First and foremost, on behalf of the Malaysian authorities, I would like to take this opportunity to record my sincere gratitude to the Bank staff for preparing this candid, balanced and well-written CAS for Malaysia. As you are aware, Malaysia has not been an active borrower for many years and only recently, when the Asian crisis began to spread to Malaysia, did the Government request for Bank’s assistance to finance reform programs to mitigate the adverse effects of the crisis. The US$300 million loan approved by this Board last year contributed in no small measure toward stimulating Malaysia’s ailing economy as the money was used to reinstate expenditures in the social sectors and for the poor, to bolster social safety net and jump-start small businesses which were badly hit by the slowdown.

Last year had been a traumatic one for Malaysia as the country’s economy suffered one of its worst shocks. GDP contracted to an unprecedented low of 6.8 per cent, following an uninterrupted growth in excess of 8 per cent for several years. The ringgit depreciated drastically, the stock market lost much of its lustre and the initial credit squeeze and high interest rates caused untold damage to businesses as well as economic activity.

Malaysians found that their purchasing power had been reduced and suddenly discovered that they were poorer. The wealth that took decades to build for many had been destroyed almost overnight. To make matters worse, the external trading environment was not friendly either. The adverse publicity that the country received also had a negative impact on market sentiments detrimental to Government’s efforts to revive the economy.

For the good part of the crisis, Malaysia adopted the “conventional” prescription for dealing with a problem of this nature. Public expenditure was slashed and the monetary policy tightened to contain the exchange rate depreciation. When the crisis turned out to be deeper and more prolonged than expected, these policies actually compounded rather than eased the problems. The high cost of capital and credit squeeze choked businesses, as they tried hard to stay afloat during the recession. Private consumption slumped and private investment contracted sharply because of extreme business pessimism. The cutting of public expenditure intensified the economic contraction and pushed the economy into a tailspin as it was swept by the regional contagion.
Since the adoption of the National Economic Recovery Plan in July 1998, monetary policy had been eased and fiscal spending increased. Selective capital control measures were imposed on September 1, 1998 not on ideological grounds but to stop internationalizing the ringgit and tame capital flows. The changes are fundamentally aimed at containing speculation on the ringgit and minimizing the adverse impact of short-term capital inflows. Malaysia is not using capital control to isolate itself. Malaysia has been benefiting greatly from being an open economy. Malaysia's international trade is about twice its GNP, and the export sector had for many years been the driver of economic transformation. This is a limited form of capital control, and certainly not 'retrogressive'. These exchange control measures continue to guarantee general convertibility of current account transactions and the free flow of direct foreign investment. They should not affect the normal conduct of business or long-term investors. In February 1999, these controls have been modified to allow for free flow of capital into and out of the country without restrictions while encouraging portfolio investors to take a longer-term view of their investments in the country. For funds that came into the country before February 15, 1999 a graduated levy is applied to the capital value depending on how long the funds are retained within the country. There is no levy on the principal after 1 September 1999. However, for new investments after February 15, only the profits are taxed upon repatriation depending on how long they are retained in the country. The principal investment is not taxed and can be repatriated at any time. With this easing of selective capital controls, foreign portfolio investors can price in the costs of the repatriation levy in their investment decisions, without causing market distortions. Other than the measures to prevent the internationalization of the ringgit, the capital control measures are as good as lifted.

Malaysia is not under any illusion that capital control is the cure to the economic troubles or a substitute for appropriate macroeconomic policies. To derive benefit from this devise, capital control measures must be accompanied with the right mix of consistent macroeconomic policies and structural reforms. In this regard, my authorities firmly believe that the current exercise of restructuring the financial institutions and corporations exercise must go on.

In the fiscal front, it should be noted that the Malaysian Government has been very conservative in its fiscal policy. Only for three years since achieving independence in 1957 did Federal Government operating expenditure exceed its revenue. Malaysia's development expenditures are funded from non-inflationary sources, such as government savings, domestic savings, and as the last resort, foreign borrowing.

During a recession, banks are naturally cautious in extending loans. However, being overly cautious and cutting the credit life-support for businesses will not help the economic recovery process. Banks were urged to increase their lending. But this has to be matched with the demand for loans for bankable projects and the decision to lend finally rests with the banks themselves, guided by prudential banking practices and assessment of risks and return. Bank loans, which hardly grew in the first half of 1998, picked up 1.35% during the second half of the year.

In terms of external trade, Malaysia recorded $1.8 billion trade surplus in December 1998, the 15th consecutive month of positive trade balance. In January 1999, Malaysia continued to record another surplus of $1.1 billion. Unlike the situation before the crisis, the current account of the balance of payments is expected to register a surplus equivalent to 14% of GNP in 1998. It is forecasted that there will also be current account surplus in 1999. The inflation rate rose by 5.3% in 1998. However, by February 1999 it had declined to 3.8% and is expected to remain below 4% in 1999.
Although Malaysia succumbed to the crisis later than the other countries, it has however made steady progress on financial and corporate sector restructuring. An appropriate institutional framework was set up in mid-1998 with the establishment of Danaharta (AMC) to take over non-performing loans from banks, and Danamodal (a Special Purpose Vehicle) to recapitalise them. Implementation of these has been accelerated, including the establishment of the Corporate Debt Restructuring Committee (CDRC) using the London framework. By December 1998, Danaharta had acquired and managed NPLs worth RM 13 billion, removing approximately 20% of the NPLs from the banking system while Danamodal had injected RM 4.55 billion in capital into nine financial institutions. The CDRC has received applications from 43 large corporations for restructuring with a total debt of RM 21.5 billion. Twenty four creditor committees have been set up and are in the process of debt resolution.

Burden sharing and transparency in the above, are key concerns of the Government. In this regard, the Government has adhered to the following: buying of the NPLs at a discount (about 40%); injection of capital into banks only after NPLs have been brought down to 10% to ensure that new capital is channeled towards financing new activities; "first loss principle" whereby the existing shareholders of the banking institutions seeking recapitalization would have to write down their shareholdings in banks; submission of business plans and establishment of business targets for banks that need recapitalization that are verified by international consultants; and the appointment of new management in recapitalized banks. In terms of transparency, all developments of Danaharta and Danamodal are made known to the public and their activities are also available at their websites. The terms of a large debt restructuring case has been made public by the CDRC.

It is generally believed that among the first steps to revive investor confidence and restore economic stability is reforming the structures of corporate governance. The urgency for reform is clear during the crisis. The Government is of the view that the real challenge is to keep the reform process going, even when the pressures of the crisis recede.

The crisis has highlighted some weaknesses in corporate governance – in particular inadequate safeguards of minority shareholder rights, in relation to connected party transactions, inadequate requirements for financial disclosure and lack of independent oversight at the board level. It is crucial to note that significant attention was drawn to this issue only as the crisis unfolded. There appears not to have been a sudden deterioration in these practices, rather, investors had been less diligent than they should have been in their choice of investments. Several measures have been taken, including amending several legislation and rules, to raise the standards of corporate governance in Malaysia. Among them are the following:

- The Securities Commission and the Kuala Lumpur Stock Exchange (KLSE) have revised the 118 KLSE Listing Rules.
- The Securities Industry Act 1983 was also amended to resolve weaknesses in insider trading rules and to take actions against directors.
- To increase transparency, the Securities Industry Central Depositories Act has been amended to prohibit persons from hiding behind their nominees.
- A comprehensive corporate governance reform exercise was undertaken in Malaysia in 1998 with the establishment of the Finance Committee on Corporate Governance to recommend the best practices on corporate governance. This report has been released to the public and many of its recommendations adopted.
Under the recovery program, there would be fiscal injection by the Government through selective spending in social and infrastructure development that use local inputs. Increased public expenditure will partly compensate for the precipitous fall in private demand. Priority projects are those that increase the productive capacity of country and social projects, such as poverty programs, education, health and housing. But this increased expenditure should well be within the means of the country and in keeping with the policy of responsible fiscal management.

The amount required to fund the recovery through 1998-2000 is estimated at $16.3 billion. This includes the funds needed for infrastructure and development expenditure, as well as to address the bank NPLs and recapitalisation. Funds will be obtained from the non-inflationary sources and without crowding out local investors. Local funding will meet two-thirds of the requirement, while the rest will be funded from foreign sources such as the World Bank. In this regard, Malaysia would very much welcome the Bank’s proposal of a base-case lending program of US$1 – US$1.5 billion over three years in investment loans in social and related sectors. Three operations are being presented together with this CAS for Board’s approval, i.e. the Education Sector Support Project, the Social Sector Support Project, and the Y2K Technical Assistance Project. With clear progress in financial and corporate reforms and greater transparency and disclosure efforts as well as increased focus on social services programs, the Malaysian Government hopes that the proposed loans will be approved today.

Even though there are still rough and difficult roads ahead, the Government believes that confidence is returning to the Malaysian economy. As indicators, the sales of passenger cars surged to 50,000 units during the fourth quarter of 1998 compared with 40,000 sold in the preceding quarter. Retrenchments have slowed down to 6,800 workers in September 1998 from the peak of 12,300 workers in July 1998. The Ministry of International Trade and Industry approved a total of $6.7 billion worth of manufacturing investments in 1998 against $5.9 billion in 1997. Foreign direct investment approvals rose to $3.3 billion in 1998 compared with $2.6 billion in 1997. In the recent home ownership campaign in December 1998, about $0.8 billion worth of houses were sold within one month, out of the estimated housing stock of $1.3 billion. The nation’s external reserves rose from $20.2 billion (3.8 months of retained imports) to $28.7 billion (6.4 months of retained imports) by 27 February 1999. At the same time, short-term external liabilities declined from $15.6 billion from end of June 1998 to $7.5 billion at the end of 1998. The present level of external reserves is more than four times the external short-term liabilities.

There are numerous other signs of improved confidence in the Malaysian economy. Certainly, the measures taken by the authorities as well as assistance received from multilateral, bilateral and other donors have proven to be beneficial. They helped to stabilize the economy and provided conditions that enabled businesses, both local and foreign, to operate. However much more needs to be done to rekindle growth to provide the impetus for social sector development and poverty eradication. The Government will continue monitoring the implementation of capital control measures while maintaining flexible macroeconomic policies, and accelerating and implementing coherent reforms in the financial and corporate sectors in order to restore growth and confidence. Undoubtedly, the full impact of all the remedies have yet to be felt and while the economy may not be out of the woods yet, there nevertheless are indications that the economy is on the mend and that it is moving in the right direction.

Once again, on behalf of the Malaysian authorities, I would like to extend my sincere appreciation to Bank’s management and the country team for being so responsive to the concerns of the Government in the preparation of the CAS as well as the project documents. The Government looks forward to greater collaborative efforts and a meaningful and positive relationship with the Bank as we move forward to achieve our mutual goals.