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Minutes of Executive Board Meeting 83/154

10:00 a.m., November 14, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	
	P. D. Péroz, Temporary
	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
	C. Robalino
G. Laske	G. Grosche
	C. P. Caranicas
	V. Govindarajan, Temporary
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
	K. A. Hansen, Temporary
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
J. C. Corr, Assistant

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Also Present

Administration Department: R. Tenconi, Director; T. Cole, J. B. Kaiser, P. D. Swain. Asian Department: K. A. Al-Eyd, J. T. Boorman, E. Gurgen, I. S. Kim, H. L. Mendis, R. J. Niebuhr, H. O. Roden, T. Yanagita. Central Banking Department: T. Balino. Exchange and Trade Relations Department: R. K. Abrams, M. Guitian, C. M. Watson. Fiscal Affairs Department: D. C. McDonald. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, Ph. Lachman. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. Wright, Deputy Secretary. Treasurer's Department: C. A. Macchiavello. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, W. Moerke, Y. Okubo, I. R. Panday, P. Péterfalvy, D. I. S. Shaw. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. Bernardo, M. B. Chatah, G. Ercel, N. U. Haque, M. Hull, H. Kobayashi, P. Leeahtam, G. W. K. Pickering, M. Rasyid, J. Reddy, C. A. Salinas, A. A. Scholten, S. Sornyanyontr, J. C. Williams.

1. INDONESIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Indonesia (SM/83/208, 10/18/83). They also before them a report on recent economic developments in Indonesia (SM/83/218, 10/28/83).

Mr. Ismael made the following statement:

The Indonesian economy showed a rapid expansion over the period of the 1970s. Between 1970 and 1980, GDP increased at an average rate of 7.8 percent a year in real terms, with estimated GDP per capita increasing at a rate of 5.5 percent a year. During this period the quadrupling of oil prices in world markets and the resulting increase in oil revenues provided much of the resource base for economic expansion. Growth in the manufacturing and construction industries was particularly notable, but increased agricultural production--primarily rice--also made a significant contribution.

Commencing in late 1981, however, the world economic recession started affecting domestic economic activity adversely. Whereas GDP in real terms grew at a rate of 9.9 percent in 1981, economic growth is estimated to have slowed down considerably to 2.2 percent in 1982. Moreover, the substantial worsening in the oil market, declining demand, and lower average prices for Indonesia's traditional commodities resulted in a decline of exports.

This stagnation of exports had an important effect on Indonesia's balance of payments. From a surplus of $2.1 billion in 1980/81, the current account moved into a deficit of $2.9 billion (3.4 percent of GDP) in 1981/82 and a deficit of $6.7 billion (7.6 percent of GDP) in 1982/83.

As government revenue from oil and gas income declined substantially, a fiscal deficit amounting to 2.5 percent of GDP emerged in 1981/82 and widened to 5.0 percent of GDP in 1982/83. The Government for the first time in 1982/83 had to utilize its deposits with the domestic banking system to finance part of the deficit.

In order to finance these fiscal and balance of payments gaps, external borrowings were increased, and a significant drawdown of international reserves occurred. As a consequence, net international reserves (exclusive of net foreign assets of commercial banks) declined from $6.6 billion (5.1 months of non-oil imports) in March 1982 to $4.3 billion (3.6 months of non-oil imports) in March 1983. Largely as a consequence of the decline of exports, debt service ratios also increased. On the basis of net exports (offset against oil sector imports and services) the debt service ratio rose to 20.2 percent in 1982/83 and is expected to increase further to 22.3 percent in 1983/84. However, if measured on the basis of gross exports, the more traditional measure of debt service used in other countries, the ratio was only 12.8 percent in 1982/83 and is projected at 14.2 percent in 1983/84.

Adjustment measures

In response to the severe and protracted world economic recession, the Indonesian authorities reacted swiftly and decisively with the implementation of a series of measures designed to preserve financial stability, while laying the foundation for longer-term structural economic adjustment. Since the beginning of 1983 a number of actions have been taken, which include the adoption of an austere budget for fiscal year 1983/84, a 27.6 percent devaluation of the rupiah against the U.S. dollar, a decision to reduce imports through the rephasing of a number of public sector investment projects, the implementation of new monetary policies designed to encourage domestic savings, the simplification of government regulations and licensing to enable the private sector to play an increased role in the country's future development, and most recently, on November 5, 1983, the presentation to Parliament of the authorities' recommendations for a major tax reform.

The proposed tax reform, arising from over two years of intensive studies, is intended to increase non-oil tax revenue significantly relative to GDP by the late 1980s. Its objective is also to provide more incentives for employment creation and productive investments. The tax reform includes a restructuring of personal and corporate income taxes, introduction of a broad-based value-added tax to replace the current sales tax system, a reform of tax administration, and a computerized tax information system. The new system emphasizes simplicity, certainty, and equity in taxation. It eliminates the bias inherent in the current system, which favors capital-intensive methods of production. Furthermore, with the adoption of the new system in early 1984 some taxes that were introduced earlier for administrative reasons but that are considered to constitute multiple currency practices will be eliminated. In preparation for the implementation of the new tax systems, technical assistance is being arranged with the Fund for the provision of expertise in the field of tax administration and computerization.

Policies to maintain an open economy and a free foreign exchange system have been basic tenets of Indonesia's development philosophy. However, Indonesia realistically has to accept the current difficult world situation where many countries have turned to protective measures. To cope with such a situation in the short run, imports of a number of products have become subject to temporary quantitative restrictions or have been limited to specially licensed importers of specific product groups. This policy is expected to make importers more specialized and to prevent erratic patterns of importing. It has been argued that these quantitative restrictions may involve some cost to downstream industries and that raising tariffs may be a better alternative. In the Indonesian case, however, this alternative has not been chosen because a major study is under way leading to a reform of the entire tariff structure.

In the face of deteriorating export performance, various measures have been taken to stimulate non-oil exports. Early in 1982 the Government introduced new export credit and export insurance facilities, simplified export documentation, abolished the export surrender requirement, and reduced or eliminated elements contributing to high export costs. In 1983, in addition to devaluation, the authorities have set up special teams to examine and make recommendations on necessary measures to solve the problems encountered in the production and export of each of the major commodities. Countertrade policy, which links government purchases with a requirement for the suppliers to undertake non-oil exports from Indonesia, has been another element of the export promotion measures. The implementation of this scheme has recently been improved by allowing banks to intermediate to match suppliers' buy-back obligations of products with third parties. With this new provision the likelihood that a penalty will be imposed for not meeting the countertrade requirement is also minimized.

Recent results of the adjustment measures

In response to the higher interest rates available at state banks after June 1, 1983, rupiah time and savings deposits increased sharply by 40 percent in the following eight-week period. Nonetheless, for the whole banking system time and savings deposits increased by 16 percent during the same period.

Though the monthly rate of inflation rose sharply by 2.3 percent in April, a month after the devaluation, there are emerging signs that price increases have moderated significantly as reflected in the monthly average rate of 0.67 percent for the following six months. The existence of weak domestic demand together with wage restraint will provide further impetus to lower the inflation rate.

The current account deficit could have topped $10.0 billion this fiscal year had the adjustment measures not been taken by the authorities. With the adjustment, the deficit was officially forecast at $6.5 billion for 1983/84. The more recent staff estimate was for a deficit of $5.7 billion.

In the review and rephasing of public sector spending involving 125 projects, the authorities have reached settlement agreements with contractors on a number of them, including the largest four which accounted for a quarter of the total value of the projects. Negotiations are under way on the remaining projects already contracted. With respect to those not yet contracted, amounting to about half of the total value, the authorities expected no major problems in implementing the rephasing policy.

In respect of net international reserves, the amount has increased from $4.3 billion at end-March 1983 to $4.6 billion at end-October 1983, equivalent to four months of non-oil imports. Even though the current level of official reserves is substantially lower than that in the previous few years, the authorities, nonetheless, considered this amount satisfactory.

With regard to the June financial reform, the Fund has agreed to provide technical assistance to assist the authorities in the design and implementation of monetary policy instruments. The authorities expect a three-member mission from the Fund to visit Indonesia later this month.

Medium-term outlook

With the global recovery, the authorities are optimistic that export performance of non-oil commodities will improve significantly for the whole of 1983. The statistics for the first half of the year appear to suggest that Indonesia's non-oil export earnings are likely to increase by more than 10 percent over the depressed level of last year.

Nonetheless, the oil export performance is not likely to improve in 1983/84, reflecting the substantial drop in oil prices early this year. Signs are, however, for the oil market situation to stabilize. A further weakening is not expected because of the economic upswing in the industrial countries. A better prospect perhaps can be expected in the next two years.

The GDP estimate for the fourth five-year plan commencing in 1984/85 is for an average annual growth of GDP of 5 percent. The plan's growth target for the manufacturing sector is 9 percent, reflecting increased reliance on this sector as a major source of growth. The authorities are aware that the achievement of the plan hinges on a number of factors: most importantly on the success in increasing non-oil exports, mobilization of domestic savings, and augmentation of the role of the private sector in development. A number of measures have already been taken to promote these sectors and others are forthcoming. However, the austerity measures undertaken in the last two years will be continued in order to preserve external and domestic balances. The authorities continued to lay emphasis on the control of government expenditures, maintenance of competitiveness of Indonesia's exports, and provision of adequate stimulus to the private sector.

> There is no denying that the Indonesian economy may still be confronted with a number of problems arising from the changing external environment, and the needed adjustments cannot possibly be completed within a short time span. Nevertheless, the policy measures that the Indonesian authorities have already introduced and those that are contemplated for the near future will, in my view, go a long way in achieving a viable internal and external equilibrium.

Mr. Yamashita commented that the Indonesian economy was moving from a period characterized by accelerating project spending and increasing oil revenues to a period dictated by a weakened external environment and consequent foreign exchange constraints. He commended the authorities for taking significant adjustment steps; they had been well managed and had had favorable effects on the economy. Nevertheless, the growth prospects for the period of the next five-year plan remained subject to uncertainties, including the recovery of the export market. He hoped that the authorities would continue to maintain a flexible and prudent stance in forming their economic policy.

The fiscal deficit, mainly the result of the decline in oil revenues since 1981, had widened to more than 5 percent of GDP, Mr. Yamashita continued. He commended the authorities' efforts to restrict current expenditure in the budgets for 1982/83 and 1983/84 through a freeze on the salaries of civil servants and price increases on some subsidized commodities. On the capital expenditure side, the rephasing of public sector project spending had been effective in curbing the expansion of the fiscal deficit as well as in reducing imports and moderating external borrowing. The level of disbursements for future development spending should be cautiously determined in view of the foreign exchange constraint and the current account deficit. He endorsed the authorities' intention to limit development spending to a level that could be financed by official development assistance or by official export credits. On the revenue side, the Government remained largely dependent on oil revenues. In order to permit a moderate but continued expansion of government spending, measures to increase non-oil revenues would be necessary. Substantial tax reform measures, including the introduction of a broad-based value-added tax and the improvement of tax administration, had recently been proposed. He agreed that those measures were appropriate.

Turning to monetary policy, Mr. Yamashita remarked that the financial reform measures taken in June 1983 appeared to have had the desired initial effect of mobilizing domestic resources for private investment. The sharp rise in interest rates of state banks had led to a substantial increase in time and savings deposits. He shared the authorities' concern that the policy instruments available to them at present might not be sufficiently effective or flexible to guide monetary policy as they would wish. For that reason, he endorsed the effort to introduce various other instruments, including a rediscount mechanism and the issuance of a central bank debt instrument as a means of open market operations.

Furthermore, the liberalization of state bank interest rates had caused a sharp increase in short-maturity deposits, but longer-term deposits had fallen. Why had the reform measures shortened the maturity structure and what were the implications for the future? The authorities appeared concerned that the change, in conjunction with decreased access to the central bank rediscount mechanism and the much higher lending rates of state banks, could affect the flow of investible resources. He invited the staff to comment on that point.

The authorities had maintained relatively flexible exchange rate policies since the devaluation in March 1983, Mr. Yamashita noted. The level of the rupiah had been stable in nominal effective terms, but it had appreciated in real terms. The authorities should continue to avoid the erosion of the exchange rate's competitiveness. As a result of the rephasing of the investment program in the public sector, the rising trend in project-related imports had stopped. It was encouraging that the forecast of the current account deficit for 1983 had been significantly reduced following the adoption of the rephasing program and the devaluation; the staff suggested that there would be no problem in financing the projected deficit. According to the staff's medium-term scenario, the public sector debt service ratio was expected to increase slightly in the coming three years from its present level of 22 percent. Although the overall structure of the debt was not a matter of immediate concern, too rapid an expansion of project spending would aggravate the situation. He agreed with the staff that the authorities should maintain a cautious approach to restoring projects that had been canceled or postponed in the recent rephasing exercise.

He also shared the staff's concern about the possible adverse effect of recently adopted restrictive measures on private incentives and investments, Mr. Yamashita said. Although such measures might be considered necessary with regard to some commodities, in order to protect domestic industries aiming at eventual self-sufficiency, protectionist measures should be limited as much as possible. He also agreed with the staff on the export counterpurchase scheme. He welcomed the authorities' intention to eliminate the present multiple currency practices through the adoption of the new tax system, and he supported the proposed decision.

Mr. Prowse stated that the staff report had been well structured and that the presentation of the medium-term scenario and the attempt to assess the balance of payments over the longer term had been useful. In particular, the charts had been instructive. He agreed broadly with the staff appraisal and with the staff's view that the policy adjustments that the Indonesian authorities had already made had been impressive. However, there appeared to be a hint that the adjustment program might not be pushed forward with sufficient vigor. The staff suggested that the adjustments already made were probably sufficient to reduce substantially the current account deficit of the balance of payments in a relatively short period, but the statistics showed that the deficit would continue to be about $5.7 billion in fiscal year 1983/84, admittedly lower than the $6.9 billion in 1982/83, but a great deal higher than several years earlier. It was probable, therefore, that further policy adjustments would be necessary. The budget deficit in 1983/84 would be 5.9 percent of GDP, inflation would continue at 12.6 percent, and there would be substantial growth in money and liquidity. The staff shared the authorities' view that export-led growth based on diversification was the best means of resolving the problems, particularly through stimulus of the private sector.

On the basis of the available evidence, Mr. Prowse continued, the 28 percent devaluation had been successful so far. In DM/83/60 (8/10/83), a staff member had examined the impact of the 1978 exchange rate adjustment on Indonesia's non-oil trade account. That analysis indicated that the competitiveness of the trade sector had been significantly improved by the devaluation in 1978 and that, as a result, private sector import growth had slowed in 1979, that the earnings from non-oil exports had grown rapidly, and that the balance of payments constraint, which had prompted the exchange rate adjustment, had been removed. The subsequent expansion of government expenditure and domestic liquidity had led to rapid growth in aggregate demand and to inflation; as a result, the improvement in competitiveness of the non-oil trade sector arising from the exchange rate adjustment had been lost. It was important for the Indonesian authorities to have that experience in mind at present.

The staff had clearly emphasized that the rephasing of the public sector investment program was important, Mr. Prowse observed, and that it would be effective in meeting its objectives. Nevertheless, the fiscal deficit as a percentage of GDP would widen in 1983/84, underlining the case for the financial revenue reforms to be implemented in 1984. In addition, money and credit growth were probably not sufficiently restrained. The financial reforms were, therefore, welcome, and the development of government instruments for intervention in the market should be encouraged.

At the time of the previous Article IV consultation with Indonesia (EBM/83/6, 1/7/83), Mr. Prowse recalled, his chair had raised a number of questions about countertrade measures and the shipping policy arrangements that had offered exclusive rights to local companies at that time. The staff encouraged the Indonesian authorities to dismantle the countertrade scheme, a suggestion that he could support in principle. However, there appeared to be no analysis or measurement of the impact of the countertrade scheme on the economy. The import restrictions, which hopefully would be reversed soon, had been adopted in response to the protectionist environment facing Indonesia, and the Executive Board should, therefore, be pragmatic in its consideration of that policy. The Indonesian authorities had not developed any formal apparatus for effective countermeasures against dumping. Had the staff studied the possibility that countervailing duties might be an alternative to the use of import restrictions and countertrade?

Indonesia had responded appropriately to the change in its external environment, Mr. Prowse considered. The information in Chart 1 of SM/83/208 strikingly demonstrated the effect of the change in the terms of trade on gross domestic product. The authorities had responded by running down the countries substantial reserves, a proper approach. Nevertheless, caution was required, as the debt service ratio was beginning to be a matter of concern. In 1983/84, the debt service would amount to 22.3 percent of net exports, a significant level.

The staff report had been comprehensive, Mr. Prowse went on, and he could support its underlying philosophy. However, the staff's views with regard to the size of the public sector needed clarification. On page 24 (SM/83/208), the staff suggested that the balance of payments would attain a sustainable position over the medium term if the growth of government spending was confined to about the rate of expansion of GDP, implying that the share of the public sector in GDP would be maintained. Later on the same page, the staff suggested that the environment dictated a more slowly expanding public sector and, thus, increased reliance on the private sector for growth. It also stated that the new environment would require a more active private sector, employing a higher proportion of domestic resources, a comment that seemed to imply a declining share of GDP for the public sector. He invited the staff to say whether it believed that it would be important in the medium term to restrain or to reduce the size of the public sector. Did the authorities agree with that view?

Mr. Leonard said that the firm response of the Indonesian authorities to the severe balance of payments difficulties facing the country had been impressive. In particular, the devaluation, the cutback in public sector investment programs, the restraint on current government expenditures, especially the public sector wage freeze, and the increase in domestic savings were all welcome. However, the projected 1983/84 current account deficit of $5.7 billion or 7.5 percent of GDP, the debt service ratio of 22 percent, the budget deficit of almost 6 percent of GDP, reliance on extraordinary financing of the balance of payments, and $4 billion foreign financing of the government deficit, all indicated a need for continued determined action for several years to come if the imbalances were to be reduced.

While fiscal restraint had already been shown, Mr. Leonard continued, the need to limit foreign borrowing in light of the external debt service ratio suggested a continuing need for current and capital expenditure restraint. Although current government expenditures had not been increasing as a percentage of GDP, the two-year wage freeze in the public sector was not the kind of measure that could be continued indefinitely. One way to reduce current expenditure would be to phase out the 35 percent petroleum product subsidy. Earlier in 1983, petroleum prices had been increased in order to cut subsidies, but the devaluation, in conjunction with further increases in domestic prices of petroleum, had again resulted in a large subsidy. It might also be worth considering the establishment of a system to monitor more effectively the activities and the financing of state enterprises, perhaps with technical assistance from the World Bank or the Fund.

The ongoing improvement in tax administration and the new tax policies would hopefully lead to improved revenue collection, Mr. Leonard remarked. Perhaps the Government could consider issuing bonds or other financing instruments directly to the public to finance the deficit; they would provide welcome additional domestic sources of financing and they might help to promote domestic capital markets. It would be interesting to hear further details on the kind of central bank debt instruments that the authorities were considering. He agreed with the staff that a further shift in the structure of investment to more labor-intensive and domestic resource-intensive production techniques would be necessary, as would an enhanced role for manufacturing. Encouraging progress was being made in agriculture through the success of the smallholder programs, modern production techniques, increased extension services, adequate producer price incentives, and multiple cropping. He hoped that, following recovery from the 1982 drought, impressive gains would be resumed, particularly in rice production. Such a development could eliminate almost $500 million in imports.

He shared the staff's reservations regarding the protectionist policies being pursued by the authorities to promote industrial development, Mr. Leonard went on. There was a grave danger that those policies would result in greater inefficiency, particularly in conjunction with the flexible exchange rate policy, because protectionism and devaluation together would appear to give a watertight guarantee to the inefficient domestic producer. His Canadian authorities regretted that Indonesia did not feel able to eliminate the multiple exchange rate system, as anticipated at the time of the 1982 Article IV consultation. However, given the reasons put forward for the delay, he could join with other Directors in approving an extension of those practices. At the same time, in view of the expected stabilization of Indonesia's external position and the authorities' view that the introduction of tax reforms in early 1984 would eliminate the need for the current measures, he hoped that an extension beyond December 1984 would not be required.

Commenting on the medium-term prospects, Mr. Leonard noted that the scenario outlined in the staff report assumed a 5 percent growth rate. While it was not an overambitious assumption, given Indonesia's circumstances it might not be easy to realize it. The growth rate was sensitive to the growth of world trade, to the development of protectionist measures in the industrial countries, and in particular, to changes in oil output and prices. However, leaving aside such considerations, a 5 percent growth rate was not likely to do much for the employment needs of the country. The labor force was increasing at the rate of about 3 percent a year, and in order to absorb it the authorities were placing emphasis on the growth of the manufacturing sector, an area in which productivity could be expected to be high, certainly more than 2 percent a year. There was, therefore, little margin left to absorb the increase in the labor force or to bring down the current high levels of underemployment and unemployment. In addition, the availability of real resources with which to cope with the country's problems would be reduced by downward adjustment of the exchange rate through the terms of trade effect. Therefore, even given the strong and commendable efforts already being made by the Indonesian authorities, a number of serious medium-term problems remained.

Mr. Senior said that he agreed broadly with the staff reports and the appraisal of recent developments in the Indonesian economy. The fall in oil export earnings and a further decline in non-oil exports explained the weakening of the balance of payments and budget positions in 1982. Although corrective measures to reverse the situation, particularly to restrain current expenditures, had been adopted, they had been insufficient to halt the widening of the overall public deficit and the emergence of a considerable deficit in the balance of payments.

In light of the unfavorable world economic environment, Mr. Senior continued, the new Administration that had taken office in March 1983 had engaged in a comprehensive adjustment effort that had already begun to change the weakening trend of the balance of payments and budget positions. The adjustment measures implemented in recent months were sufficient to improve substantially the external position of the Indonesian economy in a relatively short period of time, as the staff had pointed out in the interesting medium-term analysis in SM/83/208, provided that the world economic recovery continued. Furthermore, those measures constituted a significant step toward the achievement of a viable balance of payments position and sustained rates of economic growth.

The comprehensive review and rephasing of public sector project expenditures had reduced imports substantially by cutting in half the foreign financing requirements of the projects over the coming few years, Mr. Senior observed. Significant savings of foreign exchange and a more moderate increase in the external debt service burden were also expected. In the area of monetary and credit policy, the recent financial reform represented a major step toward the promotion of domestic savings and the more efficient allocation of resources. The financial reform had eliminated the main instrument of monetary control at the disposal of the authorities--credit ceilings--and new techniques would have to be developed. The authorities were already in the process of considering various instruments, such as rediscount mechanisms and the issuance of central bank debt instruments, in order to manage the monetary aggregates more efficiently, a policy that was clearly needed as evidenced by the rapid increase in total liquidity during the previous few months.

The substantial devaluation of the rupiah in March 1983 and the gradual depreciation against the U.S. dollar since then had maintained the competitiveness of the traded goods sector while affecting favorably the international reserve position of the Bank of Indonesia in recent months, Mr. Senior remarked. Flexible management of the exchange rate would continue to foster non-oil exports in the coming years, especially in the industrial sector. In order to take full advantage of the beneficial effects of a flexible exchange rate on the competitiveness of industrial exports, a gradual reduction of trade restrictions was necessary. However, he agreed fully with the staff that reversal of protectionist actions in developed countries was urgently needed so as not to impair the process of industrial development and export-oriented growth of developing countries, such as Indonesia, in the years to come.

The combined impact of the adjustment measures that had been taken augered well for the medium-term prospects of the economy, Mr. Senior considered. In the external sector, the current account deficit for 1983/84 was currently estimated to be 43 percent lower than forecast at the beginning of 1983. Given the external adjustment already accomplished, a moderate world economic recovery, and the continuation of current policies, the staff estimated that the current account deficit as a percentage of GDP would decline further in the next fiscal year and rise moderately in 1985/86. Such a projection was realistic. On the domestic side of the economy, the prospects for economic growth and employment in 1983 and 1984 were not favorable, given the impact of the adjustment measures adopted and the need to continue those efforts in the near future. The authorities had recognized the need to carry out basic structural changes--to move from an economy in which the public sector played an important role in fostering economic growth to an economy characterized by a significant mobilization of domestic savings and an increasing role for the private sector. The current policies and those to be implemented in the coming months were clearly appropriate and consistent with that medium-term strategy. The financial reform would permit a larger flow of resources to be channeled to both the private and public sectors while improving the efficiency of resource use. The continuation of current expenditure restraint in conjunction with the substantial reform of the tax system would improve the finances of the public sector, while flexible management of the exchange rate would contribute to the growth of non-oil exports. In sum, the authorities had taken a significant step as part of the process of structural change. He hoped that they would continue to implement their policies successfully.

Mr. Polak recalled that when the Executive Board had discussed Indonesia's request for a drawing under the compensatory financing facility a few months earlier (EBM/83/113, 7/29/83), he had commented favorably on the far-reaching new policy package that had been adopted by the Indonesian authorities; the information in SM/83/208 confirmed his views in that regard. The staff appeared to be optimistic that Indonesia was heading for a sustainable external current account position. He agreed with that assessment, provided that the conditions mentioned by the staff were met--that government spending's share of GDP remained at approximately its present size and that Indonesia pursued a cautious financial policy. The staff had not made explicit its assumptions in the medium-term scenario, making it difficult to consider what the outcome might be under different assumptions. For example, Professor William Cline of the Institute of International Economics estimated that the deficit would be $10 billion by 1985, a clearly unsustainable amount. He invited the staff to comment on the issue.

A great deal of caution would need to be exercised before projects canceled or postponed under the rephasing scheme were restored, Mr. Polak continued. Indeed, given the size of the current account deficit, the authorities would be wise not to reactivate any of the rephased projects before the end of 1984. In spite of the considerable expansion of revenue following the adjustment measures, the budget deficit was continuing to increase, and it would have to be reduced. Part of the reduction might come from the expected rise in oil exports, but it would also be necessary for further growth in real government spending to be kept below the rate of increase in domestic tax revenues. Those revenues remained at a low level, only 6.4 percent of GDP. He urged the Government to speed up the tax reform to ensure that it would have a positive impact on revenues in the first year of the five-year plan.

The trend of subsidies on petroleum products was particularly worrisome, Mr. Polak suggested. The picture was confusing because at present a large part of domestic oil consumption was subsidized through the budget and a smaller part by compelling the oil companies to deliver oil at a low price. However, combining the two factors, the information in SM/83/218 showed that the subsidy aimed at an oil price 14 percent below the world market price but that the outcome would be a subsidy of about 23 percent. There were some special factors that accounted for the failure to reach the target and for the fact that performance was only marginally better than in the previous fiscal year; it would be reassuring if the authorities could confirm that their policy continued to aim at reducing the subsidy to a low level.

At the time of the previous Article IV consultation, Mr. Polak went on, Executive Directors had tended to believe that the competitiveness of the exchange rate should be restored in small steps. In March the authorities had made a major adjustment in the rate, for which they should be congratulated. That action had triggered a return of capital and a restoration of confidence, and the inflationary consequences had been kept well under control so far. Naturally, the experience following the previous devaluation should be in the authorities' mind, as Mr. Prowse had pointed out. The success of the devaluation had produced a new problem--a sharp increase in liquidity--as a result of an increase in net foreign assets attracted by Indonesian interest rates and the restoration of confidence in the rupiah. He hoped that the move toward positive real interest rates would not be so strong as to swamp the economy in imported liquidity with the dangers of a resumption of inflation and of renewed capital outflows at a later date. The policy should also not lead to so strong an overall balance of payments that the authorities might be encouraged to depart from measures aimed at maintaining the real effective exchange rate. The relatively modest recent erosion in competitiveness was perhaps inevitable, but the real effective rate should not be allowed to appreciate from its present level. The inflation statistics presented by Mr. Ismael suggested that there was a reasonable hope that Indonesia's competitiveness could be maintained satisfactorily by keeping the rise of domestic prices in check, a solution that was much more preferable than continuous devaluation.

Given that liquidity developments indicated a clear need for new instruments of monetary policy, Mr. Polak added, the Government's plans in that regard were welcome. It might be an appropriate time to eliminate the fixed fee swap facility, which had the effect of creating unwanted liquidity. The facility was meant to provide forward cover for foreign investors, but its monetary effect appeared to be no different from an ordinary central bank credit facility at a subsidized rate. It was an impractical instrument that had produced unwanted results in the past; he encouraged the authorities to establish a forward market mechanism organized by the banks that would allow market forces to take account of relative expectations of inflation in Indonesia and abroad.

A reference had been made by Mr. Ismael in his statement to improvements in countertrade, Mr. Polak noted. What such an "improvement" meant in practice was unclear, but, given the dubious advantages of such arrangements, the implicit move toward abolishing countertrade ought to be made explicit. Reductions in barter arrangements were virtually always improvements in economic efficiency. It appeared that most foreign suppliers obliged to place Indonesian exports either sold the goods to large trading companies, to which Indonesia could have sold them in the first place at a better price, or the suppliers were buying goods that would have been exported anyway. The Indonesian Government had to pay the bill for the extra efforts that the foreign suppliers had to make, a cost that would outweigh by far any incidental advantage when a few foreign suppliers made an effort to uncover new markets for Indonesian products. The resources would be better spent by the Indonesian Government in improving its own export promotion services.

Mr. Suraisry stated that he was in general agreement with the staff analysis and that he supported the proposed decision. Like Mr. Prowse, he had been impressed by the quality of the report. When economic conditions had changed their course in late 1981 the Indonesian authorities had reacted quickly by taking strong adjustment measures. When those measures had proved insufficient, the authorities had again moved decisively in 1983 to introduce additional measures. It was encouraging that those measures had evidently had the desired initial effects on the economy. He commended the authorities on their courageous and prudent actions.

Although the 1983/84 budget outlook had had to be revised fundamentally, Mr. Suraisry continued, it was encouraging that revenue had not been adversely affected. On the expenditure side, the authorities' commitment to the original estimate of current expenditures, despite a greater than expected impact of the devaluation on prices, was commendable. It reflected a genuine willingness to adjust. In Table 9 of SM/83/218, and on page 18 of SM/83/208, the staff had shown that the fiscal deficit in 1983/84 would increase by 0.9 percent of GDP compared with 1982/83. The staff noted that the estimate did not take into account all the related elements, particularly the impact of a reduction in investment by two large public enterprises. If that factor had been taken into account, the deficit in 1983/84 would have shown no increase. If that analysis was correct, the conclusion should have been incorporated in the table; not to do so underestimated the adjustment efforts in the fiscal area. He invited the staff to comment.

With regard to monetary policy, Mr. Suraisry said that he sympathized with the authorities' intention to increase the rate of credit growth above the original target. It was logical that some of the liquidity accumulated in the banking system should be channeled into the economy even though such a policy was not a sufficient condition for the revival of economic activity, as the staff pointed out. However, vigilance would have to be exercised if the objective of such a move was to be achieved without igniting inflation; the increased liquidity ought to be restricted to productive sectors, as the authorities were aware.

Exchange rate policy was being managed appropriately, Mr. Suraisry considered. The flexibility in the exchange rate since March 1983 should help the country's exports, particularly when economic recovery became stronger throughout the world. He endorsed the authorities' intention to have official foreign exchange reserves cover at least three months of imports. While the overall debt structure might not constitute a cause for immediate concern, caution ought to be exercised, and in that regard, he supported the efforts to exercise restraint over the investment program of the public sector. He also supported every effort to monitor the private sector debt closely, and he hoped that adequate arrangements would be established to do so as soon as possible.

The authorities' views on dumping and the consequent measures taken to protect national industries were understandable, Mr. Suraisry added. However, there was no substitute for free trade if all countries were to operate in a better economic environment. He hoped that the authorities would soon be able to implement a more liberal trade policy and that Indonesia's trading partners would also do so. A worldwide free trade policy had been endorsed overwhelmingly during the 1983 Annual Meetings. That important objective ought to be achieved as soon as possible.

Mr. Laske observed that an abrupt change in oil market conditions, together with the protracted recession in the world economy, had drastically reduced the possibilities for Indonesia to maintain the rapid pace of its development effort. The changes in the overall economic environment had brought about an urgent need for both external and internal adjustment lest the Indonesian economy drift into an unsustainable balance of payments position and into serious external debt problems. The far-reaching reform and adjustment measures adopted by the authorities in 1982 and again in 1983 had forestalled such a development, and there was every evidence that the implementation of those measures had borne fruit within a relatively short time. More fundamental adjustments, such as the reform of monetary policy and of the tax system, were inevitably longer term and they would, therefore, require more time to make themselves fully felt. The actions taken by the authorities demonstrated that they had assessed the situation realistically and that they were determined to tackle the problems confronting them with vigor.

The actions taken so far constituted a first step toward securing the external viability of the Indonesian economy and resuming modest real growth, Mr. Laske continued. The first step had probably been the most dramatic and the most difficult move of the comprehensive adjustment strategy. His comments would concentrate on the shorter-term issues, therefore, because the major building blocks of the longer-term strategy had been put in place. The most important step had been the exchange rate correction in March 1983, restoring external competitiveness to the level prevailing after the 1978 devaluation. Since March, the authorities had made further slight adjustments in the dollar-rupiah rate in order to maintain competitiveness. They would have to continue to do so if the diversification of the export sector into non-oil products was to be successful. In SM/83/218, the staff pointed out that the rupiah had appreciated marginally in both nominal and real effective terms between April and August 1983. As the dollar had again strengthened against major currencies, some of which played an important role in Indonesia's foreign trade, it would be interesting to know whether the Indonesian authorities had acted to slow down or to arrest the appreciation that appeared to have begun about the middle of the year.

The massive reduction and rephasing of the development plan was a major element in reducing recourse to foreign savings, Mr. Laske said. In the first stage of that investment effort, abundant resources had appeared to be available from the proceeds of oil exports, but continuation on the originally envisaged scale would have required large-scale foreign borrowing. The data on external public sector debt presented in Table XL of SM/83/218 made it obvious that such an approach would not have been viable. It would have entailed an increase in the debt service ratio, severely curtailing the availability of foreign exchange in later years. Moreover, foreign lenders, both official and private, might not have been willing to increase further their exposure in Indonesia which, albeit not excessive, could not be considered moderate.

It was surprising that, although investment plans had been cut back sharply, capital spending in 1983/84 was projected to be almost 30 percent higher than in 1982/83, Mr. Laske considered. The grant of a wage bonus to public sector employees, an action that might have been justified on social grounds, and the local currency increase in investment spending appeared to be responsible for an increase in the government deficit by almost 1 percentage point of GNP. The staff noted that such a financial stance did not provide much demand stimulus, but it also appeared to indicate that the generation of higher public sector savings had not yet really begun. The whole deficit was to be financed by foreign borrowing, bringing the outstanding debt to almost $27 billion by the end of the fiscal year. The increase in the public foreign debt would, therefore, be considerably larger than it had been in 1982/83.

The commercial banks' foreign assets, which were substantial, appeared to reflect the attractiveness of interest rates abroad relative to domestic rates, Mr. Laske added. The size of Bank Indonesia's fixed fee swap facility might have contributed to that attractiveness, although the devaluation should have reduced the need for an exchange rate premium. A related issue was the fact that Indonesia's capital market was in its infancy and that the Government had not yet tried to finance its budget deficit domestically by issuing bonds or similar debt instruments. If such instruments carried an attractive rate of interest, the commercial banks might be induced to repatriate some of their foreign assets.

The liberalization of interest rates was welcome, Mr. Laske stated, and it should help considerably in the mobilization of domestic savings, including those invested abroad at present or invested in dollar-denominated assets at home. That aspect of the reform could usefully be complemented by efforts directed toward improving and widening the functioning of the capital market. In SM/83/218, the staff pointed out that private banks were held at a competitive disadvantage vis-à-vis state banks because interest paid by the latter was tax free. Furthermore, foreigners were not allowed to own shares in Indonesian companies. While such a limitation might have understandable grounds in the country's history, relaxing or removing the restriction could serve to widen the flow of private foreign investment capital into the country. With the replacement of credit ceilings by reserve management as the major instrument of monetary policy, its flexibility and effectiveness could certainly be increased. Adequate effectiveness required, however, that the central bank be equipped with an appropriate set of tools to inject reserves into the system or to withdraw them as the need might be.

The substantial amount of assets held abroad by the commercial banks raised the question whether the amount of liquidity available to the banks at present might not too generous, Mr. Laske considered. Repatriation of those funds could be encouraged by tightening up bank reserves, for example, by reinstituting the interest bearing nonreserve account or more simply by raising minimum reserve requirements. A policy of complementing the central bank's range of instruments with authority to issue notes or certificates to conduct liquidity mop-up operations was fully endorsed by his chair. It would be equally worthwhile to consider opening up a traditional rediscount window for banks in order to manage reserves, but not to refinance credit to priority sectors. In that context, the substitution of investment incentives through the tax system for priority rediscounts could relieve monetary policy of a task that was, in principle, alien to its objectives.

Commenting on external debt, Mr. Laske observed that, although data on public external debt appeared to be comprehensive, information on private external debt was skimpy. For a country facing an external constraint, such a situation was uncomfortable and it would be worth considering what kind of mechanism might be employed to gain more complete information without placing all such transactions under tight reporting or authorization rules. He agreed fully with the staff's critical remarks on recently adopted trade measures. His authorities were particularly concerned about the continued operation of the export purchase scheme. Such a scheme was not only detrimental to efficient resource allocation, it interfered with the maintenance of an open trading system and it could be considered protectionism in disguise. He urged the Indonesian authorities to consider its discontinuation as a priority matter. At the time of the previous Article IV consultation with Indonesia, the authorities had been encouraged to eliminate the multicurrency practices and they had been granted temporary approval of them until the conclusion of the present consultation. An extension of the Executive Board's approval until the end of 1984 was being proposed, although the authorities had stated that they would be eliminating the practices under the envisaged tax reform. He hoped that the authorities would take action well before the end of 1984.

Mr. Orleans-Lindsay noted that the impressive economic performance of the Indonesian economy during the previous three years had begun to show signs of weakness because of the adverse weather conditions, which had caused a reversal of the increase in agricultural production, and because of developments in the world economy, particularly in the oil market, which had caused oil production to decline and had led to a slowdown in the growth of government revenues, thereby necessitating cutbacks in budget expenditure. The external current account deficit had also continued to widen. Under those adverse conditions, the Indonesian authorities should be commended for maintaining inflation at a moderate level and for adapting and reinforcing their policies early in 1983 in an effort to preserve domestic financial stability and to promote external adjustment. The major adjustment measures that the authorities had introduced were welcome, and they appeared to have produced the appropriate impact on the economy. It was also encouraging that the authorities were contemplating further measures in the near future to achieve long-term balance in both the domestic and external sectors.

The most important measure had been the adjustment in the exchange rate in March 1983, Mr. Orleans-Lindsay continued. The authorities had shown their determination to take earlier corrective action based on a policy of flexible management of the rupiah consistent with developments in relative prices. That action should help to restore and to maintain the economy's competitiveness, essential for attaining Indonesia's long-term balance of payments and growth objectives. Another major step had been the review and rephasing of the public sector investment program. That measure had necessitated a revision of the 1983/84 budget estimates; revenues from oil exports would decline in dollar terms, while the impact of the recent devaluation would substantially boost the rupiah value of oil revenues, thereby increasing total revenue receipts. He shared the authorities' concern that the need to improve revenue receipts from non-oil sources remained urgent. In that connection, the efforts to improve tax administration should be encouraged. He particularly welcomed the authorities' intention to introduce substantial tax reforms in early 1984, supported by the appropriate administrative changes, as part of their medium-term policies.

The authorities' intention to continue their policy of austerity in current expenditures underpinned the substantial revision that had been made in the estimates of budget expenditures, Mr. Orleans-Lindsay observed. Current expenditures were projected to remain at about the same level in real terms as in 1982/83, after taking into account the impact of the wage bonus granted to public sector employees and the increases in subsidies for petroleum and food items arising from the need to offset the inflationary effect of the devaluation. He hoped that, as soon as circumstances permitted, the authorities would adjust prices to reduce the subsidies and eventually to abolish them. The rephasing of the public sector investment program should help to strengthen the weak current account position, but the authorities should be cautious in their approach to cutting investment outlays because of the possible adverse effects on economic growth. The authorities should be equally cautious in restoring projects canceled or postponed.

Responding to the call for measures to improve the efficiency of the banking system and for a more flexible interest rate policy to encourage domestic savings, the authorities had taken significant steps under their financial reform measures, Mr. Orleans-Lindsay commented. He hoped that with additional technical assistance from the Fund, the design and implementation of new monetary policy instruments would lead to the successful management of monetary policy in the new financial environment.

Turning to Indonesia's medium-term prospects, Mr. Orleans-Lindsay observed that the staff assumed that there would be continuous but moderate growth in the industrial countries. Such growth should help Indonesia's non-oil exports through better international prices and export volumes. Following an estimated decline in the current account deficit from \$6.9 billion in 1982/83 to \$5.7 billion in 1983/84--7.5 percent of GDP--a further decline was expected in 1985/86. In addition, the authorities were urged to continue their adjustment efforts to stimulate non-oil exports because of the uncertainties surrounding oil export performance. The authorities' intention to slow public sector expansion and to allow more active private sector participation in the new economic environment was welcome. They should be encouraged to maintain and to improve the incentives for stimulating private sector activity and non-oil exports. Mr. Ismael's statement that his authorities were undertaking to eliminate the remaining multiple currency practices with the introduction of the new tax system in early 1984 was also welcome.

Mr. Finaish remarked that, following several years of rapid economic growth in Indonesia, adverse circumstances since 1981 had induced fundamental changes in economic policy. The policy responses of the authorities in 1982 and 1983 had been based on the prudent assumption that prospects of the international economy and the availability of financing in the years ahead had become far less encouraging and that important adjustments to the changed circumstances had to be effected. The measures taken so far by the authorities were far-reaching and appeared to have had made a favorable impact already, as indicated by the staff's reports and Mr. Ismael's statement.

Although various measures had been initiated in 1982 and early 1983, Mr. Finaish continued, the most significant steps had been taken between the end of March and early June 1983. It could, therefore, be early to attempt a full assessment of the authorities' policy actions. It was clear that a major shift in economic strategy had been adopted and that additional measures were planned in various areas, including taxation. In such circumstances, as in any major shift in established policies, it might be expected that the impact of new measures would be kept constantly under review to ensure better performance in the attainment of the objectives and to minimize the inevitable costs. The sharp cuts in the public sector investment program envisaged by the review and rephasing of May 1983 had been an important decision necessitated by the changing circumstances. The adverse impact that it might have on growth and employment would depend mainly on whether expectations regarding private sector activity would materialize. If the authorities' projection of 5 percent real growth during the next five-year plan was judged to be feasible, then growth would not be seriously undermined, although it would remain, understandably, lower than during the 1970s.

The large devaluation of the rupiah in March 1983 had reversed the previous exchange rate policy of gradual adjustments, Mr. Finaish observed. It had restored the competitiveness lost since the devaluation of 1978, and the authorities intended that the exchange rate would be managed flexibly to avoid renewed loss of competitiveness. A general issue for consideration in that context was whether, following a large devaluation by a major country in the region in October 1982, reliance on exchange rate adjustments to maintain competitiveness would encourage further devaluations among countries with similar export structures in the area. It was also interesting to note that the Indonesian authorities had emphasized that the goals for exchange rate policy could change with circumstances.

The financial reforms announced in early June had been highly significant in granting state banks considerable freedom in interest rate and credit policies as a means of encouraging the mobilization of domestic financial resources and improving efficiency, Mr. Finaish went on. The authorities rightly expressed concern, however, that such reforms also might entail consequences such as the shortening of the maturity of time deposits and might have a possible adverse impact on investment lending. Furthermore, the removal of credit ceilings had left the central bank with insufficient instruments to guide monetary policy, thereby inducing a greater resort to alternative instruments. In retrospect, it could be asked whether a more gradual approach to financial reforms could have averted some of those consequences. Finally, the remarks of the Indonesian authorities on the protectionist measures that they encountered were justified and merited understanding; their trade policies had to be considered against the increasingly protectionist stance of some industrial countries.

Mr. Clark said that he welcomed the way in which the Indonesian authorities had responded to the deterioration in the country's external position; but there did not appear to be much margin to spare, and, without a favorable performance by the world economy, there might be a need for further measures. In that regard, it was worth noting Indonesia's relatively heavy dependence on exports to Japan, a market that was growing but not accelerating, and on oil, another area in which market conditions remained slack. It was questionable, therefore, how strongly Indonesia might feel the effects of the present upturn in the world economy, which had been concentrated to date in North America and in commodities other than oil. He joined earlier speakers in hoping that the experience after the 1978 devaluation of the rupiah would be borne in mind in following up the latest measures.

An adequately restrained monetary policy would be important, Mr. Clark continued. It was a matter of concern that the credit target for the current fiscal year had been set at 18 percent, a level thought to be consistent with an underlying inflation rate of about 10 percent. Given the inflation rate in Indonesia's two major trading partners, the United States and Japan, such a target might not be sufficiently tight, and the subsequent easing of credit policy warranted even closer examination. The question remained whether the measures taken to date would be sufficient to restore a sustainable external position. However, it was difficult to take all the necessary measures at one time, and the authorities' determination gave grounds for confidence, especially in view of their track record over the previous 15 years. Finally, the staff's assessment of medium-term prospects and its discussion of trade policy issues were both welcome.

Mr. Kabbaj noted that, like other oil exporting countries, Indonesia had benefited from the substantial increase in oil prices and exports in 1979, which had sharply increased government revenues and had supported liberal investment policies. The authorities had used caution in the management of the new revenues, deciding to save a considerable portion of the increased earnings, and they had channeled investment and development expenditures into key sectors of the economy, thereby restraining the inflation that would have been induced by higher domestic demand. Similarly, with the general deterioration of Indonesia's economic prospects following the world economic recession and its adverse impact on oil prices and exports, the authorities had reacted decisively to the new situation and had implemented important adjustment measures aimed at alleviating the recession's effects on the fiscal and external positions. The authorities' adjustment efforts in 1982 had also aimed at preserving the relatively high level of development outlays and of real economic growth. They had implemented export promotion measures, and, in view of the projected deceleration in oil revenues, they had improved tax administration to raise the ratio of non-oil revenues to GDP. They had also decided to hold current expenditures constant in nominal terms, particularly through a freeze on civil servants' salaries and a 60 percent increase in domestic petroleum prices.

Unfortunately, the 1982 measures had achieved little success as the problems in the international oil market had deteriorated further, Mr. Kabbaj continued. In early 1983 it had been necessary to adopt much stronger adjustment policies to cope with widening fiscal and external deficits, including a substantial curtailment of development expenditures. Indeed, performance in 1982 had been disappointing, with a considerable slowing down of real GDP growth to 2.2 percent from 9.9 percent in 1981, doubling of the fiscal deficit to 5 percent of GDP, and widening of the external current account deficit to 7.6 percent of GDP, compared with 3.4 percent in 1981 and a sizable surplus in 1980. Large capital outflows had further aggravated the situation.

The authorities' response to the deteriorating economic situation in Indonesia since early 1983 was generally appropriate, Mr. Kabbaj considered. It offered a clear indication of the cautious management of available domestic and external resources. It was particularly encouraging that the new action was aimed not only at attaining fiscal and external adjustment in view of lower revenues and export receipts, but, more importantly, at achieving the transition to a new economic environment in which the private sector could contribute more effectively to economic growth. The authorities' action was also comprehensive, covering all aspects of economic policy, including a large devaluation of the rupiah, a drastic reduction and rephasing of public sector project spending, and the introduction of a substantial reform of the financial system, which should improve the mobilization of domestic savings and encourage import substitution and export diversification.

The authorities' intention to avoid any recourse to domestic credit for the financing of the fiscal deficit was welcome, Mr. Kabbaj added. It was also encouraging that, despite increased external borrowings, the ratio of debt service to gross exports would remain at a relatively low level. Despite a number of uncertainties regarding the sustainability of world recovery and the impact on the economy of recent adjustment policies, medium-term prospects for the restoration of sustainable fiscal and external positions and for the resumption of economic growth were also encouraging. He could support the authorities' handling of economic difficulties largely induced by world economic recession, and he also supported the proposed decision, including the granting of a temporary approval of Indonesia's multiple currency practices.

Mr. Camara said that the staff gave a clear picture of the problems faced by the Indonesian authorities and that it also provided ample information on the steps taken to correct those problems. In Sections II and III of SM/83/208, the causes of the difficult economic situation of the country were examined and an approach to the solution was advanced.

The staff's medium-term scenario focused exactly on the main problem affecting the economy as seen by the Indonesian authorities, Mr. Camara continued. They were aware that the current economic conditions, characterized by rapidly increasingly public sector project spending, could no longer be supported by current resources. The revenues generated by the oil sector had been declining as a result of the deteriorating conditions in the international oil market, falling export prices, and declining output, putting a severe constraint on economic activity in general. In other sectors, such as agriculture, the problem was virtually the same, as severe droughts had adversely affected production.

The Indonesian authorities were fully committed to redressing the serious internal and external imbalances, Mr. Camara remarked. They had attempted to correct the situation through a number of policy measures adopted in 1982, but, with the deep-seated nature of the imbalances highlighted by a slower than anticipated world economic recovery, those measures had been insufficient to bring about substantial changes. In 1983, however, further efforts had been deployed by the authorities to bring the economy back on an even keel. The measures implemented recently included a 28 percent devaluation of the rupiah, the rephasing of the public sector investment program, and the reform of the financial system. The growth target of 5 percent of GDP envisaged by the authorities and the staff might be considered optimistic, given the continuing harsh external economic environment; a lower figure could be more realistic.

The authorities' decision to rely more on the private sector was understandable, Mr. Camara considered. He hoped that labor-intensive projects in the agricultural sector would be given greater consideration. The devaluation had had salutary effects on the non-oil sector, and exchange rate policy should continue to be kept under constant review in order to maintain the competitiveness of that sector. However, in order for the competitiveness to make its effects felt, protectionist tendencies around the world would need to be curtailed. He hoped that the multiple currency practice involved in the withholding of tax on exports would be phased out. The Indonesian authorities were on the right track toward the restoration of economic growth. The provisions of their next five-year plan were comprehensive, and he hoped that, with sufficient perseverance, the authorities would succeed in achieving their development objectives.

Mr. de Groote recalled that he had supported the general reorientation of policies currently being pursued by the Indonesian authorities at the time of Indonesia's request for a drawing under the compensatory financing facility (EBM/83/113, 7/29/83). The staff reports before Directors complemented the information available at that time because they included a medium-term perspective. Despite the reduction in real consumption, the ratio of savings to GDP had fallen from 26 percent in 1980 to 16 percent in 1982, and if the reduction continued in 1983 it would be the most critical negative development of the previous two years. Because the main source of savings had previously been the public sector, both trends and cyclical swings in oil revenues had directly affected the savings capacity of the economy. A substantial increase in and mobilization of savings was, therefore, the most important factor in the attainment of a satisfactory performance by the Indonesian economy in the coming year. He hoped that interest rate policy, the new financial reforms, and the substantial reform of the domestic tax system and tax administration would bring savings back to the level required by the still ambitious development targets of the authorities. Otherwise, it would be much more difficult to eliminate domestic and external imbalances than was currently anticipated. In particular, although the decision to eliminate the fiscal bias in favor of capital-intensive methods of production might be necessary to improve development policy, it might also have an initially negative impact on the savings ratio. The authorities' decision to postpone a number of public investment projects in order to reduce external and internal expenditures was a welcome contribution to a better balance between savings and investment. However, the careful implementation and very close supervision of the remaining projects would be vitally important, because any delay in the targeted reduction in investment would increase budget and foreign exchange costs, thereby placing the present objectives in jeopardy.

Commenting on monetary policy, Mr. de Groote said that the marked increase in time and savings deposits following the freeing of interest rates in June and July was welcome. However, interest paid by private, including foreign, banks was subject to income and corporate tax, while interest paid by public banks was not. Such inconsistent tax treatment not only limited the competitiveness of the former banks, it also reduced the effectiveness of interest rate policy. He invited the staff to comment on the question.

The efforts of the authorities concerning exchange rate policy had been effective, Mr. de Groote continued, especially in increasing the competitiveness of the non-oil sectors, promoting structural changes in the economy, and improving resource allocation. However, countertrade measures were not an appropriate method to deal with export promotion. The Executive Board had always held the view that market mechanisms were more efficient than barter arrangements. A realistic exchange rate, combined with appropriate macroeconomic measures to control internal prices and costs, should take care of the competitiveness of Indonesia's exports. A correct exchange rate remained the best trade policy, and he agreed with Mr. Polak's pertinent remarks in that regard. The policies currently being pursued by Indonesia were on the right track, leading to the type of structural change essential to the achievement of sustainable growth. However, a number of additional measures remained to be taken to ensure that the orientation continued in the correct direction over the coming months.

Mr. Zhang stated that the Indonesian authorities should be congratulated for their adoption of the current adjustment measures. He wished them success and he supported the proposed decision.

The staff representative from the Asian Department observed that one Director had requested information on the changing maturity structure of bank deposits following the major reform of the financial system. There had been uncertainty in the market following both the financial reform and the devaluation that had preceded it by two months. Such uncertainty almost inevitably shortened maturities; another factor had been adjustment to a more desirable asset structure on the part of depositors at some of the state banks. State enterprises, among other entities, had to deposit their funds with state banks in Indonesia. Previously, they had received relatively high interest rates on two-year deposits while rates on shorter maturity deposits were held at lower levels. After the freeing of interest rates, the shorter maturity deposit rates had risen considerably, tripling in some cases, whereas the long maturity deposit rates had remained at their previous level--close to the rate determined by other banks in the system.

The staff had not expressed anxiety about the adequacy of the adjustment program, the staff representative continued. It had noted, however, the uncertainties surrounding developments in the world economy, particularly with regard to the oil market, and the difficulty of analyzing the probable effects of the major changes that had taken place in Indonesia, including the large devaluation, the changes in government expenditure plans, and the financial reforms. The staff believed that further adjustment measures would be necessary in the new environment, including not only appropriate financial and monetary policies, but also tax reforms. A staff mission had discussed with the Indonesian authorities how the Fund might provide technical assistance for the tax administration aspects of the new measures, and a more detailed assessment and further advice would be provided by a mission early in 1984. A further area of uncertainty was the response of the private sector to the new regulations and taxes in certain areas. Similarly, the effectiveness of the shift of emphasis of the investment program to more labor-intensive activities remained to be seen.

Commenting on the growth of the monetary aggregates, the staff representative noted that the most recent data suggested that monetary growth in the first six months of 1983/84 was running at an annual rate of about 26 percent, while narrow money was increasing at an annual rate of about only 12 percent. The statistics suggested that a large amount of capital that had left the country prior to the devaluation was returning. The faster than targeted rate of monetary growth was, therefore, concentrated in quasi-money--time and savings deposits at both state and private banks. Credit expansion, however, was running a little below the target rate set by the authorities, particularly credit to the private sector and to the Central Government; only credit to the state enterprises was increasing somewhat faster than the original target. It was always difficult to assess the impact of a change in the exchange rate on the demand for money in the short run. The staff believed that in Indonesia's case the demand for liquidity was increasing, and that, given the changes taking place, monetary growth a little above the authorities' targets was not a matter of immediate concern. However, the staff would continue to monitor the situation closely.

The question of whether countervailing duties might be a viable alternative to restrictions against dumping had been raised, the staff representative went on, but the authorities did not believe that they had adequate mechanisms in place at present to deal with individual instances of dumping through countervailing duties. Furthermore, the authorities were beginning a major review of the tariff structure and they preferred to complete the review rather than to undertake short-term adjustments in that area.

The staff had not intended to express a value judgment on the appropriate size of the public sector, the staff representative commented. In the base case for its medium-term scenario, it had assumed that the public sector would expand at the rate of nominal GNP. The staff's reference to "a more slowly expanding public sector" meant relative to past performance, not relative to current GNP. Similarly, the comments referring to the private sector employing a higher proportion of domestic resources were expressed in relation to the situation in earlier years.

Government debt was not held by the public in Indonesia and treasury bills were not issued, the staff representative noted, therefore the authorities had given consideration to the issuance of a note by the central bank. The type of note and its characteristics remained unspecified at present. The staff had had preliminary discussions with the authorities on the question, and staff from the Central Banking Department would shortly be discussing with the authorities the operational aspects of some of the measures that had been proposed to deal with the management of reserves, in particular the rediscount mechanism and the possible issuance of a note by the central bank.

Indonesia's current account deficit in 1985 had been projected to be about $10-11 billion by Professor William Cline, as one Executive Director had pointed out, the staff representative said. Professor Cline's estimate did not take account of the adjustment measures that had been put into place since March 1983. The decision to rephase public sector project investment would by itself reduce imports by about $3 billion below the level originally estimated. In addition, the financial reforms and the devaluation could be expected to have important effects on the external sector. Professor Cline also used assumptions different from those of the staff with regard to oil prices and output. The staff assumed a slight increase in the dollar price of oil in 1984/85, whereas Professor Cline assumed a constant price. More importantly, Professor Cline assumed that production would remain at the 1982 level of 1.26 million barrels, the lowest level of production in Indonesia in many years. At present, production was running at about 1.4 million barrels, and the staff assumed that it would gradually increase from that level, reaching the capacity level of about 1.65 million barrels a day toward the end of the scenario period. The most recent balance of payments data suggested that in the first six months of the current fiscal year, the external position was turning out to be stronger than the staff's original estimate, which had been that the current account deficit would be $5.7 billion. Both oil and non-oil exports were increasing faster than the annual rate assumed in the staff's estimates, and non-oil imports had declined even more dramatically than anticipated.

In Table 9 of SM/83/218, the staff representative recalled, the fiscal deficit had been estimated at 5 percent of GDP in 1982/83, increasing to 5.9 percent in 1983/84. One Director had remarked that the fiscal position on a broader base did not suggest such an increase. In that particular presentation, the staff had attempted to go further than in previous reports and to estimate the deficit on the basis of a broad definition of the public sector. However, such an exercise raised a number of difficult issues. First, the Government's budget was drawn up on an authorization basis, not a cash basis, and it was possible for government agencies to spend in subsequent years the authorizations made in previous years. Thus, to give an accurate estimate of the current budget position, the staff had had to include an adjustment item in the budget presentation. Second, the staff had attempted to incorporate all of the onlending of the Central Government, some of which was off budget. That estimate was also incorporated in the adjustment item, and as a result, the overall budget deficit was estimated to increase from 5 percent of GDP in the previous year to 5.9 percent in the current year. Another factor was the off-budget activities of public sector enterprises. However, there had not been much data available on those activities, and the staff had chosen to limit its presentation to areas in which reasonable statistics were available. The staff had discussed qualitatively the impact of the foreign exchange expenditures of the two major state enterprises, Pertamina and Garuda, and its qualitative conclusions about the direction of fiscal policy incorporated that analysis. The staff was continuing to work with the authorities to reconcile differences between the balance of payments data and the budget data.

The exchange rate was currently about Rp 987 per U.S. dollar, the staff representative noted, a level more or less unchanged in nominal effective terms from the level prevailing on the day of the devaluation. The real effective exchange rate was judged to have appreciated about 2 percent. However, the latter assessment might overstate the position a little because the price indices upon which the real effective exchange rate was determined had risen, primarily because of price increases in traded goods following the devaluation. Consequently, caution was warranted in making judgments on the appropriateness of the present exchange rate level.

As a result of the uncertainty arising from the introduction of the financial reforms, it appeared that interest rates had been established at levels close to overseas rates plus the premium inherent in the fixed fee swap facility, the staff representative added. If the swap premium at that time had not reflected the market's expectations with regard to the exchange rate, it would suggest that interest rates might have been a little too high initially. Another factor to be considered was that the swap premium removed from the market the signals that would have been useful for monetary policy.

Bank Indonesia monitored private sector external debt, the staff representative continued, but it could not capture all of it. The staff had recently been able to make a more comprehensive estimate of external private sector debt on the basis of the wider statistical effort that was under way in the Bureau of Statistics. The authorities were also considering, within the context of the new tax laws, possible ways to monitor private debt, but they were concerned that too rigid a monitoring or reporting system might suggest a desire to exercise control over capital flows. They were considering the possibility that, if individuals or companies wished to write off the interest charges on foreign debt under the new income tax system, the authorities would have to be informed.

One Director had referred to other currency devaluations in the region, the staff representative observed, presumably having in mind the devaluation of the peso by the Philippines in October 1982. There was only limited direct competition between the Philippines and Indonesia on the export side. Indonesia primarily exported oil and timber, whereas the Philippines relied much more heavily on manufactures. The present pattern of the upturn in the world economy could affect Indonesia's prospects, as one Director had suggested. The faster the growth in Japan's imports, the more likely that Indonesia would benefit. If the world economy as a whole grew firmly, there would probably be a strengthening of the oil market, a beneficial development from Indonesia's point of view.

The differential treatment of banks referred to by one Director covered not only deposit categories, but also interest payments on bonds, the staff representative from the Asian Department remarked. The question was expected to be resolved under the new tax reform under which it was proposed that there would be uniform treatment of interest on deposits, possibly through a withholding of income tax on such interest. The reforms would also result in a greatly simplified income tax system. The effects on savings would be important depending on the impact of income taxes relative to the value-added tax that was to be put in place. Those effects would probably be more important than the shift away from taxes favoring capital-intensive investment, but the actual outcome was difficult to predict at present.

Mr. Ismael recalled that the question of countertrade had been discussed extensively by the Executive Board at the time of the previous Article IV consultation with Indonesia in January 1983. The Indonesian authorities regarded such a measure as a second-best solution to the problem of the protectionist world environment that they faced. Indonesia was not the only country, nor the first, responding in such a way to that environment; it appeared that about 50 countries practiced that kind of policy. However, he would communicate to his Indonesian authorities the concern of the Executive Board in that regard.

The Chairman made the following summing up:

Executive Directors warmly commended the Indonesian authorities for the decisive and timely implementation of significant adjustment measures to counter the rapid weakening of the balance of payments. Directors noted that these measures would help to reduce substantially the current account deficit over the medium term. However, the Government's program appeared to have relatively little room for maneuver, and several Directors stressed that additional measures might well be needed, given the uncertainties of the world economic environment and Indonesia's export markets.

Directors endorsed the authorities' fiscal adjustment efforts in fiscal year 1983/84. The sharp increase in domestic prices of petroleum products, continuing wage restraint in the public sector, including a courageous two-year wage freeze, the freezing of rupiah development spending authorizations at original budget estimates, and the sharp reduction in planned public sector foreign project expenditures were necessary in the face of a sizable fall in the dollar value of oil revenues and the rapidly widening public sector deficit. The projected further increase in the central government budget deficit to nearly 6 percent of GDP in 1983/84 was viewed by a number of Directors with some concern, and they urged the authorities to take further measures to reverse that trend.

Directors observed that monetary growth had slowed considerably in 1982/83, partly as a result of a gradual tightening of credit policy, but also reflecting the weakening balance of payments. They welcomed the continuation of a generally restrained credit policy in 1983/84, noting its importance in controlling inflationary pressures following the devaluation and in preserving financial stability. It was not clear, however, whether monetary policy was tight enough; in the view of some Directors, additional measures of restraint should be envisaged in current circumstances. Directors welcomed the recent monetary reforms, including a significant liberalization of interest rate policy toward the state banks and the abolition of the credit ceiling system. They hoped that the reforms would contribute to the mobilization of financial resources and that they would promote greater efficiency in the use of investment funds. Directors stressed, however, the importance of the prompt institution of alternative mechanisms for monetary control to ensure successful management of the financial sector.

The authorities were commended for the bold action taken on the exchange rate front, and Directors noted the early indications of the success of that action, including the limited increase in domestic prices, the reflow of speculative capital into the country, and increased exports of some manufactured goods. Directors also welcomed the authorities' intention to manage the exchange rate more flexibly in accordance with developments in relative prices, the balance of payments, and the level of international reserves. In that context, a number of Directors, noting the appreciation of the real effective exchange rate since the devaluation of March 1983, emphasized the need to check such a trend and to preserve the future competitiveness of the rupiah.

Directors commended the authorities on the rephasing of the public sector investment program, a major undertaking. The sizable and immediate impact of the rephasing exercise was estimated to reduce the current account deficit by about $3 billion in 1983/84 alone. At the same time, Directors encouraged caution in restoring projects canceled or postponed in the rephasing exercise, because the projected adjustment of the external sector was dependent on the successful completion of those rephasing efforts. Directors welcomed the attempt to shift the structure of the investment program to place more emphasis on projects that employed labor-intensive and domestic resource-intensive production techniques, noting the importance of that redirection for domestic employment creation. The need to improve the monitoring of the activities of the state enterprises was also stressed.

While commending the authorities' impressive adjustment efforts, Directors expressed caution over projected developments in the external debt service burden. Although still at a manageable level, the debt service ratio had increased rapidly over the previous three years, and it was projected to remain relatively high or even to increase moderately in coming years, particularly if allowance was made for private service payments. Directors stressed the need for improved surveillance over private sector borrowing abroad. They also emphasized that continued efforts would be required to mobilize additional domestic resources, to promote efficient investment and production, and to maintain competitiveness in order to sustain the momentum of economic development while avoiding a worrisome further increase in the external debt service burden.

Directors welcomed the tax reform measures recently proposed by the authorities, which were intended to increase non-oil tax revenue significantly in the years to come and to provide greater incentives for employment creation and productive private sector investment. Combined with the recent interest rate reform, the tax reform should assist the mobilization of domestic resources for investment, the key to the medium-term solution of Indonesia's economic problems. Directors supported the view that increased reliance on the private sector would help to sustain growth, and they stressed the importance of promoting an active and competitive private sector, particularly through a more export-oriented trade regime.

Directors noted that maintenance of a liberal trade policy, together with a flexible exchange rate policy, would make a strong contribution toward improving competitiveness and efficiency. In that context, several Directors expressed concern about the potential impact of recently adopted trade measures. Concern was also expressed by several Directors about the counterpurchase requirement on certain public sector imports and about the restrictive regulations on shipping services; at the same time, a number of Directors also stressed the negative consequences for Indonesia's exports of restrictive measures taken by some industrial countries. Directors noted with satisfaction that the authorities would eliminate the remaining multiple currency practices with the introduction of the tax reforms in 1984.

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

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Indonesia's exchange measures subject to Article VIII, Section 3, and in concluding the Article XIV consultation with Indonesia, in the light of the 1983 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that certain export taxes, described in SM/82/233, constitute multiple currency practices. The Fund encourages Indonesia to eliminate these multiple currency practices and, in the meantime, the Fund grants temporary approval for the retention of these practices until December 31, 1984 or the next Article IV consultation, whichever comes first.

Decision No. 7555-(83/154), adopted
November 14, 1983

The Acting Chairman took the chair.

2. MALDIVES - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Maldives (SM/83/211, 10/24/83; and Cor. 1, 10/25/83). They also had before them a report on recent economic developments in Maldives (SM/83/216, 10/27/83).

The staff representative from the Asian Department stated that the staff had been informed by telex that the 50 percent advance deposit on private sector imports referred to in SM/83/211 had been lifted by the authorities as of October 25, 1983. Consequently, it would be necessary to amend the proposed decision.

Mr. Finaish made the following statement:

Despite a deep and protracted international recession, recent economic performance of Maldives, a small and open island economy, has been impressive, with the annual growth rate of real GDP averaging 9 percent for 1981-83. This success is largely attributable to efforts aimed at raising productivity in fishing and at expanding the tourist industry. Diversification of the economy and the attainment of regionally balanced growth, both of which will contribute to making the economy more resilient, are among other important policy objectives that have met with some success.

The fisheries sector, which accounts for 80 percent of merchandise exports and 40 percent of total employment, has benefited from increased mechanization of fishing vessels and improvements in fish collection and refrigeration facilities. Timely and appropriate policies, such as the maintenance of procurement prices at a time when international prices were declining, have helped to alleviate presure on this sector through the period of slack demand. Rapid growth in the other major source of foreign exchange earnings, tourism, has also been recorded in recent years, with its contribution to GDP having risen from 9 percent in 1979 to 15 percent in 1983. To minimize the risks associated with heavy reliance on tourism and to prevent any diversion of resources from other sectors, future investment in this sector will be selective.

Realizing the necessity of diversifying the economy, the authorities, in cooperating with Hong Kong-based companies, set up two garmet factories on Gan Island and were planning a third. Import quota limitations on woolen garments by the main important country, however, have threatened the viability of this venture. The two factories are currently operating considerably below full capacity, while plans for the third are now uncertain. Although quota limits have recently been agreed upon, it should be noted that the implications of such protectionism for a small open economy with an insufficiently diversified economic base could be quite serious.

To achieve better coordination and formulation of economic policy, a Ministry of Planning and Development was set up in November 1982 and a three-year plan for the period 1984-86 is being prepared. Three principal objectives for this plan have been identified: the improvement of living standards of the population; the achievement of a better balance in economic and social conditions between Male and the outer atolls; and the attainment of a greater degree of economic and financial self-reliance through increased mobilization of domestic resources. To realize these objectives, the Government plans to intensify its efforts to improve interisland transport and communication services, develop regional growth centers, expand investment in the fishing and tourism sectors, and develop new export-oriented industries in cooperation with foreign investors.

Until recently, rising government expenditures, due mainly to increased development commitments, were to a large extent matched by growth in revenues, deriving chiefly from taxes on trade and tourism and transfer of profits from public enterprises. Revenue growth, however, is expected to slow down considerably this year, reflecting in part the effect of adverse international conditions on public enterprise profits and on customs receipts. This decline in revenue growth and an accompanying large increase in capital expenditures are likely to result in a significantly higher budget deficit for 1983. Concessional financing, including project-related loans, is available to finance much of the deficit, thus leaving domestic bank financing of the deficit at the same order of magnitude as in 1982. It is hoped that the three-year development plan will help smooth out, to the extent possible, the lumpiness in the time path of expenditures. At the same time, a number of measures to mobilize additional resources are being taken. These include the elimination of subsidies on consumer items, the continued depreciation of the accounting exchange rate, and the reform of the tax structure, including the valuation of imports on a c.i.f. basis for customs duty purposes and the taxation of imports for personal use, with higher taxes on luxury items. The authorities feel that administrative difficulties continue to prevent the introduction of income and property taxes.

Reflecting fiscal developments, the surge in private sector activity, and competition among commercial banks, domestic credit expanded rapidly in 1982-83. Measures to control domestic credit growth and to curb private sector demand for imports were, therefore, adopted. These included the raising of reserve requirements to 25 percent on demand and time deposits, the placing of all private sector imports on a letter of credit basis, and a temporary freeze on commercial bank foreign exchange overdrafts to the private sector. Furthermore, a 50 percent advance deposit requirement on private sector imports against letters of credit has been temporarily imposed. Such measures, by controlling domestic liquidity growth, will also help reduce the recent increase in inflationary pressures.

The current account deficit, though high, is not likely to increase in 1983. While prospects for fish exports look good this year, import demand for development purposes is likely to be large too. Though the financing of the current account deficit continues to be through concessional sources, mainly the Arab oil exporting countries, the authorities are concerned about the recent decline in reserves. Although the debt service ratio is rising, its level in the medium term is likely to remain well within sustainable limits.

With a view to reducing and eventually eliminating the differential between the two exchange rates, a policy of gradual depreciation of the official accounting exchange rate has been pursued since 1982, and unification of the rates is envisaged during 1984. The gradual depreciation of the official exchange rate, it is expected, will contribute to increasing government revenues and to containing the balance of payments deficit.

The Acting Chairman made the following summing up:

Executive Directors, taking note of the statement made by Mr. Finaish, and welcoming the recent abolition of the advance deposit requirement on private imports, broadly agreed with the thrust of the staff appraisal in the report for the 1983 Article IV consultation with Maldives.

It is expected that the next Article IV consultation with Maldives will take place on the standard 12-month cycle.

The Executive Board then took the following amended decision:

Decision Concluding 1983 Article XIV Consultation

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

2. The Fund notes with satisfaction that Maldives maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Decision No. 7556-(83/154), adopted
November 14, 1983

3. OFFICE SPACE - LEASE AT 1875 I STREET, N.W.

The Executive Directors considered a staff paper on the leasing of office space (EBAP/83/268, 11/1/83; and Sup. 1, 11/9/83).

The Director of the Administration Department remarked that, strictly speaking, the Fund did not immediately need the office space at 1875 I Street, N.W. proposed for leasing in EBAP/83/268, and it might not even need the space in 1984. However, at present the Fund provided office space for close to 2,000 persons and the available space scattered throughout the headquarters building could accommodate only about 40 more persons. The reserve space amounted to about 12,000 square feet, or 2 percent of the space currently used, a narrow margin relative to the potential demand. Recent budget discussions with departments indicated that the workload on staff had not abated and that requests for new positions in financial year 1985 might exceed those for financial year 1984. During the previous budget discussions, the possibility of increasing the number of participants in the IMF Institute courses and of running four courses simultaneously had also been considered. Such a decision would increase base requirements of the Institute by about 5,000 square feet. Furthermore, the establishment of a new Fund-owned data center, currently under consideration, could require an additional 15,000 square feet.

While the staff was concerned about the disparity between available space and potential needs, the Director continued, it would have preferred to delay a proposal to lease additional space until the next budget, when it would be possible to have a more realistic assessment of requirements for FY 1985. The recommendation to lease at present had been prompted by the strategic location of the 2,600 square feet in question, which represented the only connection between the space currently held by the Fund in International Square and two blocks of office space on the fifth floor of the building that might become available at a later stage. The staff believed that it was imperative to keep open the chance of leasing contiguous space in International Square because of the benefits it offered in terms of organizational efficiency and avoidance of costly duplication of services such as security, messengers, and telephones.

The Administration Department was normally expected to provide space as soon as a budget decision had been made to increase staff or to develop existing or new activities, the Director commented. Rational planning would be impossible without a measure of flexibility with respect to future space arrangements and a minimum margin of reserve space. The alternative would place the Fund at the mercy of the volatile Washington real estate market and in a position where it might have to seek space in haste at the last minute. In the recent past, such an approach had resulted in the acquisition of scattered, high cost space, sometimes of clearly substandard quality. A responsible approach required trying to prevent the recurrence of such an unfortunate situation. He was confident that departments would follow the traditionally conservative approach to staff expansion and that they would not make irresponsible requests for additional staff simply because space was available. Requests for additional staff would be subjected to the normal rigorous scrutiny.

Mr. Morrell said that he understood the difficulties of the Administration Department in having to assess the space needs of the Fund, particularly given the uncertainties with regard to future numbers of staff. Nevertheless, might it not be possible to accommodate the needs of consultants and visiting groups through careful allocation of spaces in the present building? If the lease of additional space in International Square was deemed to be necessary for strategic reasons, would it be possible to sublease such space until it was needed by the Fund? Such an approach might offset some of the expense involved. In EBAP/83/268, the staff referred to the inconvenience and duplication that would be involved if contiguous space was not available in International Square. Was it possible to quantify that aspect of the issue? Furthermore, if the proposed space was not leased at present, did such a decision preclude the possibility of leasing additional space in International Square when required in two or three years' time? Finally, he invited the staff to comment further on the state of the Washington real estate market.

Mr. Clark asked whether projections of staff numbers in the late 1980s were available and whether consideration had been given to coordinating the Fund's demand for office space with that of the World Bank?

Mr. Camara stated that, while he appreciated the need for planning future office space requirements, the Fund should not take the proposed decision hastily, particularly since the need for additional space over the next few years remained unclear. He would prefer to see the full utilization of the pockets of vacant space existing in the headquarters building. A strong case for extra space should be made before the Executive Board decided to seek a new lease.

Mr. Kabbaj noted that the amount of space involved and the cost were relatively small. However, given the expense of leasing in the downtown area, had the staff studied the possibility of relocating the Fund in a suburban area, perhaps in conjunction with the World Bank?

Mr. Caranicas commented that the case for the proposed decision had been well documented in EBAP/83/268 and that he could support it. It was particularly important to retain flexibility with regard to future space requirements. On a separate point, upon completion of the reallocation of space in the present building, would Executive Directors have available the space that had previously been used as an Executive Directors' lounge?

The Acting Chairman observed that planning was always a difficult exercise, particularly with regard to future staffing requirements. At one time the Fund had attempted to make five-year projections of staff needs, but the exercise had not proved useful. For example, in 1978, on the basis of the projections made then, he had testified before the District of Columbia zoning authorities that the addition to the headquarters building would accommodate staff members until 1988 or 1989. The nature of the Fund's activities made planning somewhat more difficult than in other international organizations. In addition, the relative lack of suitable space close to the Fund placed the organization in an undesirable bargaining position in the real estate market. With regard to the question of the Executive Directors' lounge, space would be made available for that purpose, probably on a smaller scale than in the past, in 1984.

The Director of the Administration Department said that full utilization of existing space was the first priority, but the margin of space remaining was small, amounting to room for about 40 persons. Coordinating space requirements with the World Bank was difficult because of the difference in the sizes of the two institutions, but some leasing arrangements had been made in the past, and, if the proposed space in International Square was not needed immediately, the Fund would probably look for a subleasor on a short-term basis, and the Bank was an obvious candidate. The possibility of moving some departments out of the downtown area had been discussed with the World Bank on an exploratory basis, but the only practicable areas of activity that might be moved to a suburban location were the IMF Institute and the Bank's Economic Development Institute.

The staff representative from the Administration Department observed that the Washington real estate market as a whole remained a buyers' market at the moment. However, in International Square, virtually all the available space was already leased. After considerable investigation, the staff had focused on International Square because it offered the possibility of gradual expansion or contraction. In particular, having space contiguous to existing space offered the possibility of real savings. For example, a laser beam communications connection had been put in place between the headquarters building and International Square. To repeat such an operation in another building would be very costly. Furthermore, obtaining the space proposed in EBAP/83/268 would provide greater security because, if another tenant held the space, the Fund would have to provide access through its area. In addition, the number of messengers required could be reduced.

Mr. Zhang asked whether the cost per square foot of renting the proposed space was the same as the cost of the present lease. How large was that space relative to an Executive Director's suite? How large were the groups of visitors who used Fund space?

The Director of the Administration Department replied that the rent for the new space was $26 per square foot a year, about the same as the cost of the present lease. In comparison, the cost of the space that the Fund had considered renting from George Washington University would have been about the same, but $35 per square foot would have been required in addition to fit out the space for occupancy. The fit-out cost in International Square was considerably less--about $8 per square foot. The 2,600 square feet in question represented approximately the same amount of space as one Executive Director's suite.

The staff representative from the Administration Department said that there was no single group of regular visitors that might, in practice, be accommodated in the space in question. The External Auditors were a possibility, but they already had space in the headquarters building. Another possibility might be to use the space for consultants, such as those working on compensation and career stream issues.

Mr. Zhang asked how many rooms would be provided in the new space.

The Director of the Administration Department replied that the additional space would be equivalent to about ten economists' offices, not allowing for service areas, e.g., corridors, secretarial and file space, and the like.

The Executive Directors then took the following decision:

> The management is authorized to enter into a sublease for approximately 2,641 square feet of commercial office space at the International Square building (1875 I Street, N.W.) as outlined in EBAP/83/268. The sublease could, if necessary, include a waiver of the Fund's immunity from suit on matters arising under it, as has been done in the case of previous leases.

Adopted November 14, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/153 (11/7/83) and EBM/83/154 (11/14/83).

4. ZIMBABWE - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/227, Supplement 1 (11/7/83). 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 Zimbabwe to not later than December 16, 1983.

Decision No. 7557-(83/154), adopted
November 9, 1983

5. YEMEN ARAB REPUBLIC - TECHNICAL ASSISTANCE

In response to a request by the authorities of the Yemen Arab Republic for technical assistance, the Executive Board approves the decision set forth in EBD/83/285 (11/8/83).

Adopted November 10, 1983

6. PERU - FUND REPRESENTATIVE

The Executive Board approves the recommendation set forth in EBAP/83/272 (11/3/83).

Adopted November 8, 1983

7. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the GATT consultations with Brazil, Ghana, Peru, Tunisia, and Turkey, to be held in Geneva, as set forth in EBD/83/282 (11/4/83).

Adopted November 8, 1983

8. <u>EXECUTIVE BOARD TRAVEL</u>

Travel by Executive Directors as set forth in EBAP/83/273 (11/4/83) and EBAP/83/274 (11/8/83) and by an Advisor to Executive Director as set forth in EBAP/83/273 (11/4/83) is approved.

APPROVED: March 26, 1984

LEO VAN HOUTVEN
Secretary