INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/99

10:00 a.m., July 8, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	L. E. J. Coene, Temporary
	P. D. Péroz, Temporary
	C. A. Salinas, Temporary
	T. A. Connors, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	M. Casey
	H. Arias, Temporary
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
	L. Ionescu, Temporary
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
	M. Camara, Temporary
M. A. Senior	
	A. Lindø
	C. Taylor
	Wang E.

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

Asian Department: Tun Thin, Director; H. Neiss, Deputy Director; B. B. Aghevli, N. N. Choudhry, R. G. Di Calogero, S. Kashiwagi, G. R. Kincaid, A. N. Mansur, T. J. Rommel, K. Saito, D. A. Scott, S. Shah, G. Szapary. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; M. Guitian, J. R. Marquez-Ruarte. Fiscal Affairs Department: M. A. Wattleworth. Legal Department: W. E. Holder, J. V. Surr. Treasurer's Department: A. G. Chandavarkar. Bureau of Statistics: H. Flinch. Advisors to Executive Directors: C. J. Batliwalla, S. El-Khouri, P. Kohnert, H.-S. Lee, I. R. Panday. Assistants to Executive Directors: R. Bernardo, J. Bulloch, N. U. Haque, M. Hull, H. Kobayashi, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Reddy, D. I. S. Shaw, P. S. Tjokronegoro, N. Toe.

1. KOREA - 1983 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Korea, together with a request by Korea for a stand-by arrangement equivalent to SDR 575.8 million (EBS/83/119, 6/9/83). They also had before them a report on recent economic developments in Korea (SM/83/141, 6/27/83).

Mr. Prowse made the following statement:

Under the previous one-year stand-by arrangement completed in February 1982, all performance criteria were observed, as they have been under all of the previous arrangements Korea has had with the Fund. The major macroeconomic objectives of that program were achieved.

The Korean authorities have remained in close contact with the staff during the intervening 16 months, including through an Article IV consultation that the Board conducted in May 1982. During this period, policy has been firm and resolutely maintained, and the result is, I believe, one of the most successful economies among Fund members in terms of current and prospective performance. For instance, in the first quarter of 1983 real GNP is estimated to have grown by 9.3 percent. At end-June, the wholesale price index was 1 percent lower than in December 1982, while the consumer price index had risen only 1.7 percent.

Although there was no Fund-approved program in 1982, the broad objectives of policy were surely acceptable to the Fund, and, indeed, were endorsed by the Board in May 1982. The principal objectives of Korea's economic management plan for 1982 were to curb domestic inflation, further improve the external position, and within this framework to sustain growth. In January 1982, the Government prepared a policy package designed to stimulate economic recovery within the framework of the overall stabilization program. Significant emphasis was also placed on basic structural and institutional reforms aimed at promoting competition through the use of the market mechanism. Additional measures were implemented in midyear to contend with the continued weakness in exports and with the problems arising from a severe disruption in domestic financial markets in May. Under these difficult circumstances, the outcome for 1982 was satisfactory. The inflation rate declined to a historically low level, the current account deficit was almost halved, and some growth momentum was maintained. Domestic inflation was reduced to below 5 percent, with declining import prices, good harvests, and lower interest costs contributing to the success in stabilizing prices. In addition, the Government undertook a nationwide campaign to reverse the inflationary psychology and restrain wage demands by promoting a better public understanding of the economic situation.

In particular, the current account deficit was reduced from \$4.6 billion--7.4 percent of GNP--in 1981 to \$2.5 billion--3.9 percent of GNP--in 1982. The reduction reflected principally an improvement in the terms of trade and an increase in earnings from invisibles. Export volume increased by 6 percent; while this increase fell short of historical standards, it compared favorably with the performance of Korea's main competitors. Real GNP growth of 5.4 percent was achieved in 1982. This performance, although below expectations, also was good in comparison with that of most other countries.

Given the adjustment program and the strength of the political commitment to it, and particularly in view of the more encouraging external outlook, prospects for consolidating the substantial gains made last year, and for further progress, are favorable. In close consultation and agreement with the staff, the Government has set its macroeconomic objectives to include an inflation rate of below 5 percent through 1983 and 1984, a current account deficit of about \$2.3 billion (3.2 percent of GNP) in 1983 and \$2 billion (2.5 percent of GNP) in 1984, and output growth of 7.5 percent in both years. The actual outcome will of course greatly depend on external developments, but these objectives represent realistic targets and deserve the endorsement of the Executive Board.

Fiscal and monetary policy will, of course, be directed to achieving the objectives of the program. The staff report sets out both areas of policy very well. Here I would say, relatively briefly, that fiscal policy in 1983 will continue to play a major role in stabilizing the economy. The 1983 budget provides for a further reduction in the overall public sector deficit through improvements in the financial performance of both the Central Government and the nonfinancial public enterprises. Government revenues in 1983 are estimated to rise to 21 percent of GNP. Increases associated with the underlying elasticity of the tax system and with the lagged effects of the tax reform package introduced in January 1982 will be important, and additional revenues will be raised by imposing a tariff on imported oil. To reduce further the overall deficit of the public sector, expenditures are budgeted to decline to 25 percent of GNP. The financial position of the public sector enterprises will be improved by enhancing their managerial efficiency and by appropriate pricing policies. In particular, the deficit of the Grain Management Fund will be further reduced by adjusting purchase and release prices.

The Government will make every effort to achieve the revenue target for 1983. However, a revenue shortfall from the budget estimate could arise should the recovery in domestic activity be delayed. It is notable that in such an eventuality, the Government intends to lower expenditures below the budgetary target. In any case, the Government is determined to contain the public sector deficit to below the 1982 level. Under current projections, the ratio of the deficit to GNP would fall to 4 percent; bank financing of this deficit will be limited to the equivalent of 1 percent of GNP.

The Government has stated that fiscal policy in 1984 will be consistent with the objectives of the program. The Government intends to reduce the public sector deficit as a ratio to GNP at a pace similar to that envisaged for 1983. In keeping with the Government's goal of reducing the relative size of the public sector in the economy, adjustments will be made mainly on the expenditure side.

As to monetary policy, the current objectives are to consolidate the recent success in reducing both inflation and strengthening the external balance and, within that framework, to support economic recovery. The Government recognizes very clearly that any rekindling of inflation and inflationary expectations would generate pressures on wages, interest rates, and the exchange rate. Therefore, the Government will continue to pursue a cautious approach to monetary management.

To ensure that the inflation and balance of payments objectives are met, the growth of the net domestic assets of the banking system will be curtailed to no more than 19 percent in 1983. This increase in net domestic assets, together with the projected decline in net foreign assets of the banking system, is consistent with an estimated 15 percent growth in the demand for broad money. The Government's commitment to limit the public sector's recourse to credit from the banking system should, however, ensure that the private sector's credit requirements are satisfied.

With the rapid fall in inflation in early 1982, interest rates became high in real terms. To reduce interest costs of firms and spur investment, interest rates were reduced by mid-year. Deposit rates were halved to 8 percent, lending rates were reduced to 10 percent, and preferential interest rates were eliminated. It is to be noted that the reduction in interest rates was kept below the decline in inflation so as to preserve a positive level of real interest rates. The Government will continue to maintain positive real interest rates. In implementing this policy, the Government will also take into account movements in foreign interest rates and their implications for capital flows.

The staff, in the commendably compact and concise EBS/83/119, and in SM/83/141, deals adequately with the range of policies seeking structural adjustment to the economy as a whole--not only the industrial sector. In regard to energy policy, Directors may wish to note that only 30 percent of the recent $5 reduction in OPEC oil prices has been passed through to domestic consumers and that the prices of only two oil products, used exclusively for agricultural and industrial purposes, have been lowered significantly. Some 40 percent of the decline in oil import prices has been earmarked for a special multipurpose fund to finance projects primarily in the energy area. There is a deliberate policy to expand and accelerate the assimilation of new technology. In 1982 the Government introduced a comprehensive tax reform package.

Evolution and development of the financial system will continue to receive high priority. In 1983 the Government transferred ownership of its remaining three nationwide banks to the private sector and licensed two additional banks and a large number of short-term finance and mutual savings institutions.

The Korean authorities remain committed to trade liberalization through the program period and beyond, even though about 40 percent of Korea's exports to OECD countries are subject to nontariff restrictions of various kinds. As of July 1, 1983 the import liberalization ratio was raised to 80.4 percent from 76.6 percent in 1982. The ratio will be raised further over the next three years to 90 percent, the level which seems broadly to prevail in the industrialized nations. Restrictions on foreign direct investment have also been further dismantled.

As to external policy, it may be recalled that in the past year or two the Fund has had a vigorous debate with the Korean authorities about exchange rate management. There is no need to recapitulate it; there is now evidently substantial agreement. As the staff says (page 18), "the decision to allow the won to depreciate...in 1982 resulted in significant improvement in competitiveness," and the staff notes the authorities' view that this effective depreciation has been sufficient to restore profitability in the export sector. The staff is of the view (page 19) that the present level of competitiveness should be adequate for the realization of the external objectives. Chart 3 on page 14a of EBS/83/119 is instructive in this regard. Moreover the authorities have affirmed their intention to use exchange rate policy in support of balance of payments objectives. Of course, the major achievements in containing price and cost increases has also contributed greatly to the improved competitiveness of Korean industry.

To recapitulate: Korea has pursued strong adjustment policies since 1980, responsive to changing internal and external circumstances. Unfavorable external economic conditions in recent years including recession in important markets, high interest rates, and growing protectionism have hampered Korea's efforts to adjust. Nevertheless, significant progress has been made in inflation, the balance of payments, and structural reforms, while some momentum in economic growth has been maintained. Under such circumstances, however, it was perhaps inevitable that Korea should turn to commercial borrowings to finance the current account deficit of its developing economy. The Government is conscious of the level of external debt and is making strenuous efforts to restrain further increases chiefly by improving the balance of payments position and increasing domestic savings. However, Korea's single-handed efforts alone cannot resolve all the problems unless her partners are willing to cooperate. In this connection, the Korean authorities wish to draw attention to the dangers of protectionism against exports of developing countries. They are concerned too about a careless generalization regarding external debt problems which does not pay due regard to the circumstances of individual countries.

Much has been said about external indebtedness in developing countries. In regard to Korea, the staff makes some important points. The starting point is the comment on page 15 that "...Korea's high marginal productivity of capital and its present stage of development justify continued reliance on foreign (capital)...." On page 19 the staff says, correctly, that "the level of Korea's outstanding external debt is consistent with its debt servicing capacity." Moreover, the dangers in the accumulation of short-term debt are well recognized by the authorities, and this particular aspect of Korea's debt structure will be substantially improved by the decision to freeze the level of short-term debt in 1983 and to reduce it in 1984. The staff's projections indicate that the external debt position and the debt service ratio will continue to improve over the period to 1985 of the projections. They strongly hope that this stand-by program with the Fund will play a helpful role in securing and justifying flows of private commercial capital.

Korea's present quota is absurdly small in relation to its economic position, although there will be a significant rectification when the Eighth Review is implemented. Nevertheless, this low quota as it stands is very relevant to the perceived relatively high ratio of use of Fund resources. Moreover, the amount of the proposed stand-by, while substantial in relation to quota, does not look large in terms of the payments gap to be financed in the circumstances prevailing in the world's capital markets. It is a modest contribution to enable the underwriting of a very satisfactory program for a member whose record of achievement in partnership with the Fund is outstanding and whose economy is increasingly important not only to its own region but to the wider economy, and not merely for its substantial contribution but also for its much-needed capacity to demonstrate what can be achieved with sound economic policies. This is a program which may be commended to the Board without reservation.

Extending his statement, Mr. Prowse commented that it was appropriate and efficient to consider the Article IV consultation and the request for a stand-by arrangement at the same time. The stand-by arrangement was the key issue being discussed by the Executive Board, but the observations provided by the staff and the Executive Directors on policy issues were particularly important to the Korean authorities. The authorities regarded the Executive Board's decision on the stand-by arrangement to be important in determining international perceptions not only of Korea but also of the region as a whole.

The growth in real GNP of about 9.3 percent was a remarkable achievement, Mr. Prowse considered, and was based on substantive improvements in many sectors. In the first five months of 1983, industrial production was estimated to have increased by about 14.5 percent over the corresponding period in 1982. Capacity utilization in manufacturing had risen to 82.3 percent in 1983 from 69.8 percent in December 1982. The authorities had had great success in controlling inflation; the wholesale price index had been 1 percent lower in June 1983 than in December 1982, and the consumer price index had shown an increase of only 1.7 percent over the same period.

Furthermore, in the first quarter of 1983 the consolidated public sector deficit had been only W 98.6 billion--less than 1 percent of GNP--as a result of better than expected revenue performance, Mr. Prowse went on. In the first half of 1983, tax revenue had increased more than 18 percent compared with the corresponding period in 1982. The Government had decided to freeze the purchasing price of barley at the 1982 level in order to reduce the deficit of the Grain Management Fund (GMF). Finally, during the previous eight months M-2 had grown at an annual rate of 13 percent.

Mr. Hirao noted that over the previous three years the Korean authorities had implemented a wide-ranging adjustment program, supported by two one-year stand-by arrangements with the Fund. That program had aimed to curb domestic inflation, improve the external position, and sustain growth. Substantial progress had been made in 1982 in reducing both inflation and the current account imbalance, and the authorities had requested a stand-by arrangement for a 1983/84 program that sought to consolidate the gains of 1982.

On fiscal policy, Mr. Hirao commented, the authorities' efforts to reduce the public sector deficit had effectively contributed to the improvement in inflation and the external position. The authorities had demonstrated their commitment to containing the public sector deficit by restraining expenditures to below the budgeted amount in response to the 1982 revenue shortfall. It was commendable that they were determined to maintain a cautious attitude with respect to the public sector deficit when implementing the 1983 budget, in particular by adjusting prices of rice in order to reduce the deficit of the GMF.

As to monetary policy, Mr. Hirao welcomed the authorities' commitment to restrain credit expansion in an effort to avoid a rekindling of inflation and to support the balance of payments objectives. The ceilings on net domestic assets of the banking system and net banking credit to the public sector were important prerequisites for the achievement of policy objectives, and recent measures to slow money expansion and to tighten the rediscount policy should contribute toward that end.

On the external front, Mr. Hirao remarked, although the current account deficit had been reduced significantly during the previous two years, it still had amounted to 2.5 billion in 1982. The overall external deficit had deteriorated in 1983, mainly as a result of reduced net capital inflows, and it was appropriate that the authorities had resolved to reduce the current account deficit further with a view to limiting their dependence on external borrowing.

The growth of external debt was projected to slow markedly in 1983/84, and the level of outstanding external debt would remain consistent with Korea's debt servicing capacity, Mr. Hirao went on. However, he shared the staff's concern that the recent rapid expansion of short-term debt had increased Korea's vulnerability to potential disruptions in the international capital markets. He therefore welcomed the Government's decision to reduce the level of short-term external debt gradually over the program period.

In conclusion, the authorities' structural policies--including industrial restructuring, tax and financial reform, and trade liberalization--would significantly increase the productivity and efficiency of the Korean economy, Mr. Hirao observed. Their continued efforts to liberalize imports during a period of rising protectionism was welcome. Finally, he could support the request for the stand-by arrangement as well as the decision under the Article IV consultation.

Mr. Connors considered that the Korean authorities had managed the economy exceptionally well. Economic growth had returned to a high rate, inflation had been reduced significantly, and there had been a substantial reduction in the current account deficit. The policies to be pursued under the program were consistent with the objective of continuing to improve the economic and financial situation in Korea.

Interest rates for lending and deposits had been unified at 10 percent and 8 percent, respectively, Mr. Connors noted; although they were positive in real terms they were still low by international standards and might be partly responsible for the unusually large errors and omissions item in the balance of payments for 1982. It was difficult to determine precisely an appropriate level of interest rates, but it was important to take into account movements of foreign interest rates. Furthermore, he recommended greater reliance on flexibility and market determination of interest rates, rather than reliance on administered rates.

Turning to fiscal policy, the authorities had indicated that purchase and release prices of rice would be adjusted to reduce the deficit of the GMF, Mr. Connors observed. He urged them to adjust prices so that they not only improved the financial position of the GMF, but also reflected international prices more closely. Moreover, the authorities' commitment to maintain flexible management of the exchange rate was welcome.

Finally, Korea seemed to enjoy relatively good access to international capital markets, Mr. Connors remarked. It was important that the authorities should implement a strong adjustment program so that they could continue to have good access to those markets. Capital markets were currently volatile and, while the authorities wished to reduce the amount of its short-term debt, it might be possible for them to obtain medium-term and long-term credit on terms not too dissimilar to those available under the proposed stand-by arrangement. He therefore hoped that the authorities would use the Fund resources on a truly stand-by basis. A similar suggestion had been made in the case of Turkey a few weeks previously. If developments in the international capital markets became more unfavorable than projected, Korea would then be able to use Fund resources available under the program.

Mr. Casey considered that the authorities' stabilization policies had been successful in 1982, although competitiveness had remained a problem until the exchange rate had been allowed to depreciate in line with the U.S. dollar at the end of the year. The present level of competitiveness should be adequate to achieve the external objectives. The authorities were committed to a flexible exchange rate policy and, more importantly, they seemed willing to make adjustments in monetary and fiscal policy should the need arise.

On the external side, the further liberalization of imports at a time when many larger industrial countries were increasing restrictions was welcome, Mr. Casey commented. Containing and improving the maturity of external debt were important elements of the adjustment program; however, if Korea's remarkable record with respect to productivity and export volume continued, there was little doubt about its capacity to service debt.

On the fiscal side, Mr. Casey said, he was not clear how pricing policy would be conducted in the GMF and in other state enterprises. Was there a movement toward greater market determination of prices and interest rates? He would appreciate some clarification from Mr. Prowse or the staff on those issues. On a related point, could the staff clarify the authorities' policy with respect to divestiture?

The reduction in the rate of inflation to below 5 percent was an excellent development, Mr. Casey noted, but it might mean that the 10 percent guideline for wage increases in the private sector would be too high, particularly since Korea depended to a large extent on labor-intensive forms of activity. Furthermore, the target of 15 percent growth for broad money and 14 percent growth in government spending could prove to be excessive in relation to a lower than expected inflation rate. Those aspects of the program would therefore need to be carefully monitored.

He was not fully convinced that Korea really needed to make such a significant drawing under the stand-by arrangement, Mr. Casey went on. He had been a little surprised to note that the potential drawing entitlement represented about 128 percent of quota on an annual basis; even though Korea's existing quota was relatively small, the percentage was fairly high. The staff projected an overall balance of payments deficit of $1.7 billion in 1983 and $1 billion in 1984. However, those figures omitted substantial inflows through banks, which had been included below the line. Whether or not that type of presentation was appropriate, it seemed as though some reserve accumulation would be possible in Korea, even without drawing on Fund resources. Such a reserve accumulation would also apparently be accompanied by a high rate of economic growth. Moreover, Korea had relatively sizable access to medium-term and long-term commercial bank credit, and he therefore hoped that the authorities would make a drawing under the stand-by arrangement only if balance of payments developments turned out to be less favorable than expected. He recalled that that kind of approach to a stand-by arrangement had recently been suggested by several Directors in the case of Turkey.

Mr. Laske said that, in 1980 and 1981, the Korean economy had suffered a serious setback from its previously favorable path of economic development. Considerable progress had been made in 1982 in restoring economic growth, and internal and external stability, owing to determined corrective action taken by the authorities. The adjustment program under the stand-by arrangement was designed to consolidate those gains already made and to achieve further progress.

The objectives of the new program were appropriate, Mr. Laske considered, namely, to contain inflation, restrain monetary expansion, tighten fiscal policy, and significantly reduce the external debt. He welcomed in particular the authorities' intention to strengthen their adjustment efforts if external developments turned out to be less favorable than assumed.

Korea was the fourth largest international debtor among developing countries, with its external debt totaling well over 50 percent of GNP, Mr. Laske went on. However, given the country's record and the prudent policies adopted by the authorities, he had no reason to seriously question Korea's ability to manage the debt burden. Nevertheless, a further rapid increase in the total foreign debt would be hazardous; it could strain the servicing capacity of the economy and expose the authorities unnecessarily to changing sentiments in the international capital markets. The limit on external debt of $4.2 billion was therefore welcome, particularly since that ceiling encompassed all maturities and constituted a performance criterion for the stand-by arrangement. However it represented an increase of more than 12 percent over the level recorded at the end of 1982, which was a considerably stronger increase than the expected overall increase in the international exposure of commercial banks. He wondered whether the banks would, in fact, be so forthcoming with new credit to Korea.

The share of short-term maturities in Korea's foreign debt was relatively high, Mr. Laske continued. Difficulties that might arise in rolling them over could cause serious complications for the adjustment process. He was therefore pleased that the level of short-term debt would be frozen in 1983 and reduced in 1984. Nevertheless, the present level should be treated not as a target, but rather as a ceiling. The authorities should take advantage of opportunities to substitute medium-term or long-term borrowing for maturing short-term obligations, even if the terms were less favorable.

Direct investment could contribute to the financing of the balance of payments deficit, Mr. Laske considered. Net foreign direct investment had made up only a fraction of the medium-term and long-term capital inflow over the previous five years, possibly because of the authorities' restrictive licensing practice for foreign direct investment. He encouraged the authorities to review their policies in that area.

Turning to monetary policy, a 15 percent increase in broad money was projected, Mr. Laske noted, which was perhaps too expansionary, especially given the projected increases in GNP of 7.5 percent and in the consumer price index of 4.5 percent. The severe crisis in the non-bank credit market--the "curb market"--had brought to light serious shortcomings in the structure of the financial system. The authorities had adopted measures to liberalize the banking business but had not gone as far as rerouting the extension of credit into orderly banking channels. The authorities should urgently consider steps to strengthen market mechanisms in banking and to ensure that the liquidity and solvency of banks were carefully monitored.

On the fiscal side, the public sector deficit--as a percentage of GDP--was projected to decline, while the central government deficit was projected to remain unchanged, Mr. Laske commented. Improvement in the public sector's financial performance was obviously centered on the public enterprises and public funds, but the staff had not mentioned any specific measures that would be adopted to achieve that improvement. Had the authorities adopted measures to reduce the financing requirements of the public sector entities? Any delay in action would be regrettable, since it would be even more difficult to produce the desired results in a shorter period of time.

The strong increase in export volume projected by the staff might be optimistic, Mr. Laske said. After all, Korea was confronted with protectionist policies by some industrial countries, and it had important markets in developing countries, which might not increase demand in the near future given the need of many countries to restrain imports.

Like Mr. Connors and Mr. Casey, he noted that Korea's use of Fund credit was not far from the upper limit established under the enlarged access policy, Mr. Laske remarked, and Korea's request for a stand-by arrangement would have to be financed almost exclusively by borrowed resources. The objective of the adjustment program was to strengthen

Korea's external position, to add to its international reserves, and to bolster its creditworthiness in the international capital markets. It was his understanding that the resources obtained from the Fund would be used to increase external reserves, which he did not consider to be at a worryingly low level. He hoped that the authorities would only use Fund resources if the balance of payments objectives could not be met because of exogenous factors. He would be even more pleased if Korea could achieve a reduction in the net use of Fund credit during the period of the stand-by arrangement.

Mr. Taylor stated that it was evident both from the staff paper and from Mr. Prowse's statement that the economy had recovered remarkably well from the setbacks of 1980 as a result of the authorities' stabilization policies.

The authorities should be commended for their success in reducing inflation from almost 35 percent in 1981 to under 5 percent in 1983, Mr. Taylor indicated; the achievement was a considerable one, especially since it had been combined with continued strong growth and output and a reduced current account deficit. Certainly, the adjustment effort had been helped considerably by developments in the external sector, in particular by the 8 percent decline in import prices during 1982. The favorable external developments could not be expected to continue indefinitely, however, and he therefore endorsed the authorities' intention to pursue prudent policies in an effort to keep inflation under 5 percent. He welcomed their commitment to reducing still further the substantial current account deficit, although that commitment did not imply that they should cease importing capital in the long term.

In trade policy, the authorities were to be congratulated on the progress that they had made in liberalizing the trade regime, Mr. Taylor continued, which should improve resource allocation in the economy and the general efficiency of Korean industry. Perhaps the authorities might aim for a 90 percent liberalization ratio sooner than 1986. Even though Korea had been a member of the Fund since 1955, it still maintained Article XIV status. Were there any particular obstacles that prevented Korea from changing to Article VIII status? On a related point, he was pleased to note that restrictions on direct investment from abroad had been further reduced.

The authorities' decision to pass on to consumers less than a third of the $5.00 reduction in oil prices was commendable, Mr. Taylor remarked. That prudent policy would conserve energy in the medium term, increase revenues, and offset any potential losses of income deriving from falling workers' remittances from the Middle East area.

The crucial importance of export performance in the economy underlined the need to continue with a flexible exchange rate policy, Mr. Taylor considered. While the December 1981 devaluation had been helpful in reversing some of the deterioration experienced in that year, the real effective value of the won had remained at almost the same level as in 1982, and therefore the anticipated recovery in competitiveness had been constrained, notwithstanding the 4 percent improvement in the terms of trade. He hoped that the further fall in the real exchange rate projected for 1983 would be realized.

With external debt worth more than half of GNP, the country could maintain the debt service ratio only by continuing its strong export performance, Mr. Taylor noted. The high level of debt meant that Korea was exposed to changes in international interest rates and in the confidence of international capital markets. He therefore welcomed the authorities' recognition of Korea's vulnerability, which had been made more acute by the rapid growth in the proportion of short-term debt. The decision to freeze the level of short-term debt in 1983 and to reduce it in 1984 was prudent and consistent with the adjustment effort. It would be even more desirable if the authorities could start to reduce short-term debt sooner.

The current arrangement would be Korea's fifteenth stand-by arrangement with the Fund in an almost unbroken chain dating back to 1965, Mr. Taylor recalled; it was of some concern that such an economy, which had experienced an enviable performance and had developed an extremely strong and highly competitive industrial base, should continue to be a candidate for Fund assistance. He agreed that Korea had a balance of payments need as defined by the Fund, that there was no doubt about the excellent record of cooperation, and that the authorities were putting in place appropriate policies to deal with their external problems. However, the authorities had demonstrated their ability to raise finances on the international capital markets, and perhaps their need of Fund resources was not as great as that of other potential candidates. He was concerned about the heavy pressures being exerted on the Fund's liquidity position at the present time. Would it be possible for the authorities to use the discipline of the Fund program to reassure creditors, without necessarily making the full purchase unless external developments deteriorated? Fund resources could then be used by countries whose need might be greater, and the stand-by arrangement would have functioned on a truly stand-by basis.

Mr. Suraisry stated that it was clear from the staff papers that the Korean economy had performed well in 1982 in the face of generally difficult circumstances; inflation had been reduced considerably, and the current account deficit had been halved. Output growth had been satisfactory in spite of the weakness in export markets and lower public spending. In order to consolidate those gains, the authorities had adopted a stabilization program in support of which they were requesting a stand-by arrangement.

On fiscal policy, Mr. Suraisry noted, the program aimed at a further reduction of the public sector deficit to 4 percent of GNP in 1983. That reduction was to be achieved mainly through strict expenditure control and improvements in the financial position of the Enterprise Fund. On the revenue side, however, the ratio of public sector revenue to GNP was expected to remain about the same as in 1982. The stimulative tax measures, taken in early 1983, would have an adverse effect on revenue. What was the staff view on those tax measures, given their revenue effect? Why had the authorities imposed a 5 percent tax on imported oil, and at the same time reduced the excise tax on gasoline?

Commenting on monetary policy, Mr. Suraisry said that the authorities had followed a tight credit policy since September 1982, which had helped to hold down inflation. That policy would be maintained throughout 1983, in order to limit the rate of increase in broad money to 15 percent. However, that target appeared to be ambitious, since the rate of increase in broad money had been close to 25 percent in each of the preceeding four years. Nevertheless, he was encouraged by the figures provided in Mr. Prowse's statement.

With respect to the external sector, the recent depreciation of the won in real terms should help to improve Korea's competitiveness in exports, Mr. Suraisry went on. The authorities were committed to using a flexible exchange rate policy in an effort to preserve export competitiveness and support the balance of payments objective. However, the attainment of the export targets also depended on Korea's access to foreign markets, and he shared the authorities' concern about the high degree of protectionism that was still facing Korea's exports.

The sharp increase in Korea's short-term external debt in recent years was a cause for concern, particularly since it increased the country's vulnerability to disruptions in international capital markets, Mr. Suraisry continued. The performance criterion of freezing the level of short-term debt in 1983 and of reducing it in 1984 was therefore welcome. The overall ceiling on external debt related to disbursed rather than contracted debt, which was in line with the latest Executive Board discussion of the guidelines on external borrowing in Fund-supported programs. However, it was unusual that debt of all maturities was included under the ceiling; perhaps the staff could explain the reasons for that inclusion and, if possible, indicate how Korea's external indebtedness had evolved during the first half of 1983.

On more general points, Mr. Suraisry noted, a review clause included in the program as a performance criterion required consultation with the Fund prior to April 30, 1984, in order to reach understanding on performance criteria for the remainder of the program. Did that deadline refer to the Executive Board's discussion of the review, or simply to an agreement between the authorities and the staff? Whichever was the case, he hoped that the timing of the Executive Board's discussion would make the quarterly performance criteria for 1984 meaningful. Furthermore, it would have been useful if the staff report had included a section on the policy discussions between the authorities and the staff, so that the Executive Directors could have a clearer picture of the adjustment measures.

Mr. Lovato stated that the authorities should be commended for their progressive liberalization of restrictions on payments for current international transactions. He urged them to move further in liberalizing imports, even though restrictive trade practices abroad constrained their efforts.

In 1982, Korea had achieved remarkable economic results, Mr. Lovato commented, particularly by bringing down the inflation rate from 12.6 percent to 4.8 percent as measured by the consumer price index, by maintaining the GDP growth at a relatively high level, and by reducing the current account deficit from 7.4 percent to 3.9 percent of GDP. In spite of that good performance, further adjustment was needed. It was particularly important to reduce expenditure in the public sector, to increase the level of savings through more efficient management of the Enterprise Fund, and to introduce a more appropriate pricing policy. The authorities' intention to reduce expenditures further if revenue increases did not materialize as envisaged was welcome.

The authorities should adopt more restrictive fiscal and monetary policies in order to leave more room for adjustment in the private and export sectors, Mr. Lovato considered. Furthermore, they should aim to reduce domestic demand as a means of improving the balance of payments position.

The improvement in the external current account was not particularly significant, Mr. Lovato went on. In spite of the relatively high level of GDP growth, Korea had maintained a current account deficit. Where did the staff draw the line between cases in which financial support from the Fund was necessary to restore the balance of payments equilibrium, and cases in which financial support was necessary for economic development?

He was also concerned about the level of outstanding external debt, Mr. Lovato continued. Even though the current account deficit had declined since 1980, the overall external deficit had deteriorated, and the authorities had had to resort to short-term debt. Consequently, the outstanding external debt had increased substantially and its structure had worsened. The authorities' intention to reduce the level of short-term debt over the program period was welcome, but would it also be possible to restructure existing debt? In fact, even the authorities were doubtful about the possibility of having sufficient access to medium-term and long-term borrowing in 1983.

Given the increased vulnerability of Korea to potential disruptions in the international capital markets, the authorities should attempt to stabilize the economy with a lower growth of domestic demand and with reduced recourse to external financing, Mr. Lovato concluded. Korea still had large reserves, and, although he would support the proposed decision, he recommended that the authorities refrain from using Fund resources if they were not required.

Mr. Coene considered that the Korean economy had performed well in recent years, and that the authorities' request for a stand-by arrangement demonstrated their intention to continue pursuing an adjustment program. Yearly drawings under the stand-by arrangement would be equivalent to about 128.5 percent of the present quota. Balance of payments projections indicated that the use of Fund resources was quite small in relation to the payments gap, and the adjustment program would help the country to raise the required market financing. Like others, he hoped that the authorities would use the Fund resources on a truly stand-by basis and would show some restraint unless balance of payments developments turned out more negative than anticipated. In that respect, it would be useful if the staff could provide some justification for the amount of the drawing under the stand-by arrangement.

He agreed with the staff appraisal of the policies for 1983, Mr. Coene continued. While the Korean economy was performing, in general, satisfactorily, the major weakness seemed to be the low level of profitability in manufacturing. Although the figures in the staff paper on recent economic developments had to be looked at with caution, they seemed to indicate a sharp drop in profitability in 1980 and only a marginal improvement since then. Furthermore, they indicated a very low level of investment in machinery and equipment. Some further improvement in profitability might be expected when the recovery took hold, but it was not certain that profitability would recover sufficiently to permit investment to increase--in relation to GDP--to the level of the 1970s.

Given the low level of profit, the doubts concerning the durability of the world recovery, and recent upsurges in protectionism, the medium-term outlook for the balance of payments would perhaps be more like scenario B than scenario A, Mr. Coene considered. In other words, there would be a much slower adjustment of the external situation. If the external debt situation was to improve significantly, continuous vigilance would be required and the authorities would need to accelerate the adjustment efforts particularly in 1984 and 1985.

He was concerned about the large amount of short-term debt, Mr. Coene said. It would be wise to reduce short-term debt as soon as possible, and some measures had already been introduced to maintain its level in 1983. The authorities should try to reduce outstanding short-term debt in 1984 by replacing it with medium-term and long-term loans.

Commenting on monetary and fiscal policy, Mr. Coene stated that the expected growth of money was sufficient to allow an expansion of economic activity. If fiscal policy were kept tight, such monetary expansion should have no negative consequences for inflation. Interest rates might, however, be used to attract a larger volume of capital inflows.

The staff representative from the Asian Department, commenting on interest rate policy, stated that lending rates in Korea were 10 percent and that expected inflation was certainly below 5 percent; thus, domestic interest rates were positive in real terms. With respect to international interest rates, LIBOR was currently at 9.5 percent, and interest rates in most industrial countries were less than those in Korea. Korea's interest rate policy was therefore appropriate. Capital outflows in 1982 had been due, in part, to interest rate differentials, but since that time foreign rates had declined significantly and eliminated the interest rate differential. The large size of errors and omissions in the balance of payments could perhaps be attributed to exchange rate speculation, as the public had believed that the won would depreciate with the dollar; speculative pressures had eased toward the end of 1982, when eventually the dollar and the won had depreciated.

The authorities intended to liberalize interest rates when expectations of lower inflation had firmed, the staff representative explained. In that way, interest rates in the unorganized financial market would be closer to bank rates, and after the liberalization, there would be no abrupt upward movement in bank rates. If conditions were favorable, the authorities intended to take action in spring of 1984, but they had made no firm commitment.

Commenting on pricing policy and more generally on the operations of the public sector, the staff representative said that the deficit of the GMF had decreased from 1.3 percent of GNP in 1980 to about 1 percent in 1982. The deficit was projected be reduced further to approximately 0.7 percent, mainly as a result of limitations on the increases in purchase prices. Recently, the purchase price of barley had been frozen while the release price was being increased gradually. It was hoped that in a few years, the GMF deficit would be eliminated completely.

Data for the first quarter of 1983 indicated that the public sector targets would be met and perhaps even surpassed, the staff representative remarked. Government expenditure was 22 percent of GNP, as compared with the program target of 25 percent, and although expenditure would probably increase in the later part of the year, it should remain well below the ceiling. Furthermore, revenues were higher than projected.

The authorities were aware that to maintain a low rate of domestic inflation, they would have to keep liquidity expansion under control, the staff representative went on. The projected 15 percent growth of broad money was a target that would be kept under review. The target allowed the authorities some flexibility, but given their determined efforts to maintain a low level of inflation, it was unlikely that a 15 percent growth of broad money would be reached. On a related point, if the private sector guidelines for wage increases of 10 percent materialized, then the Government's anti-inflationary efforts would be reinforced. Expected substantial gains in productivity would compensate for the higher real wages resulting from reduced inflation.

The major efforts made by the authorities with respect to divestiture had been to denationalize all nationwide commercial banks during the previous two years, the staff representative commented. The telecommunications agency had been denationalized a few years previously, and he did not anticipate any further actions in that respect.

Historically, Korea's export performance had been good, even when market conditions had been unfavorable, the staff representative went on. In 1981 and 1982, when most countries had recorded declining export volume, Korea's exports had increased by about 6 percent. Data for the first six months of 1983 indicated that export volumes had increased by over 9 percent. However, export prices had remained lower and therefore, in value terms, export earnings were below the program target. On the other side, lower import prices had helped to reduce the value of imports. Preliminary figures for the trade account for the first six months of 1983 indicated a deficit of $1.2 billion as compared with a program target of $2.3 billion for 1983. The staff expected export performance would strengthen toward the end of the year, and did not consider the export target to be optimistic. Furthermore, preliminary estimates of the current account deficit indicated that the program was on track, and as long as the recovery in the industrial countries was sustained, a 7 percent export increase for 1983 was realistic.

The authorities had been progressively liberalizing their exchange and trade system, but some restrictions still remained, the staff representative continued. The staff hoped that in the near future Korea would move to Article VIII status.

The ceilings on external debt which included debt of all maturities, was difficult to control, the staff representative remarked. The limit on external debt of $4.2 billion was a ceiling and not a target. Thus, the projected accumulation of international reserves of about $0.5 billion was optimistic in order to allow flexibility in external debt management. In the first five months of 1983, short-term debt had been frozen, and medium-term and long-term borrowing had been well below target; financing requirements had been met through a reduction in international reserves. The staff expected that those developments to be reversed toward the end of the year, but it was of some concern that international reserves had declined by about 10 percent.

With respect to the definition of the balance of payments, the staff representative from the Asian Department explained that all commercial bank liabilities--almost exclusively public and publicly guaranteed--had been put below the line, while all autonomous medium-term and long-term borrowings had been included above the line. The presentation of balance of payments statistics was in line with usual Fund practice.

The Associate Director of the Exchange and Trade Relations Department confirmed that the presentation of the balance of payments in the staff report was in line with typical Fund practice: balance of payments financing--whether from the Fund or from other sources--as included below the line. It was evident from the presentation that there was expected to be some reserve accumulation, which would be financed by borrowing from commercial sources.

The staff projected a balance of payments deficit close to SDR 2 billion over a two-year period, the Associate Director indicated. The amount of net credit from the Fund was perhaps one tenth of that amount for the period concerned. Moreover, the authorities were making considerable use of commercial sources to finance their balance of payments deficit.

The staff on the mission had not been convinced that the ceiling on short-term debt would be feasible, the Associate Director explained. If the commercial banks were to make available syndicated loans and other medium-term credits that would fit an appropriate debt profile for Korea, such a ceiling would be appropriate; but syndicated credits were hard to obtain, and voluntary lending to Korea might not be substantial. The staff had informally approached some of the leading banks concerning a syndicated loan of a substantial amount, but it had not received any clear assurances. He hoped that, with the implementation of appropriate policies, the banks would respond. Nevertheless, it was uncertain whether Korea could obtain the financing, and it was important for the Fund to support the proposed program in order to give confidence to the international capital markets.

With respect to Turkey, its indebtedness to the Fund had been relatively close to the access limits, which in cumulative terms had been quite high, the Associate Director recalled. Korea was not in the same situation, and it would be unwise to imply that the authorities were making too great use of Fund credit.

Responding to a question concerning Korea's use of Fund resources, the Associate Director of the Exchange and Trade Relations Department commented that from the mid-1960s to the early 1970s there had been continuous use by Korea of Fund resources but that such use had been the pattern in a number of other member countries. At the time of the first oil price shock between 1973 and 1975, Korea had decided to implement an adjustment program supported by Fund resources. That adjustment effort had been successful, but the authorities had had to make use of Fund resources again at the time of the second oil shock. Owing to the current international situation and the growth of short-term debt as a result of changing attitudes of commercial banks, Korea was once again requesting the use of Fund resources under a stand-by arrangement. The authorities had not misused Fund resources, and the staff considered the use of those resources to be temporary.

The staff representative from the Asian Department, responding to a question by Mr. Suraisry, explained that in April 1984 the review of the adjustment program would be discussed by the Executive Board.

Mr. Prowse thanked the Associate Director of the Exchange and Trade Relations Department for his comments, which put into perspective Korea's request for a stand-by arrangement. Concerning exchange rate movements, the won had depreciated vis-à-vis the dollar by 3.7 percent, and vis-à-vis the trade-weighted basket by 2 percent in 1983. Competitiveness was probably adequate at the present time.

He agreed with Mr. Laske's comments concerning the structure of the banking and financial system, Mr. Prowse went on. The authorities had been acting rapidly to develop their financial system, as evidenced by the divestiture of five banks and the licensing of a considerable number of mutual savings institutions.

Korea's reserves, equivalent to only about 2.6 months of imports, were not great, Mr. Prowse continued. Korea would have to restructure its external debt, and it had problems of access to export markets.

With respect to interest rates, Mr. Prowse commented, figures included in the International Financial Statistics and World Economic Outlook publications indicated that for the major industrial countries the average of real rates was about 4.4 percent during the most recent period. The average of real rates in Korea was almost the same at about 3.5 percent or 4.2 percent, depending on how they were measured. It should not be assumed that Korea's interest rates had to be at the same level as rates in the United States, and, indeed, most countries would decline to accept that proposition. Real interest rates in Korea were appropriate, and the authorities had indicated that they would consider movements in international rates in their own interest-rate management process.

Given the problem of access to commercial markets, there was an appropriate role for financing by the Fund in Korea's case, Mr. Prowse remarked. Fund borrowing represented about 3 percent of Korea's total external debt, a relatively small amount given the significance of the Korean economy. There was also the issue of whether a stand-by arrangement could be adopted but not used. The Fund would have more participation in economic management under an operational financial arrangement with a country. The surveillance role under Article IV consultation did not have a similar impact on policymaking. Nevertheless, the concept of a country's agreeing to a nonoperational stand-by arrangement was interesting, and was worthy of further consideration in relation to other countries with economic problems.

The authorities intended to achieve Article VIII status, Mr. Prowse concluded. The pace at which they did so would depend on their ability to stabilize export growth, to increase their entry to export markets, to have sure access to capital markets, and to build up their reserves.

The Acting Chairman then made the following summing up:

> Executive Directors generally agreed with the thrust of the staff appraisal contained in the report for the 1983 Article IV consultation with Korea. They highly commended the Korean authorities for the considerable internal and external adjustment that had been achieved since 1980. The Government's stabilization policies in 1982 were reinforced by favorable developments in external prices and resulted in a substantial reduction in domestic inflation and in the external current account deficit.

Directors observed that the public sector's financial position had improved through expenditure restraint, and that monetary policy had contributed to a dampening of inflation while avoiding excessive credit tightening. They commended the authorities' skillful management of the financial difficulties arising from the curb market incident in early 1982. Directors noted that external competitiveness had remained unfavorable during most of 1982 but had improved significantly with the depreciation of the Korean currency since late 1982. They also noted the Government's continued efforts to liberalize both the trade and the financial systems.

Directors observed that the Government's economic and financial policies for 1983 and 1984 were designed to reduce the current account deficit further, to contain inflation, and to raise output growth. Directors believed that these policies constituted a well-conceived program, which merited the support of the Fund. Realization of program objectives would require continued adherence to fiscal discipline and monetary restraint. As part of this program, Korea was urged to reduce the financing requirement of enterprise funds, in particular the Grain Management Fund. It was also suggested that market forces be allowed to play a greater role in determining interest rates.

Directors underscored the importance of maintaining external competitiveness and welcomed the authorities' commitment to support the balance of payments objective through a flexible exchange rate policy. Directors hoped that the recovery in the world economy and an easing of protectionism abroad would facilitate the attainment of the external objectives. They supported the Government's intention of further liberalizing imports.

Directors welcomed the Government's intention to reduce reliance on short-term foreign debt in the coming years. They observed that while the aggregate level of Korea's external debt had remained consistent with its servicing capacity, the maturity structure of the debt had shortened excessively in recent years. Directors expressed confidence that the authorities' sound economic strategy for the period ahead would bolster Korea's standing in financial markets and permit a rapid improvement in the maturity profile of its debt. Several Directors expressed the hope that it would be feasible for Korea to use less than the full amount of the stand-by arrangement being approved.

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

The Executive Board then took the following decisions:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Korea, in the light of the 1983 Article IV consultation with Korea conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes Korea's progressive liberalization of restrictions on payments for current international transactions. The existing restrictions on payments for current international transactions are maintained by Korea in accordance with Article XIV. The Fund encourages the authorities to remove the remaining exchange restrictions as Korea's external position improves. (EBS/83/119, 6/9/83)

Decision No. 7460-(83/99), adopted
July 8, 1983

Stand-By Arrangement

1. The Government of the Republic of Korea has requested a stand-by arrangement for the period July 8, 1983 to March 31, 1985 in an amount equivalent to SDR 575.775 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/119 (6/9/83).

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7461-(83/99), adopted
July 8, 1983

2. MALAYSIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the report for the 1983 Article IV consultation with Malaysia (SM/83/128, 6/14/83; and Cor. 1, 7/6/83). They also had before them a report on the recent economic developments in Malaysia (SM/83/144, 6/27/83).

Mr. Jaafar made the following statement:

The two papers give an excellent overview of the substantial economic progress that Malaysia achieved over the years. The first Five-Year Economic Plan (1966-70), referred to in the staff paper, laid the infrastructure and foundation for the more rapid growth in the coming decade. The economic policies in the second and third Malaysian Five-Year Plans (1971-80) made substantial progress. During this decade real output growth averaged 8 percent a year; inflation was low and stable, the balance of payments strong, and the reserves position comfortable. At the same time, the economy was diversified. The size of the vigorously promoted manufacturing sector expanded, from 13 percent of GNP to 20 percent, and became increasingly export oriented. By 1980, the share of manufactured goods in total exports rose to 22 percent, only slightly lower than that for agricultural commodities.

Malaysia still leads the world in its traditional output and exports of tin and natural rubber, but it added to this list the production of crude petroleum and palm oil in the mid-1970s. Malaysia is now the world's largest supplier of palm oil and is also developing production and export potential of cocoa.

The New Economic Policy (NEP) introduced in 1971 was aimed at upgrading the standard of living and assuring a more equitable distribution of wealth. The implementation of these objectives was to be achieved within the context of growth so that no one group of the multiracial society would be worse off. The policies pursued to make progress toward these objectives led to substantial increases in employment in all sectors, particularly in manufacturing. The incidence of poverty declined from 49 percent of households in 1970 to 29 percent in 1980. However, efforts toward an equitable distribution of wealth by resructuring the ownership of corporate assets (to at least 30 percent by 1990) fell short of its target by the end of the Third Plan. The momentum of restructuring the assets was lost to some extent owing to the international recession in 1975 and the more recent one beginning in mid-1980. Greater growth would now appear to be needed in the years ahead in order to meet this target.

The impact of the global recession was pronounced in Malaysia in 1981 and 1982 in view of the wide-open nature of the economy. Despite a diversified export base, demand for nearly all of Malaysia's exports remained weak in the major industrial economies amid growing protectionism--quotas and other tariff barriers--against manufactured exports, particularly on exports of textiles and processed palm-oil products. As a result, economic growth progressively slowed to below 5 percent by 1982, compared to nearly 9 percent a year achieved during 1976-80. With the slump in the demand of Malaysia's exports, the terms of trade declined for the third consecutive year.

The domestic consequences of the impact of the recessions were countered to a large extent by public sector expenditures, a traditional countercyclical policy pursued by the authorities in the past. However, the Government's fiscal stance was reversed in favor of austerity in mid-1982 in response to the worsening economic situation resulting from the persistence and severity of the international recession. As federal revenue became sluggish with the steep decline in commodity and oil prices, it gave rise to a significantly larger overall budget deficit than expected. With their traditional style of pragmatism and prudence in fiscal management, the Malaysian authorities restrained expenditure to a manageable level in line with available resources. Projects of lower priority were deferred or phased out, while those contributing to economic growth and the objectives of the New Economic Policy continued to be implemented. As a result, federal expenditure originally targeted for M$28 billion gave rise to an actual outcome of M$26.3 billion, with the budget deficit reduced from M$10.5 billion to about M$9.7 billion in 1982.

The austerity drive was continued in the 1983 budget, where the increase in expenditure was planned at 2.8 percent over the 1982 preliminary actuals. At the same time, the Government introduced new tax measures estimated to yield an additional M$1.2 billion or 2 percent of projected GNP. The budget deficit is envisaged to be at M$9.4 billion, equivalent to 14.8 percent of GNP.

The stance of monetary policy in 1982 was to promote sustainable growth with relative price stability. Monetary and credit expansion continued to be moderate as economic activity slowed down in the course of the year. The relatively high liquidity that prevailed through 1981 eased moderately in 1982. Domestic credit expansion slowed to 23 percent in 1982, while net foreign assets declined marginally, compared with the substantial decline of 17 percent in 1981. Domestic interest rates, which were freed in 1978, have lately moved closer to the levels of international rates. Domestic interest rates have been maintained at positive levels, reflecting in part the lower rate of domestic inflation.

The principal factor for the deterioration in the external position has been the general weakness in exports and the continuing growth of imports. The balance of payments remained under strain in 1982. The trade account recorded a deficit of M$1.4 billion for the second consecutive year since 1975, and the current account deficit rose to M$7.8 billion, equivalent to 13.4 percent of GNP.

The financing of the large and sustained deterioration of the external current account resulted in increases in external debt. Total outstanding external debt in 1982 was M$23.9 billion, about 41 percent of GNP, and debt service was equivalent to 9 percent of exports of goods and services. With prospective increases in foreign borrowing in 1983, medium-term and long-term debts are likely to increase further as a proportion of GNP.

The prospects for 1983 are somewhat better. However, much would depend on the strength and durability of the recovery of the industrial economy. The expected outturn is for a 5 percent increase in GNP, and the current account of the balance of payments is projected to record a lower deficit of some M$6 billion.

The staff in their appraisal cautioned against excessive expenditures, where, in their opinion, the imbalance derives mainly from the growth of public expenditure after 1979. In their opinion, there is limited scope for correcting the fiscal imbalance on the revenue side. My authorities have already initiated measures to cut back substantially on public expenditure and have also made efforts to increase revenue. This austerity drive is continued in the 1983 expenditure plans. My Government has also introduced a substantial revenue package estimated to yield an additional M$1.2 billion, equivalent to 2 percent of projected GNP. Reflecting these adjustments, the budget deficit is expected to decline to M$9.4 billion. With a view to further strengthening government finances, my authorities are now conducting another review of the 1983 budget with a view to deciding a substantial cut if necessary for the current year.

The authorities are of the view that the economic slowdown highlights a number of structural weaknesses in the domestic economy. They view with concern the continued dependence of the economy on external cyclical forces. In my authorities' view, the downturn in exports in 1981 and 1982 has served to highlight the need for injecting greater dynamism into the production and exports of traditional output while simultaneously generating and promoting domestically based expansion of output. Potential areas identified for such promotion include medium-cost and low-cost building and construction activities, domestic resource-based manufacturing industries, and food production. Also, to increase productivity of the traditional sector, the authorities are engaged in the program of replanting and new planting of natural rubber and the reafforestation of logged areas. This strategy also calls for an increased participation of the private sector.

Finally, my authorities' aim remains to restrain public sector expenditures for strengthening both domestic and external balances. They remain committed to seeking appropriate solutions to improve the external payments position and to restore growth with stability.

Extending his statement, Mr. Jaafar commented that the budget performance in the first five months of 1983 had been much better than performance during the same period in 1981 and 1982. Revenues had increased by about 24 percent, owing in part to measures introduced in 1982. Development expenditure had been lower than in the same period of 1982, reflecting a reduction in direct development disbursements and net lending. Expenditures had been strictly controlled, and his authorities had taken steps to limit new contracts pending a review of projects to be implemented. Consequently, the overall government deficit in the first five months of 1983 had been less than half the deficit in the same period in 1981 and 1982. The authorities were monitoring the situation closely to ensure that the 1983 deficit was kept within prudent limits.

Mr. Hirao stated that the Malaysian economy had recorded an impressive performance during the 1970s in terms of growth and price stability. The balance of payments position had been strong, and reserves had been at a comfortable level. The open and well-managed economy, however, had been hard hit by cyclical external conditions beginning in mid-1980. While inflation had decelerated considerably, the real GDP growth rate had declined, and the current account deficit had widened. It was encouraging to note the staff's view that those adverse movements would be reversed in 1983; the growth rate was expected to be slightly higher than in 1982, and the current account balance was expected to be somewhat reduced. While prospects for 1983 were brighter, there were some areas for concern, perhaps in a medium-term context.

First, on fiscal policy, the ratio of federal government expenditure to GNP had increased from 30 percent in 1978/79 to 40 percent in 1980/81, and would be higher in 1982/83, Mr. Hirao observed. Federal government revenues had varied between 25 percent and 29 percent of GNP over recent years, and therefore the overall deficit--which had increased sharply in 1981--had been mainly attributable to the sharp increase in expenditures. Considerable efforts had been made to restrain expenditure growth in the 1983 budget. Given the limited scope for expenditure restraint due to the automatic growth of statutory expenditures, the authorities had decided to reduce development expenditure by 5 percent and to contain the increase in current expenditure to about 8 percent. Might there be further scope for expenditure cuts in the medium term? For example, growth of expenditure on wages and salaries, which accounted for about 35 percent of current expenditure, seemed to be relatively high. He hoped that the authorities would explore additional ways to reduce expenditure.

On the revenue side, Mr. Hirao remarked, the staff paper indicated that the tax system depended heavily on petroleum taxes. The authorities had introduced a package of tax measures in the 1983 budget that included, inter alia, sales and service taxes. As a result, nonpetroleum revenue was expected to increase by 23 percent. Those changes in the tax system seemed appropriate, and the authorities might wish to review the liberal exemptions and fiscal incentives that had apparently affected domestic-based taxes.

Petronas, the state oil company, could no longer contribute appreciably to financing the fiscal deficit, Mr. Hirao went on, but increased use of bank credit could cause monetary expansion. In those circumstances, the Government intended to reduce domestic borrowing in 1983 and to rely more on borrowing from foreign markets to cover the fiscal gap. Consequently, federal government external debt would increase to 27 percent of GNP. At present central government debt accounted for about 56 percent of external indebtedness, but debt servicing would remain relatively modest through 1985 because of grace periods on the large market-related borrowings of the Government since 1981. If the authorities wished to maintain a high international credit rating and to maintain the economy's external stability, a timely and comprehensive reassessment of expenditures was essential.

Second, with respect to monetary policy, the differential between domestic and external interest rates had narrowed as external rates had declined from very high levels in mid-1982, Mr. Hirao noted. The interest rate policy should remain flexible and the level of external rates should be considered when determining domestic rates.

Finally, Mr. Hirao commended the authorities for maintaining a liberal exchange and trade system, not an easy task under current circumstances. He hoped that the exchange rate policy would be implemented in a flexible manner in order to sustain the competitiveness of the export sector.

Mr. Joyce agreed that the Malaysian economy had had a long and enviable record of sustained growth, particularly through the 1970s. Indeed, the authorities had managed to maintain reasonably high levels of real growth into the 1980s, despite sluggish world trade, increased protectionism in export prices, and falling commodity prices that had resulted in low export growth and reduced imports. The authorities had attempted to offset those negative tendencies through fiscal expansion, but, as the situation had continued into 1982, they had been forced to take some corrective action.

He was particularly concerned that the overall fiscal deficit was still expected to remain at the high figure of 15 percent in 1983, Mr. Joyce said. That degree of fiscal imbalance could not be regarded as purely temporary or cyclical, and was not sustainable even given the external borrowing capacity of Malaysia. He welcomed the steps already taken to curtail expenditures, but was concerned that sufficient steps had not been taken, particularly as there were weaknesses in the tax system and it was unlikely that the authorities could count on an increase in revenues. He therefore urged the authorities to make a more comprehensive review of expenditure priorities, especially of expenditure related to some of the major projects. Malaysia continued to rely heavily on export taxes and petroleum revenues, which would amount to almost 24 percent of total tax revenues in 1982/83. However, that source of revenue was dependent upon fluctuations in world trade and export markets. There was therefore an urgent need to diversify the tax base. Staff members from the Fiscal Affairs Department had visited Malaysia prior to the 1982 Article IV consultation, and he wondered whether the staff could provide any information about recommendations on the tax system that it had made to the authorities.

The authorities had been using monetary and credit policy instruments to increase capital inflows and to strengthen the liquidity base of the banks, Mr. Joyce commented. In both 1981 and 1982, there had been a sharp rise in domestic credit in order to accommodate the needs of the public sector. He was somewhat concerned that access to credit by the private sector had been somewhat limited because of the requirements of public sector borrowers. However, it was expected that access to the credit market by the private sector would be more substantial in 1983. The crowding out of the private sector and the large savings investment gap could only be resolved through recourse to foreign borrowing, which would increase the debt burden. Could the staff comment on the appropriateness of the fairly high rate of capital formation in Malaysia, and what measures were being taken, or could be taken, to increase the rate of domestic savings relative to the desired level of investment?

He was also concerned about the external sector, Mr. Joyce went on. The balance of payments situation had deteriorated markedly, largely as a result of the highly unfavorable terms of trade and of the expansionary demand management policy being pursued by the authorities. The current account deficit had reached 13.4 percent of GNP in 1982. Furthermore, the rapid increase in imports since 1979 associated with a rise in investment relative to GDP had created problems. Access to the international capital markets could be maintained only if the current account and budget deficit remained under firm control. The authorities should examine the structure of imports in order to try to keep trade deficits to a more manageable level, especially with respect to imports for capital projects funded by public expenditure.

Finally, he shared the staff view that the authorities should avoid any trend toward appreciation of the real exchange rate, Mr. Joyce remarked. While the volume growth of imports in 1982 did suggest that Malaysian exports remained relatively competitively priced, an overvalued real exchange rate would work against efforts to control the level of imports and to reduce the trade deficits.

Mr. Prowse noted Malaysia's remarkable performance over the previous decade: the growth rate had averaged 8 percent, inflation had been below 6 percent, and savings and investment had been at about 30 percent. That record was all the more noteworthy since the benefits of growth had been translated into an improvement in the quality of life for the whole population, including poorer Malayasians. Economic performance had been good due to the rich resource base of the country, but it was also due to sound economic management and a comparatively stable political and economic environment.

His main concern was with the unsustainable fiscal and current account deficits, Mr. Prowse explained. Those deficits were due, in part, to the fact that Malaysia's open, well-managed and successful economy had been hit particularly hard by cyclical external conditions. Nevertheless, the budget deficit had been of the order of 15 percent for the previous two years, which seemed high. He welcomed the authorities' forthcoming review of expenditure and of the revenue base. There was still time for a phased adjustment, but adjustment measures needed to be implemented in the near future. Finally, was it possible that the authorities might approach the Fund with a request for a purchase under the compensatory financing facility?

Mr. Suraisry commented that the Malaysian economy had been adversely affected by the prolonged economic recession, after a decade of remarkable economic prosperity. In 1982 the budget and the current account deficits had been 17 percent and 13 percent of GNP, respectively. He was pleased to learn from Mr. Jaafar that the picture for 1983 was brighter.

The fiscal situation was a matter for concern, Mr. Suraisry considered. Despite the shift from an expansionary fiscal policy, the budget deficit had been large for 1982 and was projected to increase in 1983; unless more restraint were exercised over expenditures, that deficit would be difficult to manage. The Malaysian economy was open and was subject to changes in external demand and fluctuations in primary commodity prices. The authorities should, therefore, deal with fiscal imbalances in a careful manner. Mr. Jaafar's statement confirmed the authorities' determination to bring the economy back on track.

Monetary policy was sound and appropriate, Mr. Suraisry observed. However, the monetary objectives might be difficult to achieve if the fiscal imbalances were not corrected. With respect to external debt, Malaysia had a relatively low debt service ratio. Nevertheless, given the latest developments in the international capital markets as well as overall economic conditions, the authorities should monitor external debt closely in order to maintain Malaysia's excellent creditworthiness.

The balance of payments had come under pressure since 1981, Mr. Suraisry remarked. It was encouraging, however, to see that balance of payments projections for 1983 indicated a surplus in the trade account for the first time since 1980. If the expected world economic recovery materialized, the outcome might be even more positive. He would be interested in the staff's view of the possibility of a request by Malaysia for a drawing under the compensatory financing facility.

In conclusion, Mr. Suraisry said, he commended the authorities for following a liberal exchange system and hoped that protectionism against Malaysia's exports would be removed. The record of sound economic management and the continued international confidence in the economy provided a firm base from which to deal with recent economic difficulties.

Mr. Alhaimus welcomed the authorities' successful development efforts. The average growth rate of 8 percent a year in real output in the 1970s had been accompanied by an increasing share of manufactures in exports, and by moderate rates of inflation. Like many low-income countries, Malaysia had been unable to insulate itself completely from the effects of the world recession of the 1980s. Being a small, open economy, it was vulnerable to the general decline in prices of primary products, high external rates of interest, and weak export demand. Consequently, since mid-1980, the current account deficit had increased, and output growth rates had declined.

The apparent international economic recovery was expected to ease Malaysia's economic problems by increasing export demand, Mr. Alhaimus observed. The current account deficit was projected to improve from 13 percent of GNP in 1982 to 10 percent of GNP in 1983. Higher growth was forecast for most nonagricultural sectors in 1983, but agricultural output was unlikely to show significant growth owing to bad weather.

In response to the declining economic situation after 1980, the authorities had pursued expansionary fiscal policies through 1981 and the first half of 1982, Mr. Alhaimus continued. As a result, the budget deficit had increased, and government expenditure had risen to 45 percent of GNP by 1982. The Government had been quick to respond and by mid-1982 had initiated policies of expenditure restraint. Mr. Jaafar had indicated in his statement the austerity measures already taken by the authorities and their intention to carry out another review of the 1983 budget. Efforts should continue to be made to maintain projects contributing to economic growth. More fundamentally, it was encouraging to note the authorities' emphasis on improving the structural weaknesses in the domestic economy, given the continued dependence of the economy on external cyclical forces as highlighted by recent experience.

External debt and the debt service ratio--which had grown rapidly since 1982--seemed likely to increase at a slower rate in the immediate future, Mr. Alhaimus considered. The authorities were continuing to pursue a cautious monetary policy, increasing liquidity in line with growth needs and with due regard for maintaining price stability. Interest rate ceilings had been lifted, and the exchange rate of the ringgit was determined by market forces. Those policies illustrated the authorities' pragmatism and ability to adapt to new circumstances.

Mr. Connors stated that he was concerned about the large fiscal imbalances incurred in recent years. Given the high level of expenditure--45 percent of GNP--he agreed that the fiscal imbalance should be corrected mainly through reductions in expenditures, rather than through increases in revenues. The authorities were attempting to control expenditures in 1983, but he cautioned them against relying excessively on cutbacks in development outlays.

The external debt had grown rapidly over the previous few years, reflecting weak world demand for Malaysia's exports and the pursuit of expansionary financial policies by the authorities, Mr. Connors commented. While the debt service burden was not yet large, the staff had indicated that debt service payments could increase rapidly as the grace period for debt incurred over the previous few years expired. Malaysia should take advantage of its excellent credit rating and strong economy to effect the necessary internal and external adjustments in an orderly and efficient manner.

Finally, Mr. Connors said, the real effective exchange rate of the ringgit had appreciated since the beginning of 1981, although the present exchange rate was still lower in effective terms than it had been in 1978 and 1979. The authorities' intention to continue to manage the exchange rate with the aim of maintaining export competitiveness was welcome.

Mr. Grosche remarked that the Malaysian authorities had believed that the recession beginning in mid-1980 would be less pronounced than it had turned out to be. They had reacted to the weakened external demand by pursuing expansionary fiscal policies, and only in mid-1982, recognizing the persistence of the global recession, had they decided to take action against the rapid weakening of government finance.

The shift in fiscal policy through expenditure restraint had not been sufficient, Mr. Grosche considered; in 1982, expenditures had risen to 45 percent of GNP, and the budget deficit had reached 17 percent. In 1983, in spite of additional expenditure restraint and some additional revenues, the budget deficit was still likely to be about 15 percent of GNP. Could the staff comment on whether the latest news provided by Mr. Jaafar on the budget performance indicated that the budget deficit would remain below 15 percent in 1983? He noted with satisfaction from the staff report that the authorities recognized that financing large and continuing deficits could result in undue pre-emption of domestic savings and the possible crowding out of private expenditure. However, he was concerned that the tax system, which was heavily dependent on export taxes, would not be able to finance a larger part of the expenditures. The authorities intended to rely on borrowing from foreign markets to fill the fiscal gap, he noted.

The strength of Malaysia's economy and its creditworthiness might allow for some more financing from abroad in order to lengthen the adjustment period, Mr. Grosche went on. Nevertheless, he urged the authorities to be prudent in accumulating further foreign debt, which had risen rapidly over the previous two years and was likely to reach 49 percent of GNP at the end of 1983. The staff projections for the coming two years were even more cause for concern and demonstrated clearly the need for rapid and decisive action.

He shared the staff view that the fiscal deficit derived from the excessively rapid growth in budgetary expenditure since 1979 and should not be viewed as cyclical, Mr. Grosche continued. A comprehensive review of expenditure priorities was necessary. Any delay in reducing expenditure through borrowing would make the task of budgetary adjustment even more difficult, since interest payment obligations--currently a large part of unavoidable expenditures--would increase.

Clearly, more fiscal adjustment was necessary, Mr. Grosche stated. High rates of investment and domestic savings in the 1970s had placed Malaysia in a better position to adjust to changing circumstances than most primary producing countries. The authorities should improve the economic situation by avoiding the temptation to crowd out private expenditures through excessive budget deficits, and by creating a favorable environment for private investments, including direct investment from abroad.

Manufactured exports had continued to increase in 1982, and the favorable outlook for 1983 indicated that manufacturing industries were competitive, even though the ringgit had appreciated somewhat, Mr. Grosche said. Exchange rate policy should be managed with a view to avoiding continued appreciation. Finally, the authorities should be commended for maintaining an open exchange and trade system.

Mr. Salehkhou observed that the international recession during 1981 and 1982, rising interest rates, and falling commodity prices had negatively affected Malaysia's economic development efforts, which had been remarkable during the previous decade. The authorities had introduced in 1982 a series of measures aimed at restraining domestic expenditures, inter alia. An accommodating monetary policy had been adopted to supplement fiscal efforts with a view to sustaining economic growth, together with domestic and external stability.

The international recession had affected Malaysia's export performance, but since 1981 the authorities had tried to maintain the growth and the momentum of employment initiated during the second and third Five-Year Plans, Mr. Salehkhou commented. Economic achievements during the period 1971-80 had been impressive: real growth and real output had increased, and the economy had been further diversified with greater orientation toward manufacturing.

In 1981 and 1982, Malaysia's terms of trade had deteriorated as a result of the recession in industrial countries, and real growth had declined, Mr. Salehkhou went on. The level of investment had been maintained despite insufficient private savings, and inflation had been moderate mainly as a result of weak private demand. The Government had adopted a more restrictive fiscal policy; nevertheless, the budget deficit had reached 17 percent of GNP in 1982, and the authorities had made greater recourse to foreign and domestic borrowing. Malaysia's good credit standing with the commercial banks had enabled the authorities to increase their external indebtedness.

Commenting on the 1983 fiscal policy, Mr. Salehkhou said that the authorities intended to strengthen revenues and greatly control expenditures. Current and development expenditures had been targeted for close scrutiny and control. Furthermore, development expenditure would be cut by 5 percent in the 1983 budget. Simultaneously, the authorities had made efforts to raise tax revenue, with the principal increases relating to sales and service taxes. They were aware of the consequences of continued deficit financing and the undesirable effects that it would have on domestic savings and private expenditures.

With respect to the external sector, declining export revenues and the resulting external current account deficit had increased Malaysia's recourse to foreign borrowing and had resulted in the depletion of the oil sector savings, Mr. Salehkhou continued. The staff had stated that in the medium term current economic trends would be hard to sustain and had recommended greater expenditure control, the introduction of measures to increase revenue, a more flexible exchange rate policy, and a reduction in external debt.

The authorities anticipated a recovery in the industrial economies, a continued strengthening of private commodity prices, and a fall in world interest rates, Mr. Salehkhou observed. They therefore intended to increase their borrowing on foreign markets. Although foreign reserves had declined over previous years, they were still at a comfortable level in terms of imports.

The authorities' confidence in the future prospects of the world economy was optimistic; an early relaxation of their restrictive policies was not justified, Mr. Salehkhou considered. The current strength of the Malaysian economy provided a good base for an adjustment program. Failure to take tougher measures at an early stage would make it more difficult for the authorities to initiate needed adjustments in the future.

Mr. Tshishimbi commented that Malaysia was endowed with rich natural resources, including rubber, palm oil, and natural gas. It had developed an important manufacturing sector and had become a major exporter of oil. Overall, its economic performance during the previous decade had been good.

A high rate of investment directed toward diversifying the economic base had contributed to vigorous growth, Mr. Tshishimbi observed. Real GDP had risen by an average rate of 8 percent a year over the previous decade, and exports had grown at an even faster rate. During those years, the public sector and current account deficits had remained small, while the overall balance of payments had recorded surpluses. Unfortunately, during the previous two years, Malaysia had been adversely affected by negative developments in the world economy, particularly by the recession in industrial countries. The terms of trade had deteriorated, dropping sharply from an annual average of over 6 percent in the second half of the 1970s to 3 percent in 1981 and 5 percent in 1982. Malaysia's major trading partners had intensified protectionist practices, and consequently economic growth had declined to about 5 percent. Despite those setbacks, the authorities had maintained a flexible approach to the management of their economy, particularly in the fiscal and monetary areas.

The countercyclical fiscal policies adopted as a result of the deepening world recession had helped to relieve the pressure on the government budget, Mr. Tshishimbi considered. The authorities had already taken measures to curtail inessential expenditures, but more substantial progress was needed on the fiscal front, and he urged them to continue reviewing the expenditure program. Mr. Jaafar's introductory remarks on budgetary performance during the first five months of 1983 and the authorities' intention to pursue the adjustment effort were encouraging.

With respect to monetary policy, the authorities' commitment to redirect domestic credit at a reasonable cost to priority sectors--namely, the agricultural sector, small-scale enterprises, and other special groups--was welcome, Mr. Tshishimbi indicated. They had also authorized the commercial and merchant banks to lend to residents in foreign currencies and also to accept deposits in foreign currencies for nonresidents. The removal of exchange restrictions was commendable.

He agreed with the authorities that much of the external deterioration was due to cyclical and external factors, Mr. Tshishimbi concluded. However, some restraint on imports might be unavoidable in the short term until exports increased as a result of world economic recovery.

Mr. Camara stated that the Malaysian economy provided a typical example of the negative impact of the economic slowdown in industrial countries on less developed countries. For more than a decade, economic performance had been good; real GDP had grown at an annual average rate of 8 percent, inflation had been maintained below 6 percent a year, and the balance of payments had consistently recorded surpluses. The authorities had pursued appropriate economic policies. Exports had increased considerably, and the oil sector had been developed. However, recession in the world economy had reversed the positive trend of economic development; the terms of trade had depreciated considerably as export prices had declined sharply, contributing to a weakening of domestic demand and thereby to a slowdown in economic growth. Oil exports had failed to generate sufficient revenue, and the budget deficit had increased to 17 percent of GNP. The budget deficit had been financed by borrowing from the banking system and from foreign markets.

The overall external position had worsened considerably, Mr. Camara remarked; the current account deficit had widened to 13 percent of GDP, outstanding external debt had increased to 41 percent of GDP in 1982 from 27.9 percent in 1981, and debt service had increased to 9.2 percent in 1982 from 6.3 percent the previous year. Moreover, a further increase in debt service was projected for the near future.

Prospects for 1983 were not bright, since they were dependent on a recovery in the world economy, Mr. Camara went on. With respect to fiscal policy, the projected increase in revenues was unlikely to be sufficient, and it was essential that expenditures were substantially reduced. To what extent would the substantial increase in revenues announced by Mr. Jaafar improve the budgetary position? The authorities were reviewing their expenditure program with the aim of limiting nonessential development outlays and of increasing the tax base.

The authorities intended to borrow from foreign markets in order to cover the fiscal gap, Mr. Camara observed. Did the staff see that move as unavoidable? It seemed that many developing countries resorted to foreign borrowing in order to prevent a total collapse of the economy. Developing countries with relatively well-developed financial markets--such as Malaysia--would be able to cope with the long-term effects of such borrowings.

Monetary policy was appropriate, Mr. Camara considered, and was consistent with the balance of payments projections. The further narrowing of the differential between domestic and external interest rates was welcome.

Commenting on the exchange rate, Mr. Camara said that, given the balance of payments problem, the appreciation of the real effective exchange rate should be halted or at least reduced. Finally, the authorities should be commended for maintaining a liberal exchange system.

Mr. Malhotra commented that Malaysia was a fine example of a country that had achieved strong economic growth with price stability. During the period 1971 to 1980, real output had grown at an annual average rate of 8 percent, while inflation had remained at less than 6 percent. Furthermore, the external position had strengthened, reserves had risen, and the value of the ringgit had been maintained. Difficulties, however, had arisen in the recent years owing to the world recession, which had lasted longer than expected by the authorities.

The authorities had reacted to the recession by bolstering domestic demand through a countercyclical budgetary policy, Mr. Malhotra observed. Such a policy might have succeeded if the recession had not lasted so long. Developments in the fiscal area gave some cause for concern. Over the previous three years, the budget deficit had been high, ranging from 15 percent to 17 percent of GDP. Similarly, the external current account deficit had ranged between 10 percent and 13 percent of GDP. The revenue base appeared to be weak in relation to the size of expenditures. The authorities had drawn considerably on the accumulated savings of the national oil company, Petronas, but such a drawdown could not be sustained over the longer term, and the authorities were now trying to finance the deficit through domestic and external borrowing. Malaysia had an excellent credit rating; its present debt service ratio was low, at about 9 percent. However, the debt service ratio had been moderated by the grace periods--typically four to five years--on recent borrowings from commercial sources. The medium-term outlook was therefore not so good, and the authorities should keep the external debt situation under constant review.

The strain on the external current account would be reduced if the world economic recovery materialized and demand for Malaysia's exports increased, Mr. Malhotra concluded. Even assuming world economic recovery, however, the current account deficit would still be at about 10 percent of GDP until 1985. He therefore hoped that the authorities would succeed in reducing the fiscal deficit.

The staff representative from the Asian Department stated that the staff considered that the high rate of investment since the late 1970s, which had been associated with a rapid increase in public expenditure, had been excessive and unsustainable. Consequently, the staff had urged the authorities to implement a comprehensive review of investment expenditure priorities. An appropriate adjustment strategy should not attempt to restrain expenditure through short-run restrictions on disbursements from the treasury office, but rather follow from a re-examination of expenditure priorities for the current year and for the medium term. In the late 1970s, higher oil revenues and, more recently, dividends and purchase of government debt by Petronas had been used to finance the budget deficit, but the recent scale of such transfers from the oil sector was unsustainable.

On the revenue side, the staff representative stated, given the relatively high level of revenues in relation to GNP, the tax system was not sufficiently elastic to allow for a considerable increase in revenue. Thus, the thrust of fiscal adjustment should come from the expenditure side. The Fiscal Affairs Department team that visited Malaysia in early 1982 had not been requested to consider additional short-term revenue measures; rather, it had carried out a broad review of tax policy and administration, and some of its recommendations had been included in the revenue package of the 1983 budget. In June 1983 a FAD expert had again visited Malaysia to discuss with the authorities opportunities for increasing revenues through improved administration, and to review recommendations of the earlier report. It was hoped that a closer working relationship between the Fund and the authorities could lead to the identification of opportunities for increasing revenues through improved administration and policy adjustments. Experience indicated, however, that large gains could not reasonably be expected from efforts to improve tax administration in the short run.

With respect to the possibility of a request by the authorities for a purchase under the compensatory financing facility, preliminary staff calculations indicated an export shortfall for 1982 of substantially more than 50 percent of quota, the staff representative went on. However, it was the staff view that if a member's policies were contributing to unsustainable domestic and external deficits, then it was inappropriate for them to make drawings under the compensatory financing facility in excess of 50 percent of quota. The Malaysian authorities accepted that view. If they adopted a comprehensive fiscal adjustment program--which was the thrust of the staff appraisal--a request for use of the Fund's resources would be considered.

The staff was not in a position to comment in detail on the preliminary budget figures for the first five months of 1983 provided by Mr. Jaafar, the staff representative from the Asian Department explained. The staff had reviewed those data, but there was no indication that the fiscal outturn for the year as a whole would be different from the data presented in the staff report. Nevertheless, it was clear that the Treasury was endeavoring, through administrative means, to restrain expenditure. The apparently large increase in revenues provided a welcome indication that the tax measures introduced with the 1983 budget were yielding the intended revenues.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/98 (7/6/83) and EBM/83/99 (7/8/83).

3. ARAB REPUBLIC OF EGYPT - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with the Arab Republic of Egypt to not later than July 27, 1983.

Decision No. 7462-(83/99), adopted
July 6, 1983

4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/83/145, Sup. 2, 7/7/83) on the canvass of votes of the Governors on Resolution No. 38-3, with respect to the Direct Remuneration of Executive Directors and their Alternates, approved by the Executive Board (EBM/83/79, 6/2/83) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		404,383
Total negative votes		222,570
Total votes cast		626,953
Abstentions recorded	3,730	
Other replies	0	
Total replies		630,683
Votes of members that did not reply		16,415
Total votes of members		647,098

The Executive Board approves the report of the Secretary (EBAP/83/145, Sup. 2, 7/7/83) on the canvass of votes of the Governors on Resolution No. 38-4, with respect to the Home Leave

Allowance for Executive Directors and their Alternates, approved by the Executive Board (EBM/83/79, 6/2/83) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		538,138
Total negative votes		88,815
Total votes cast		626,953
Abstentions recorded	3,730	
Other replies	0	
Total replies		630,683
Votes of members that did not reply		16,415
Total votes of members		647,098

Decision No. 7463-(83/99), adopted July 7, 1983

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal set forth in EBAP/83/173 (7/1/83).

Adopted July 7, 1983

6. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the proposal set forth in EBAP/83/174 (7/5/83).

Adopted July 7, 1983

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 83/21 through 83/23 are approved. (EBD/83/180, 6/29/83)

Adopted July 6, 1983

8. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/176 (7/6/83) is approved.

APPROVED: December 19, 1983

ALAN WRIGHT
Acting Secretary