issued a gray statement, so I would just like to make two comments.

First, we welcome the authorities' commitment to undertake an MTRS to increase their domestic resource mobilization. This MTRS should also be an opportunity to reflect the adequacy and efficiency of social spending in Malaysia. Investment in health, education, and the improvement of the existing social safety net could improve medium-term productivity prospects and increase the growth inclusiveness. Once these needs have been identified, the MTRS will be a useful instrument to efficiently raise public revenue in order to finance them.

Second, I would like to add to the discussion that my colleague launched on the exchange rate. I do think that, indeed, the literature is filled with problems when it is too volatile and when it is not volatile enough and too rigid. So the question is, what measures do you put in place, what policies do you put in place to increase the absorptive capacity of the exchange rate if the exchange rate is actually variable? In this institution, there has been extensive work on that, so I think that is a way we can move forward on this discussion.

Mr. Sassanpour made the following statement:

I thank staff for the very well-written set of reports and Ms. Mahasandana and Mr. Mahyuddin for their buff statement. We issued a gray statement, in which we posed a number of questions, and the staff very ably answered those questions.

First of all, we commend the authorities for their able stewardship of the economy in the face of heavy external headwinds. The Malaysian authorities have a long and successful track record of pragmatic policies, which was probably best demonstrated during the Asian crisis.

On the exchange rate, I tend to agree with Mr. Alkhareif and support the staff's balanced approach to exchange rate policy. Obviously, there is a need for further analysis, which was mentioned in the report, and we urge the authorities to work closely with the staff on this.

Finally, Malaysia is the largest hub for Islamic finance. We urge the staff to explore the issues in this area related to the Islamic financial sector, possibly as a selected issues paper in the next Article IV.

The staff representative from the Asia and Pacific Department (Ms. Choueiri), in response to further questions and comments from Executive Directors, made the following statement:[2]

There were a few questions. I will take those first before addressing the issue of the Appendix VII and our messaging on the exchange rate.

Mr. Alle had a question on the reforms of the authorities, if we could comment on the fiscal reforms that are happening. First of all, we need to recognize and really support the authorities' strong commitment to move forward with fiscal reforms to consolidate the fiscal position, to put in place a framework that makes it sustainable over time, including the fiscal responsibility law, and developing a Medium-Term Revenue Strategy to make sure that revenues are enhanced and meet the spending needs of the country over the medium term.

I am very pleased to report that Fund staff has started to work closely with the authorities on these issues. We have already had a TA mission from the Fiscal Affairs Department (FAD) on the MTRS, where we presented to the authorities the concept of the Medium-Term Revenue Strategy, the importance of anchoring a revenue strategy, given the spending needs, given the objectives of the authorities, and where this could come from. This work is

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[2] 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.

building on the work of the authorities themselves. When the government took over about two years ago, in May 2018, they realized that they needed to strengthen revenues. They have formed a Tax Reform Committee to look at this issue, and our FAD colleagues are working with them on that.

We also have a mission that is about to go—maybe they are in the field—to discuss the fiscal responsibility law and to work with the authorities to develop the best alternative for them.

On the question from Mr. Tanaka, how to improve productivity beyond what the authorities are doing. Of course, this is a very complex issue. I believe it is an issue that all the countries of our membership are facing, and there is no secret recipe for that. We plan to continue to do work on that because it is a very core issue for Malaysia. It would help the country to reach their target of becoming an advanced economy. We need to look at issues like how to leverage technology and embed it in production processes to make them more productive and how to leverage openness, trade openness and openness to services and to investment, to also foster productivity.

On the issue of Appendix VII and our exchange rate policy advice and what the staff are looking at. It is important to start from the premise that staff and the authorities deeply believe that exchange rate flexibility is a key instrument and a first line of defense for shocks. However, in the current context of the significantly large capital flows that are very volatile and when we look at the future, where this is likely to be sustained, the authorities have a question: Is there a situation where the exchange rate can amplify those shocks, instead of absorbing them? The purpose of Appendix VII was to just specifically look at this issue. What are the cases in which the exchange rate could play that role? We focused on the most recent literature because this is an issue that has come to the forefront more recently, where very small, very open economies, since the global financial crisis, have seen all these capital flow movements in substantial volumes. We focused on what the Fund staff have been doing recently to try to understand in which cases, in general, the exchange rate may be a shock amplifier, with the purpose to try to address these issues for Malaysia and to make sure that we put in place the policies that would strengthen the role of the exchange rate as a shock absorber.

This work is in process. Looking at this issue has helped us to have a conversation with the authorities on what they need to do to strengthen exchange rate flexibility and to strengthen the fact that it can play the role of a shock absorber. We have started a discussion with colleagues in the Monetary and Capital Markets Department who are discussing with the authorities some joint work that they can do to model the role of the exchange rate to understand for the case of Malaysia what are the hurdles, if any, for the exchange rate to be the shock absorber that we expect it to be, given the theory and all the knowledge that we have at the IMF. Based on that, what we hope to have are some specific policy recommendations that would help the authorities in that trajectory.

Going to Mr. Buissé's question: What are the measures to increase the absorptive capacity? This is precisely our motivation behind all this work. Of course, one of the most important things is looking at the foreign exchange market and to make sure that it works seamlessly and that it is deep enough to provide the investors with all the hedging that they need in order to protect themselves from balance sheet risks, which are at the core of where the exchange rate can be a shock amplifier, instead of a shock absorber.

This is a work in progress. This is the conversation that we are having with the authorities. We are hopeful that, by working jointly on this, we can help them with their objectives to deepen the foreign exchange market and to enhance the capacity of the exchange rate to be a shock absorber.

Ms. Pollard made the following statement:

Let me thank staff for those answers and make a suggestion.

Your explanation makes a lot of sense, but I just did a search through the text where you referred in Appendix VII. There is no mention as to what was just said, that you are doing this as a way to increase dialogue and then look at how to strengthen exchange rate markets. And I would add to Mr. Guerra's point that you should actually look at this in the context of macroprudential policies. This is very important as well.

I know there will be no change in this because of the transparency requirements, but I think in the future, if you could have put an explanation either in the text or in Appendix VII as to what the purpose of Appendix VII was, it would have solved this issue. Clearly, Appendix VII can be pulled out of the document and circulated on its own. As it stands, it sounds like it is saying: exchange rate flexibility is a problem, and you need to intervene to make sure that exchange rates are stable. I do not think that is what you want to say, but I think that is the risk you take in the way it is written.

The Acting Chair (Mr. Furusawa) made the following statement:

Thank you very much for your very insightful and constructive comments, which will be helpful for the authorities to continue their reform efforts and will also be very helpful to us in our ongoing work on the Integrated Policy Framework and the communications strategy.

To conclude this discussion, I call on Ms. Mahasandana.

Ms. Mahasandana made the following concluding statement:

On behalf of the Malaysian authorities, we would like to thank Ms. Nada Choueiri and her team for their engagements and candid discussions with the authorities during the Article IV missions. We also thank Directors for all the insightful comments, which we will certainly convey to our authorities.

I am encouraged by the authorities' acknowledgement of Malaysia's commendable economic performance and the Board's support for the current macroeconomic policy setting and the reform initiative under the Malaysian authorities.

The challenging global environment necessitates a continued emphasis to further strengthen Malaysia's economic resilience. Building on the past reforms that have strengthened the macroeconomic fundamentals and financial system in Malaysia, collaborations of macroeconomic management will continue to focus on the adoption of the appropriate policy framework with sufficient flexibility, a timely policy response, and the availability of ample policy buffers.

Meanwhile, the authorities remain focused on further strengthening the economy's resilience with the reform agenda to accelerate Malaysia's transition to a high-income economy and to strengthen public institutions and governance.

I would like to take this opportunity to briefly elaborate on a few key points.

First, on fiscal policy, the authorities remain committed to the medium-term fiscal consolidation and a gradual reduction of the debt level. The authorities also reiterate their commitment to strengthen fiscal governance and fiscal policy management through the Fiscal Responsibility Act, Debt Management Office, and the various initiatives mentioned in the buff statement. As highlighted by many Directors, the authorities acknowledge the importance of revenue mobilization and would like to reaffirm its commitment to formulate and implement the Medium-Term Revenue Strategy. The authorities are committed to greater fiscal transparency, including information and assessments involving the government's contingent liabilities.

On monetary policy, the Monetary Policy Committee will remain data-dependent and will 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 the authorities wish to emphasize their commitment to exchange rate flexibility. We concur with staff and many Directors, that further developments in FX markets is key to strengthen exchange rate flexibility.

In addition to this, further study and a greater understanding of how a flexible exchange rate could act as a shock amplifier is equally important to assess the effectiveness, trade-offs, and, ultimately, the net benefits of allowing exchange rate adjustments in response to shocks.

Similarly, our authorities are also committed to an open financial market environment. Our authorities wish to highlight that the consideration to gradually review the capital flow measures will continue. Taking into consideration the measures' effectiveness and the prudential elements to address targeted risks, continuous engagement with investors and business will also continue to play a pivotal role in forming an appropriate policy response. My authorities wish to avoid any distortions to their business operations.

Our authorities welcome the assessment that Malaysia's financial sector remains sound and take note of the concerns raised by Directors on Malaysia's high household debt levels and the real estate sector. Our authorities continue to closely monitor and assess the developments in this area and would like to ensure Directors that risks to financial stability emanating from household indebtedness and the real estate sector has receded and remains manageable amid sound underwriting standards, risk management practices, and loan affordability assessments.

Finally, the authorities remain steadfast in implementing the structural reforms and governance reforms to raise productivity and potential growth, including reforms to boost female participation and addressing the skill gap and quality of education. The labor force participation rate has steadily increased in the recent years, but our authorities agree that more can be done. In this regard, the labor law amendment--which would favor more female participation and the various incentives announced in the recent 2020 budget that would encourage flexible working arrangements, a return-to-work initiative, and adequate child care facilities--reflects our commitment to this.

I thank the staff for detailing out all these initiatives in response to the technical questions, including the issue related to quality education.

On behalf of my Malaysian authorities, I would like to convey their appreciation to staff and management for their efforts to further understand the domestic economy and greater recognition of country-specific challenges. To this end, our authorities benefit greatly from the ongoing dialogue with the staff of the Fund.

As the risks and challenges become more complex, the need for an expanded policy toolkit and an integrated approach to policy formulation is critical, as Malaysia remains vulnerable to external shocks and cross-border spillovers. In this regard, we urge the Fund to continue to play a greater role in highlighting the spillover risks and to expedite its ongoing work on the Integrated Policy Framework.

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

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed that the Malaysian economy has been stable despite internal and external challenges. Directors recognized the progress made on the reform agenda and encouraged the authorities to remain committed to governance and structural reforms. To address the risks facing the economy, Directors recommended that policy priorities ahead should continue to focus on a medium-term fiscal consolidation plan, while safeguarding growth and financial stability.

Directors welcomed the planned pace of fiscal consolidation and encouraged the authorities to identify well-defined spending and revenue measures to support this adjustment, including in the context of the upcoming medium-term revenue strategy preparation. They also encouraged the authorities to push ahead with the adoption of a Fiscal Responsibility Act, and with plans to improve debt management, public procurement, and the public investment framework.

Directors supported the broadly neutral monetary policy stance, given a closing output gap and broadly neutral financial conditions. They agreed that monetary policy should remain data dependent. Directors commended the authorities' commitment to exchange rate flexibility as well as recent initiatives to deepen the FX markets and encouraged them to explore further options in this area, as this would enhance the ability of the exchange rate to act as a shock absorber. In general, they advised the authorities to continue to review the effectiveness of FX market measures and consider gradual phasing out of such measures.

Directors agreed that the financial sector is stable, and that profitability, capitalization and asset quality of banks are sound. However, they noted that household debt is high compared to peers, with pockets of vulnerability among lower-income groups. Directors advised the authorities to closely monitor risks in the real estate and household sectors. Further enhancing the macroprudential toolkit would be helpful. Directors commended the ongoing efforts to strengthen financial literacy and manage cyber risks and climate change risks to the financial sector.

Directors commended the authorities' progress in developing and implementing governance reforms. They stressed the importance of sustaining the momentum and anchoring the reforms in legislation, particularly to help secure the independence of anti-corruption institutions, freedom of information, and to establish an asset declaration system. Further strengthening the AML/CFT framework will also be important.

Directors underscored that continued structural reforms aimed at raising investment and productivity are important to safeguard macroeconomic and financial stability and help address the external imbalances over the medium term. They supported the authorities' emphasis on raising productivity as it would help achieve high-income status and inclusive growth. Directors advised that priority be given to enhancing the business environment and improving access to credit for SMEs; promoting trade openness; enhancing the quality of and access to education; encouraging innovation, including through digitalization of the economy; and boosting female labor participation.

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

APPROVAL: September 23, 2022

CEDA OGADA
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:

Fiscal Policy

1. *Could staff elaborate on the adequacy and efficiency of social spending in Malaysia?*
2. *Can staff comment on whether the authorities are monitoring the targets to assess the effectiveness of social spending?*

- Spending on education in Malaysia, at about 6 percent of GDP, is higher than in other emerging markets in Asia, but Malaysia's student achievement outcomes lag those of its peers (although with improvements in recent years). Malaysia achieves relatively good health outcomes but does so with higher per capita health spending relative to its peers. Malaysia's social assistance spending is lower than its comparators, and targeting could be improved to increase the share of this spending which benefits the poor, which is currently estimated at about 20 percent.
- Recent efforts by the authorities to increase the efficiency of social spending include encouraging data sharing amongst agencies providing assistance to minimize overlaps, and efforts to target subsidies and strengthen verification of eligibility.
- Undertaking structured and targeted spending reviews could help the authorities increase the efficiency of social spending.

3. *In this regard, could staff elaborate further on the consideration given by the government to revenue-enhancing measures suggested by the Tax Reform Committee? What is the potential increase one can expect in the tax revenue-to-GDP ratio, if adequate reforms were fully implemented?*

- The Tax Reform Committee has submitted a report to the government on options to enhance revenues. The report is confidential and was not shared with the Article IV mission team at the time as it was still under consideration by the government.
- An FAD technical assistance mission visited Malaysia during January 20-21 and met with the Minister of Finance, senior MoF officials, and with the Chairman and members of the Tax Reform Committee to discuss the possible development and implementation of a Medium-Term Revenue Strategy (MTRS). The authorities confirmed to the FAD mission their intentions to move swiftly in this direction.
- The development and implementation of a MTRS could result in substantial revenue gains. A more precise estimate of potential revenue gains would become available in due course as the authorities make more progress towards implementing the MTRS.

4. *The main report could provide more information on the impact of fiscal risks stemming from contingent liabilities.*
5. *Staff identifies contingent liabilities as a fiscal risk. We welcome further elaboration.*

- The fiscal risk from contingent liabilities is related to the possibility that loan guarantees provided by the government might be called. Loan guarantees provided by the government stood at 18 percent of GDP at-end June 2019. About half of the loan guarantees are channeled to the infrastructure sector, while the rest are mostly directed to services, investment holding, and utilities sectors. Several factors mitigate the fiscal risks from guarantees, including a relatively long average maturity of outstanding loan guarantees (seven years), and the fact that more than 90 percent of loan guarantees are denominated in ringgit.
- The government identifies a subset of loan guarantees as "committed guarantees". Those are guarantees extended to entities which currently receive a transfer from the government or have a high probability of requiring financial assistance from the government in the future. Most of those entities are carrying out public infrastructure and public transportation projects. The contingent liabilities shock analyzed by staff in the Debt Sustainability Analysis assumes that the government is obliged to assume all "committed guarantees" (about 12 percent of GDP) over five years. The shock also assumes a negative feedback effect on the interest rate. Under this shock, the debt-to-GDP ratio would rise above 60 percent of GDP, thus breaking the authorities' debt limit of 55 percent of GDP.

6. *Can staff comment on the policy recommendation to increase flexibility of the current debt limit framework as presented in Appendix V? How does this relate to the staff recommendation of building additional buffers by reducing the debt level in the medium-term in order to reduce exposure to shocks? Can staff comment on the reasons behind the recent increase in federal government loan guarantees?*

- The main conclusion of the analysis presented in Appendix V is that the current debt limit of 55 percent of GDP is appropriate for Malaysia and should be retained. This is consistent with the recommendation in ¶12 of the Staff Report to continue gradual fiscal consolidation in the medium term to build buffers against shocks, given that an analysis based on the historical distribution of shocks shows that building buffers as recommended in ¶12 would significantly reduce the probability of breaching the 55 percent of GDP limit.
- At the same time, the analysis presented in Appendix V suggests that Malaysia could afford to temporarily breach the 55 percent of GDP limit without affecting investor confidence. Treating the debt limit in a flexible way by allowing such temporary breach, subject to well-defined caveats, would increase the capability to respond in a counter-cyclical way to large negative shocks. This would be particularly important in the case in which the authorities were to decide to enshrine the currently self-imposed 55 percent of GDP limit into legislation.
- As the Malaysian authorities have reported in the 2020 budget documentation, outstanding loan guarantees extended by the federal government stood at 273.8 billion ringgits at end-June 2019 (or 18 percent of estimated 2019 GDP), compared to 266.5 billion ringgits at end 2018 (or 18.4 percent of 2018 GDP). New guarantees were mainly to finance

public infrastructure projects such as the Mass Rapid Transit and Pan Borneo Highway, as well as for civil servants housing loans managed by the Public Sector Home Financing Board, and education loans under the National Higher Education Fund Corporation.

Monetary, Exchange Rate, and Financial Markets Policies

7. ***Could staff elaborate on the lessons learned from the reduction of the current account deficit that could be useful to other countries whose current account surplus are largely above their fundamental value?***

- Malaysia's current account (CA) surplus has been on a declining path since 2012, reflecting rebalancing in the economy from external to domestic demand, as savings declined, and investment increased.
- National saving has fallen from 34 percent of GDP in 2011 to 26 percent in 2018-19, driven by robust private consumption growth, itself fueled by strong employment and wage growth, rapid credit growth, and government transfers. Gross domestic investment has steadily increased from 18 percent of GDP in 2009 to about 26 percent in 2016-2017, driven by a strong rebound post the GFC, low interest rates, and the catalytic effects of large projects under the Economic Transformation Program (ETP). These projects are highly import intensive, particularly concentrated in oil, gas, and infrastructure. This sustained and substantial increase in investment is a welcome development and helps ease supply bottlenecks, boost productivity, and support efforts to modernize the economy and raise incomes.

8. ***We also note that the authorities do not find the ARA assessment methodology sufficiently granular to account for the characteristics of the Malaysian economy. Could staff elaborate on the difference in opinion?***

The indicator-based ARA methodology provides quantitative benchmarks for reserve adequacy. While the ARA methodology cannot take into account all country-specificities, the Guidance Note allows staff to have leeway in determining which formula to apply based on their understanding of the characteristics of the assessed economy. The Malaysian authorities highlighted the additional buffers to counter external sector stress (which are outside the ARA formula), such as FX assets held by resident banks and corporates, the large share of ringgit-dominated external debts, and the prudential and supervisory requirement by the BNM. Staff concur with the authorities and take these factors into account when assessing the reserve adequacy of Malaysia (see Appendix VIII, ¶6). However, although these additional buffers help mitigate external debt vulnerabilities, they might not be readily available in times of stress and hence cannot be treated as complement to central bank reserves at all times.

9. ***On the level of foreign reserves, we note that the gross FX reserves are increasing steadily in recent years, however, at the same time the reserves adjusted for net forwards (net reserves) appear volatile and low, and the gap between two reserve measures seem pronounced compared to the past (Figure 4, Right Middle). Could staff provide more explanation on this figure and how we should assess reserve adequacy?***

The BNM engages in the forward FX market in order to meet the liquidity needs in that market. Per the ARA guidance note, staff compared both gross and net reserves with relevant reserve adequacy metrics. While the guidance note makes it clear that reserve adequacy is a gross concept, it also suggests considering the impact of potential drains (if the impact could be material) on the availability of reserves buffers, given that such drains limit the usability and availability of reserves.

10. ***Could staff elaborate on the benefit and cost of existing capital flow management measures implemented by Malaysia relatively to alternative macroprudential measures?***

BNM has used CFMs to address macrofinancial shocks. Alongside these measures, the authorities have also taken a number of steps to further deepen FX markets and expand hedging opportunities. These have been discussed in recent staff reports which presented the authorities' motivations and staff assessment (see for example CR 19/71 and CR 18/61). Staff's advice on capital flow management has been guided by the Institutional View: capital flows should be primarily handled through macroeconomic policies, which in turn need to be supported by sound financial supervision and regulation and strong institutions. In certain circumstances, CFMs can be useful to support macroeconomic adjustment and safeguard financial stability but should not substitute for warranted macroeconomic adjustment. In particular, in the case of capital inflow surges, CFMs may play a useful role particularly when: (i) the room for adjusting macroeconomic policies is limited; (ii) appropriate policies require time to take effect; and/or (iii) the inflow surge contributes to systemic financial risks. In the case of disruptive capital outflows, the IV envisages a role for CFMs only when: (i) the country is in crisis or imminent crisis circumstances; and (ii) CFMs form part of a broader policy package that addresses the fundamental causes of the crisis. CFMs should be temporary, to be lifted once capital inflow surges or crisis conditions abate.

Staff has discussed the costs and benefits of the CFMs with the authorities and market participants during the 2019 Article IV consultation (IMF CR 19/71, Appendix IX) in the context of discussing the range of measures implemented by BNM to develop and improve the functioning of FX markets. Staff's findings suggest that the BNM has made important progress in developing onshore financial markets, including the foreign exchange market. Good progress has been made with respect to establishing an appropriate market infrastructure, and FX market turnover has been increasing. Onshore participants find that the markets are functioning reasonably well while offshore participants tended to be more negative about the tightening of regulation.

Assessing the balance of costs and benefits of any specific CFM measure is difficult, however, because costs and benefits are hard to quantify. While the CFMs may have helped increase onshore FX market turnover, staff has pointed out to the authorities in past discussions that CFMs create distortions by introducing administrative costs (costs involved in complying with the regulations, including associated paperwork), and by affecting economic agents' desired resource allocation.

11. ***The authorities have partly agreed with staff's external debt sustainability analysis but expressed reservations on the external balance assessment methodology. Could staff offer comments on this divergence as well as the positive impact of the CFMs?***

The Malaysian authorities highlighted a range of buffers, in addition to official reserves, to counter external sector stress, including FX assets held by resident banks and corporates, the large share of ringgit-dominated external debts, relatively stable intercompany loans and intra-group interbank borrowing, and BNM's prudential and supervisory requirements. While these additional buffers are not part of the ARA methodology, staff agree that these present additional buffers and take these factors into account when assessing overall reserve adequacy of Malaysia (see Appendix VIII), with the caveat noted in the answer to Q8 above.

Separately, on the external balance assessment (EBA) methodology, while the authorities took positive note of the 2018 EBA refinement, they continued to see limitations in the IMF's analytical framework given the relatively weak explanatory power of the current account regression model in the context of Malaysia.

On the impact of CFMs, please see the discussion above (Question 9).

12. ***Are staff arguing for greater management of exchange rates or more extensive use of intervention? Are staff suggesting that in situations where reserves are adequate and exchange rates undervalued, it should be FX intervention rather than external adjustment that serves as the primary shock absorber to shifting external conditions? In the specific case of Malaysia, can staff comment on the rationale for further FX reserve accumulation?***

- Staff's advice on FX intervention and reserves accumulation is in line with that in previous years. The staff report notes the importance of exchange rate flexibility as part of the policy toolkit (paragraph 10) and recommends that the exchange rate should be allowed to act as a shock absorber in response to macro-financial shocks (Appendix III). Moreover, staff concludes with a clear call in the staff appraisal for continued efforts to deepen domestic FX markets, which would enhance the ability of the exchange rate to act as a shock absorber (paragraph 47). Appendix VII reviews the literature on the exchange rate as a shock absorber or amplifier to provide context for the authorities' concerns on excessive exchange rate volatility. This technical work has facilitated traction; the authorities have requested technical assistance from the IMF to further study this issue.
- On the issue of FX reserve accumulation in Malaysia, the staff report notes that FX intervention should be limited to prevent disorderly market conditions, and that this would be appropriate in the case of an inflow surge to help increase the reserve coverage ratio. This is supported by Appendix IX (External Sector Assessment), which notes that the ARA metric is on the lower end of the adequate range (net official reserves stood at 102 percent of the ARA metric as at September 2019, with the adequate range spanning 100-150 percent). It is also consistent with the 2019 AIV staff report and recommendations.

- Separately, Appendix VI describes the authorities' policy framework, particularly in response to macro-financial shocks in a factual manner, without expressing staff endorsement of that framework. As explained in paragraph 23, the authorities' framework and views are not fully in line with staff's.

13. ***The authorities note that they wish to "wait for the outcome of the ongoing analytical work on the Integrated Policy Framework…" before doing so. Yet, as far as we are aware, the IPF will not address publication of FX intervention data. On the contrary, we understand that the review of data provision to the Fund is considering making FX intervention data mandatory. Staff comment would be welcome.***

- Publication of foreign exchange intervention (FXI) data is recommended by staff in Article IV consultations across the membership, but its provision is not an obligation under Article VIII. The plan is to circulate staff guidance on FXI data transparency to the board shortly.
- The Review of Data Provision to the Fund is scheduled to be discussed at the Board closer to the end of this year. It is premature to state specific changes to Article VIII obligations, including regarding the provision of FX intervention data. The IPF workstream is not envisioned to include guidelines for data publication.

14. ***We believe the conclusions expressed in Appendix VII that the exchange rate can act as a shock amplifier rather than a shock absorber may be seen by the public as contradicting, or it may weaken the policy recommendation in the staff appraisal. Can staff comment on the consistency between the staff appraisal and the conclusions in Appendix VII?***

- Staff and the authorities agree that the exchange rate has an important role to play in Malaysia as a shock absorber, and that exchange rate flexibility is an important tool to counter external shocks. Nonetheless, the authorities have raised the issue that at times the exchange rate can play the role of shock amplifier and, to examine this question, Appendix VII provides a review of the literature on the exchange rate as a shock absorber or amplifier. This helps provide context for the authorities' concerns on excessive exchange rate volatility. While more work is needed to ascertain the specific role of the exchange rate in Malaysia's economy, staff 's advice continues to be that the exchange rate should be allowed to act as a shock absorber in response to macro-financial shocks (Appendix III) but, to reinforce this role, staff concludes with a clear call in the staff appraisal for continued efforts to deepen the domestic FX markets, which would enhance the ability of the exchange rate to act as a shock absorber (paragraph 47).

Financial Sector

15. ***Given the authorities' assessment that sector-wide LTVs on first and second properties and DSTIs for all income groups are not currently needed, and that individual LTVs are informed by affordability assessments, we would welcome more details on the benefits and costs of introducing these measures on a non-binding basis?***

Loan-to-value (LTV) limits and debt-service-to-income (DSTI) are two of the most commonly used macroprudential instruments, both in advanced economies and emerging markets. LTV limits aim primarily to increase the resilience of borrowers to asset price and income shocks and can thereby indirectly increase the resilience of lenders. They are often targeted at mortgages, but can also be applied to other segments, including credit cards, commercial property or leveraged loans to corporate sector. These tools have been found to have a relatively strong impact on the volume of credit, thereby helping to moderate procyclical feedback between asset prices and credit. These tools are also changed relatively often in many countries to reduce financial stability risks over the cycle. Introducing LTVs and DSTI, initially calibrated to be non-binding to most loans, would strengthen the macroprudential toolbox over the medium term. Introducing LTV and DSTI often require changes to the banks data and reporting system. With the framework in place, the LTV and DSTI requirements could be tightened in periods of rapid growth of overall credit (and mortgage credit in particular) as warranted by cyclical considerations. Exemptions to first-time home buyers could also be implemented.

16. ***Regarding the real estate market risks, we would appreciate staff's elaboration on commercial real estate, especially in Kuala Lumpur.***
17. ***Can staff comment on possible vulnerabilities in the commercial real estate market?***

The commercial real estate market is characterized by oversupply conditions. The BNM Financial Stability Report (2019) highlights that the incoming supply of office space in the Klang Valley (including Kuala Lumpur) between 2019-21 is sizeable at 4.4 million square feet annually and significantly higher than annual demand of around 2.3 million square feet. Bank exposures to commercial real estate (office space and shopping complexes) are small at 3.4 percent of outstanding loans and non-performing loans in this sector are currently low, but a prolonged downturn could pose challenges to developers and investors and add risks to the financial system.

18. ***We invite staff comments on ways that the Islamic finance institutions could help support the SMEs as financing availability is flagged as one of the issues hindering their development. More generally, given the important role of Islamic finance in Malaysia, we were expecting a deeper analysis of issues in this sector. Staff may wish to comment.***

The Islamic finance sector has continued to chart positive growth in recent years and is an important part of the financial system. Islamic finance is recognized by the government as a key enabler to support growth in the SME sector (see BNM, Financial Stability and Payment Systems Report, March 2019, for a discussion of recent initiatives). Owing to time and staffing constraints, this year's consultation did not feature a significant focus on Islamic finance issues, but future consultations will do so.

19. As for fintech, ***has the reduction in physical distribution networks been matched by an increased use of mobile alternatives in all age and income groups of the population? Are there any risks of financial "exclusion"?***

The BNM has a strong focus on ensuring financial inclusion. A strategy is in place to enhance financial inclusion and monitor inclusion indicators. BNM data suggests that close to all adults are within convenient distance of at least one financial access point and more than 90 percent of adults have deposit accounts. The small decline in the ratio of ATMs per 100000 persons does not appear to have reduced financial inclusion, in particular given the rise of online and mobile banking solutions.

Structural and Governance Reforms

20. ***Could staff provide information on any new labor market reforms aimed at increasing female labor force participation since the 2018 Article IV report?***
21. ***Could staff elaborate on the measures taken so far and those that are in the pipeline to boost female labor force participation?***
22. ***Could staff offer more details on the progress in boosting female labor participation?***
23. ***Staff's elaboration on the authorities' progress on boosting female labor force participation would be welcome.***

Female labor force participation rate has increased from 54.1% in 2015 to 55.2% in 2018 and it is expected to increase further to 56.5% in 2020.
To implement the reform agenda laid out in the Mid-Term Review (MTR) of Eleventh Malaysia Plan (Oct. 2018), the Government of Malaysia has focused on improving FLFPR through the implementation of flexible working arrangements (FWA) as well as work from home and returning to work initiatives such as flexWorkLife portal and Career Comeback Program.

Women@Work initiatives announced in Budget 2020 aimed at increasing the participation of women in the workforce and included: a RM500 monthly incentive for two years for women aged 30 to 50 who return to work; a RM300 hiring incentive each month for two years for employers; extended income tax exemptions for women returning to work until 2023.

The government is amending the Employment Act 1955 to increase maternity leave from 60 to 90 days in the private sector and improve working conditions (e.g. increase the penalty for sexual harassment offences.) Additionally, regulations on childcare facilities is currently being reviewed to better facilitate employers to establish childcare centers at the workplace or within the vicinity of the workplace.

24. ***We welcome staff comments on the consistency of various plans and initiatives mentioned in ¶38 of the Staff Report.***

Malaysia's overarching goal is to achieve high income status and inclusive growth. To achieve this goal, boosting productivity growth is key.

The authorities are making progress in implementing the national-level initiatives identified in 2017 Malaysia Productivity Blueprint. Four out of nine priority subsectors chosen for the Establishment of Productivity Nexus have seen stronger labor productivity growth (average: 7.1 percent) in 2018, including machinery and equipment, tourism, ICT, and private healthcare. In addition, the Mid-Term Review (MTR) of Eleventh Malaysia Plan (Oct. 2018) has laid a comprehensive reform agenda for the period of 2018-2020. It has identified 803 actions under the six pillars to be implemented in the ministry- and agency-level. The six pillars are reforming governance, enhancing inclusive growth and wellbeing, pursuing balanced regional development, investing in human capital, enhancing environmental sustainability, and strengthening economic growth. Moreover, the recently released Shared Prosperity Vision 2030 outlines a long-term commitment to sustainable and inclusive growth.

Staff is of the view that the authorities' reform package helps provide a growth-enabling environment and incentivizes productivity growth. Nonetheless the issue of consistency of the various plans is an important consideration. Unfortunately, assessing the consistency of these plans and initiatives was beyond the scope of the Article IV mission.