2. Project Objectives and Components

a. Objectives

The Economic Recovery and Social Sector Loan (ERSL) was a single-tranche operation to support ongoing Government reforms in the financial, corporate and social sectors. These reforms were pre-emptive measures to strengthen the economy and mitigate the impact of the regional financial crisis. Core objectives of the reform program were to minimize the downturn in economic activity, resume sustainable growth, protect the hard-core/near poor and preserve investments in the human resource base.

b. Components

The ERSL supported GOM policy actions in four main areas:

- **flexible, sound, macroeconomic management**: (1) rebalance macropolicy in response to changing events. This required shifting from earlier (Oct 97) policies of restraint and austerity to fiscal easing (e.g., from a target surplus of 2.7% to 0.5% of GNP), while also maintaining tight monetary policy.

- **strengthening the financial sector**: 1) consolidation of finance companies; (2) pre-emptive recapitalization of banking institutions; (3) improved regulation and supervision of financial institutions.

- **improve competitiveness of corporate sector**: (1) enhance transparency/information disclosure; (2) market-based corporate restructuring; (3) strengthen competition policies; liberalizing foreign equity ownership

- **strengthen social safety nets**: (1) maintain key social services to poor; (2) protect public expenditure on health, education and safety nets; (3) enhance income earning opportunities of rural poor/newly poor urban via small-scale credit.

c. Comments on Project Cost, Financing and Dates

The loan was a single-tranche operation in support of ongoing GOM initiatives. Disbursement occurred on June 23rd, 1998. The loan was the start of the Bank’s renewed relationship with Malaysia and was followed by three additional loans amounting to US$404m and grant funds for institutional development.

3. Achievement of Relevant Objectives

Substantial progress was made in implementing the reform program, and with some exceptions, most policy reforms in the loan document proceeded on track. The GOM demonstrated flexibility in carrying out the reforms, which contributed to its success. However, performance was mixed regarding the social sector component--while budgets for social sector investments were preserved, the measures designed to provide income generating opportunities to the poor were seriously hampered by slow disbursement.

- **Rebalance macroeconomic policy**

The downturn in economic activity was greater than anticipated and the Government reacted flexibly to changing conditions, with good results. As the crisis deepened, earlier austerity measures (Q3 1997) were followed by easing of monetary and fiscal policies. A fiscal stimulus program was launched. [The March 98 targeted surplus of 0.5%
turned into a targeted deficit. The actual deficit in 1998 was about 1.8% of GDP and estimated to be 5.8% of GDP for 1999. Selective exchange and capital controls were introduced, but subsequently modified in light of an adverse reaction from the international investor community. The economy bottomed out in Q3 1998 and recovery is underway; GDP growth in 1999 is expected to be 3-4%, compared to -7.5% in 1998, exports and foreign exchange reserves have increased, inflation has fallen, interest rates have declined and the stock market has recovered substantially.

- **Strengthen the financial sector**
  An institutional framework for financial restructuring has been established. An asset management company was set up to acquire non-performing loans from the financial system and is operating ahead of schedule. A special purpose vehicle was established to recapitalize banking institutions, which will require significantly less capital than originally estimated. The Central Bank also planned to oversee finance company mergers, and as of July 99, 14 companies had been merged or absorbed by others. A committee set up to oversee voluntary restructuring of corporate debt had processed, as of July 1999, 62 applications for loans totaling almost US$10 billion. Disclosure throughout the restructuring process has been good. Measures to tighten banking sector regulation were introduced, but some of the measures were subsequently relaxed when the authorities became concerned that the stricter regulatory standards might be inhibiting bank lending.

- **Improve corporate governance & disclosure**
  Malaysia improved its corporate governance structures and legislative/regulatory framework. A year-long corporate governance reform exercise culminated in a comprehensive Government report which charts reforms in three areas: (a) development of a Code of Corporate Governance, (b) reform of regulatory framework for public listed companies, (c) building competencies for company management. A number of these recommendations have already been implemented. Measures have also been taken to strengthen corporate disclosure and protection of consumer rights and minority interests.

- **Strengthen social safety net**
  The 1998/99 budgets for social sector/safety net investments were protected, and the funds allocated for water, education, and health facilities were quickly utilized. The income generation components fell short of targets due to slow disbursement.

### 4. Significant Outcomes /Impacts:

The overall performance and outcome was satisfactory. The loan supported a "home grown" Government-designed program of financial sector restructuring and policy actions to strengthen corporate governance. Social sector budgets were protected and the loan enabled the expansion of safety nets to vulnerable groups. It also enabled the Bank to provide policy contributions (e.g., highlighting the risks of economic contraction, assisting the GOM to take stock of its contingent liabilities from guarantees to privatized infrastructure projects) and to re-establish a relationship with Malaysia.

### 5. Significant Shortcomings (including non-compliance with safeguard policies):

While the unexpected imposition of capital controls may have created breathing room for the Government (as argued in the ICR) the international market reacted negatively and the Government subsequently needed to modify the controls. Secondly, while it may have made sense to relax prudential standards for financial institutions, there seems little rationale for relaxing disclosure requirements, since this is contrary to the principle of transparency (also noted in the ICR). The most serious shortcoming, however, was the long delay in disbursing funds for some of the social sector programs, particularly the income-generation activities (credit programs) designed to offset the effects of economic slowdown on the poor and other vulnerable groups (the design of this component was controversial; the Bank advocated direct transfers to protect the poor while the GOM favored extension of credit).

When the GOM changed gears from restrictive to expansionary policies, line ministries had difficulty changing course and there were shortfalls in achieving targets of the fiscal stimulus package (actual 1998 budget deficit of 1.8% vs. projected 3.4%). One area of concern is the GOM’s decision to relax competitive procedures for public procurement. Though this was a temporary measure to accelerate implementation of development projects and increase the size of fiscal stimulus, it may jeopardize future attempts to institutionalize competitive bidding practices. The Bank overestimated the social impact of the crisis and missed opportunities to provide early advice on financial structuring.
6. **Ratings:**

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<th>OED Review</th>
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7. **Lessons of Broad Applicability:**

1. The single-tranche operation worked well as a crisis response instrument. A QAG review (August 1999) of Bank adjustment loans made in response to the global financial crisis also confirms that in situations such as this one—where the Bank is building a new relationship with Government, where the depth/breadth of Government ownership is uncertain, and the Government does not offer a strategy for building popular support for reform—a single-tranche operation based on actions already taken is appropriate.

2. In a fluid and uncertain environment, the GOM's ability to adjust monetary and fiscal policy in accordance with changing events improved outcomes. Flexibility should, however, include increased coordination between ministries.

3. In economies like Malaysia, strategies to manage the poverty impact of an economic crisis should include the urban as well as rural poor (until recently safety net/social sector programs tended to focus primarily on rural poverty).

8. **Audit Recommended?**

   ☐ Yes  ☐ No

9. **Comments on Quality of ICR:**

   The ICR was well written and detailed, but three areas merit greater mention. In addition, the region is to be commended on its follow-up supervision to a fully-disbursed loan, which enables the ICR to give a full picture of policy implementation and the occasional reversals.

   1. The income-generation components performed poorly, but the ICR does not provide much discussion about why disbursements for this type of activity were so slow and why so few targets were achieved. The ICR notes the disagreements between the Bank and the GOM about the design of social safety nets, but does not discuss why this was a poor performance area—was it a matter of poor design, insufficient commitment, overestimation of the social impact of the crisis, and what does this tell us about designing future operations of this type?

   2. On the issue of ownership, the August 1999 QAG review (referred to in 7.1 above) noted that support for the reform program was occasionally uneven and uncertain in Malaysia. The earlier March 1999 QAG Assessment reported many signs of resistance to Bank involvement among government officials in Malaysia. However, the ICR does not mention the QAG reports and characterizes Government ownership as being exceptionally strong, with the reform program enjoying wide public support. It would have been useful if differences with the QAG views had been discussed in the ICR.

   3. Finally, the ICR could have been more explicit about whether there were any conditions of this loan for Board presentation or effectiveness (apparently there were not) and could have discussed the pros and cons of using a single tranche, condition-less loan in crisis situations, to derive lessons/recommendations for other crisis situations.