MASTER FILES
ROOM C-525

0404

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/76

10:00 a.m., May 16, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
G. K. Arora	
F. Cassell	C. Enoch
C. S. Clark	
Dai Q.	
T. C. Dawson	
	L. Hubloue, Temporary
	L. B. Monyake
	F. E. R. Alfiler, Temporary
	R. J. Lombardo
	M. A. Fernández Ordóñez
	G. García, Temporary
	J. Basiuk, Temporary
	M. A. Ahmed, Temporary
	A. Gronn, Temporary
M. R. Ghasimi	O. Kabbaj
G. Grosche	
J. E. Ismael	T. Sirivedhin
	S. P. Shrestha, Temporary
	L. I. Jácome, Temporary
J.-P. Landau	J.-L. Menda, Temporary
	G. Serre, Temporary
Mawakani Samba	C. V. Santos
	A. R. Ismael, Temporary
	M. Al-Jasser
G. A. Posthumus	
K. Yamazaki	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

Also Present

IBRD: R. Bendokat, L. Hinkle, Africa Regional Office; S. Ahmed, Asia Regional Office. Administration Department: H. Wiesner. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; P. Dhonte, P. H. Mathieu, I. S. McCarthy, R. L. Sharer. Asian Department: H. Neiss, Deputy Director; K. A. Al-Eyd, S. V. Dunaway, A.-M. Gulde, E. Gurgen, N. Happe, L. M. Koenig, H. Vittas. Exchange and Trade Relations Department: T. Leddy, Deputy Director; R. A. Feldman. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; P. L. Francotte, J. W. Head. Secretary's Department: B. Burton, R. S. Franklin. Treasurer's Department: D. Williams, Deputy Treasurer. Western Hemisphere Department: M. Kabedi-Mbuyi. Advisors to Executive Directors: N. Adachi, M. Eran, Z. Iqbal, P. O. Montórfano, A. Napky, P. Péterfalvy, A. Raza. Assistants to Executive Directors: C. Björklund, H. E. Codrington, T. T. Do, S. K. Fayyad, J. Gold, M. A. Hammoudi, M. E. Hansen, A. Hashim, A. Iljas, M. E. F. Jones, K. Kpetigo, H.-J. Scheid.

1. INDONESIA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Indonesia (SM/90/66, 4/18/90). They also had before them a background paper on recent economic developments in Indonesia (SM/90/78, 5/2/90).

Mr. Ismael made the following statement:

Since 1983, the Indonesian Government has been taking a coherent series of measures with broadly the same objective: to adjust the economy to lower oil revenue by developing a more diversified and competitive economy with sources of production less dependent on the public sector.

Faced with a reduced availability of external resources for the public sector, the Government curtailed public spending through austere budgets that progressively reduced subsidies while introducing a series of tax reform measures that simplified the system and widened the tax net. The Government also encouraged a greater private sector contribution to the economy and promoted non-oil exports.

To create a more competitive economy and encourage private domestic and foreign investment, far-ranging deregulatory measures have been introduced. Protective barriers have gradually been removed, and greater freedom to import, trade, and distribute goods has been introduced. Regulations affecting the financial and banking system have been modified to encourage higher levels of domestic savings, revitalize the stock exchange, and facilitate the effectiveness of monetary management.

In February 1989, the Government took a number of measures to further stimulate oil exploration by reducing uncertainties regarding new contracts and renewals of expiring contracts by foreign oil companies. To further improve the investment environment, the Government in May 1989 replaced its complicated investment priority list, which classified some 1,300 sectors open to investment, with a negative list of 110 fields closed to foreign and domestic investors. At the same time, the minimum investment amount was lowered from $1 million to $250,000. In addition, private foreign and domestic investors are now permitted to build new industrial estates and operate them for 30 years.

Several follow-up measures in the banking sector have been adopted as well. To help bring about a reduction in the prevailing high interest rates, offshore borrowing ceilings were lifted in March 1989 and replaced with a new provision requiring banks to maintain daily foreign exchange net positions not exceeding

25 percent of their capital. In an effort to develop the interbank foreign exchange market and prepare for the possible eventual free float of the rupiah, the procedure of controlling the currency's value by fixing the selling rate of the rupiah each morning and supporting that rate as necessary to clear the market was changed in October 1989. Now, the spot market fixing is made in the afternoon, forcing foreign exchange dealers to make two-way quotes and rely more heavily on the interbank market during most of the trading day. Rapid developments in the area of financial savings, where more than 80 types of savings schemes were developed by banks during 1989, encouraged the Government to deregulate the two government savings schemes, Tabanas and Taska, in early December 1989.

Monetary policy during 1989 supported higher economic growth. As a consequence, domestic credits and broad money--M2--expanded sharply, by 52 percent and 37 percent, respectively. However, a major change to credit policy was introduced in late January 1990 to make the banks more competitive and market oriented. A number of interest rate subsidies have been reduced sharply, and subsidies for exports have been completely eliminated. Eligibility for these so-called liquidity credits of the central bank has also been tightened and is now restricted to farmers, cooperatives, the state market intervention agency, Bulog--which provides price support for certain key commodities--and investment. To ensure access to credit for small businesses, banks other than foreign and foreign joint venture banks have been given one year to increase their allocation of lending to this sector to 20 percent, excluding their liquidity credit portfolio.

Fiscal policy during the past year focused on enhancing the Government's ability to increase development expenditures through further intensification of tax collection.

Exchange rate policy continued to be concentrated on maintaining export competitiveness by allowing the rupiah to depreciate steadily against a basket of currencies. This was an important factor in expanding non-oil/gas exports. With the dollar gaining strength against most major currencies in 1989, the rupiah was allowed to fall slightly faster--by about 4 percent.

The economy has continued to respond well to the series of structural adjustment measures that have been taken, as well as to the monetary, fiscal, and exchange rate policies that have been directed toward promoting economic activity. These measures have taken into account the maintenance of monetary stability as well as a sustainable balance of payments.

The inflation rate in 1989 was contained at 5.97 percent, which is slightly higher than the rate of 5.47 percent in 1988; however, on a fiscal year basis, the 1989/90 inflation rate, 5.48 percent, was significantly lower than the 6.6 percent rate of 1988/89. These rates, it should be noted, have been calculated on an accumulated monthly point-to-point basis, which is the common practice in Indonesia; the Fund's calculation is made on an annual average basis, resulting in slightly higher rates.

Real GDP growth, estimated at 6.5 percent 1/ during 1989 and 5.7 percent in 1988, continued to be characterized by rapid development in the manufacturing sector. Real annual growth of per capita income during the fourth Five-Year Development Plan of 1984/85-1988/89 was 3 percent. In 1989, real per capita income grew by 4.4 percent. As a result, the ability to save increased remarkably. Total demand, time, and savings deposits recorded a 40 percent increase to Rp 50.6 trillion in 1989, as savings deposits rose to Rp 5.2 trillion from Rp 2.2 trillion in 1988, and time deposits increased by 36 percent, or Rp 7.3 trillion. Because this increase was more significant in time deposits with longer maturity, the term structure of banks' funds was improved, thus providing more longer-term funds to finance investment.

During 1989, approvals of foreign investment totaled \$4.7 billion. Although this amount was only 6.8 percent higher than in 1988, the number of projects increased over 80 percent to 264, reflecting a greater interest in smaller-sized projects, especially in the manufacturing sector.

Total exports are estimated to have risen by 18 percent to \$23.4 billion in 1989/90, almost matching the record high of \$23.7 billion in 1981, but with a much better composition, as non-oil/gas exports accounted for 60.7 percent. The growth in investment and non-oil/gas exports, as well as the increased economic activity, has strengthened the demand for capital goods and raw materials, thereby boosting the value of imported goods by 19 percent to \$16.2 billion in 1989/90. Nevertheless, the current account deficit is estimated to have improved from \$2 billion in 1988/89 to \$1.7 billion in 1989/90.

1/ The World Bank estimated the growth rate at 7.5 percent while the Fund staff adopted the Indonesian Central Bureau of Statistics' unofficial estimated growth rate of 7.3 percent. Until that estimate is made official, the Indonesian authorities prefer to state conservatively that the growth rate during 1989 was about 6 percent. The estimated growth rate used here is not only the average of the official 1988 and unofficial 1989 estimated growth rates, but also the estimated growth rate used recently by the Asian Development Bank.

Net official reserves have been roughly sustained at about five months of non-oil/gas imports, namely, at $6.1 billion in 1989/90, compared to $5.7 billion in 1988/89. However, reserves decreased from April to September 1989, mainly because only 10 percent of the available special assistance was disbursed during that period, instead of the expected 50 percent. Subsequently, almost 65 percent of the total special assistance available for the whole fiscal year was disbursed, which realigned official reserves with the initial projections.

Recently released actual budget data for the fiscal year 1989/90 show that oil and gas revenues amounted to Rp 11.2 trillion, compared with the Rp 7.9 trillion projected in the budget. Higher import growth also resulted in greater than anticipated revenues from import duties. Consequently, actual domestic revenues were Rp 28.7 trillion, compared with Rp 25.2 trillion budgeted for the year. On the expenditure side, actual development expenditures amounted to Rp 13.7 trillion, against the budgeted Rp 12.1 trillion, while actual routine expenditures amounted to Rp 18.3 trillion, against Rp 16.9 trillion as budgeted. The actual deficit was a combined Rp 3.3 trillion, compared with Rp 3.8 trillion as projected in the budget.

There is no doubt that the adjustment policies that have been introduced since 1983 have produced favorable results. These efforts will therefore be continued. Because the direction of government policies has been clearly determined, the forthcoming adjustment measures will be complementary in nature and intended to strengthen the policies that are already in place.

Monetary policy will continue to aim at fostering economic development while maintaining monetary and balance of payments stability. To achieve the intended 5 percent annual rate of growth under the fifth Five-Year Development Plan, financing support from the banking sector will continue to play a very important role. Therefore, mobilization of the resources required for financing will be further improved. In passing, it should be noted that a yearly growth rate of about 6 percent should not be ruled out in light of recent developments.

The 1990/91 budget that was presented to Parliament in early January 1990 calls for a fall in the budget deficit to about 1.9 percent of GDP, compared with the previous fiscal year's budget deficit of 2.4 percent of GDP. In line with established fiscal policy, the expected shortfall between expenditures and domestic revenues of an estimated Rp 3.5 trillion--about $1.9 billion--will be covered by inflows from abroad, mainly in the form of aid and official borrowing. Revenues are expected to increase by 25 percent, while expenditures are slated to grow by

20 percent over the current fiscal year budget. As in past budgets, a significant portion of routine expenditures will be allocated to pay interest on the Government's foreign debt. For 1990/91, interest servicing is expected to amount to Rp 5.2 trillion, or $2.85 billion--about 26 percent of total routine expenditures.

Continuation of the chartered course of actions will present major challenges to the authorities. However, with the momentum generated by increased exports and output, the authorities are confident that developments in 1990 will continue to improve the prospects of success for the whole economy.

In conclusion, I would like to state that, on the whole, my authorities concur with the general thrust of the staff appraisal.

Mr. Yamazaki made the following statement:

The Indonesian authorities are to be congratulated on the continued progress in their economic adjustment efforts. As this chair noted on the occasion of the 1989 Article IV consultation, the authorities' timely and judicious response to the decline in oil prices has brought about satisfactory economic performances since the middle of the 1980s. In 1989, in particular, against a backdrop of recovery in oil prices, significant progress was made in the structural areas, thereby providing further momentum to the adjustment process.

Despite such favorable developments, Indonesia still faces formidable economic challenges in the years ahead. In terms of per capita GDP, the country is one of the poorest in the world, with close to one fifth of its population living below the poverty line. Also, despite remarkable growth in the non-oil/gas sector, the country is still heavily dependent on the oil and natural gas sector, and its economy is vulnerable to external shocks. There is no room for complacency, therefore, and the authorities should continue to strengthen the adjustment momentum so that the population can benefit from the improved economic situation brought about during the 1980s.

Because I broadly agree with the staff's analysis, I would only like to emphasize the following points. First, on fiscal policy, it should be noted that, although the remarkable progress in reducing the fiscal deficit in the 1989/90 budget is welcome, most of the improvement is attributable to higher than expected oil and natural gas revenues. In this connection, I am somewhat concerned about the recent salary increase of government workers and the large subsidy payments. According to Mr. Ismael's opening statement, the final budget outcome indicates that not only routine but also development expenditures increased during this period. In view of the recent decline in development expenditures in relation to GDP, the authorities' decision to allocate part of the unexpected additional revenue for development is understandable. Given the need to increase domestic savings through fiscal restraint, however, one might argue that the gain from higher oil prices should have been used to consolidate the fiscal position further, thereby providing more resources for the private sector. Perhaps the staff could comment on this point.

As regards the 1990/91 budget, I broadly support the authorities' intention to increase non-oil/gas revenues while making prudent assumptions on oil prices. Like the staff, however, I am not very optimistic about the prospects for gains from improved tax administration. In my view, it will take some time before any significant benefits can be seen.

On monetary policy, I fully agree with the staff that a significant reduction in the rate of monetary and credit expansion is essential to provide the adjustment effort with a sound macroeconomic foundation. In this connection, I welcome the major change in credit policy in February 1990, which aimed at providing a more competitive and market-oriented environment for banks and monetary authorities. Looking ahead, the authorities are expected to strike a delicate balance between the need to contain credit and the need to foster economic growth. As I stressed at the outset, increasing per capita income is critically important for alleviating poverty; nonetheless, given the continued vulnerability of the Indonesian economy to external shocks, it would be premature to loosen credit policy at this stage. Specifically, I agree with the staff that there is not much scope for reducing interest rates.

With respect to structural policies, Table 5 on page 12 of the staff report provides striking evidence of the adjustments made to the Indonesian economy in a relatively short period of time. In addition, the unwavering commitment of the Indonesian authorities to continue the structural adjustment process that Mr. Ismael referred to in his opening statement is welcome. Nonetheless, given the need to meet the ambitious targets contained in the Five-Year Development Plan, much remains to be done.

First, the reform of the financial sector needs to be strengthened. In particular, given the rapid expansion of the banking system, the strengthening of bank supervision should be given high priority. The role of Fund technical assistance in this area should be heavily emphasized.

Second, although the recently formulated plans to reform the public enterprises are welcome, the mixed ownership scheme that has been envisaged might not be sufficient to eliminate completely the inefficient management system. In any event, a transparent accounting system needs to be established to provide data for correctly assessing the performance of the enterprises.

Third, although the liberalization measures pertaining to investment and foreign trade are welcome, the remaining restrictions in these areas are not consistent with the goal of doubling non-oil exports by 1992/93. I would therefore encourage the authorities to take additional measures aimed at diversifying the economy in the medium term.

On the external front, I broadly support the flexible exchange rate policy aimed at maintaining competitiveness. Moreover, I welcome the inclusion of environmental issues in this year's consultation paper, in view of the subject's growing importance.

I conclude by reiterating my appreciation for the unrelenting adjustment efforts of the Indonesian authorities. Looking ahead, it is clear that their continued perseverance in pursuing economic adjustment will go a long way toward eliminating the long-standing problem of poverty and transforming the economy into a more diversified and industrialized one.

Mr. Al-Jasser made the following statement:

Over the past several years, and despite a relatively weak international oil market, Indonesia has recorded impressive growth while keeping inflationary pressures under check. The external current account deficit has been reduced steadily through a determined increase in non-oil exports. National savings and investment have grown steadily and, combined with an increasing share of nongovernmental investment in total investment, have laid down a solid basis for longer-term growth. These achievements reflect the pursuit of appropriate financial policies and comprehensive structural reforms. Fiscal restraint has been maintained, and exchange rate policy has continued to be appropriate. The authorities should be commended for persevering with sound policies that have improved the domestic economic environment. Moreover, Indonesia has carried out an orderly and timely servicing of its debt, despite a large external debt burden and external financing pressures.

Given the strengthening of the external environment, the medium-term outlook is highly promising. In these circumstances, the authorities' objective of undertaking rapid export-oriented growth with the aim of reducing poverty and increasing employment is entirely appropriate.

The staff and the authorities broadly agree on the thrust of the economic strategy required to achieve Indonesia's medium-term objectives, and I concur with their appraisal. In view of past developments and the medium-term outlook, however, I wonder whether it would not be advisable for the staff to make their future assessments of the Indonesian economy in a framework that is more growth oriented than adjustment oriented.

The authorities' strategy of diversifying to reduce excessive dependence on petroleum and natural gas exports is fully justifiable. Although, in this context, the central role of an appropriate exchange rate cannot be overemphasized, it will also be essential to strengthen the environment for expanding non-oil output and exports. The authorities are aware of the need to enhance Indonesia's attractiveness for foreign direct investment; therefore, although appropriate macroeconomic policies for establishing the appropriate environment are being pursued, a speedy reduction of trade restrictions and deregulation of foreign direct investment would also help greatly. The staff has observed that, in this respect, additional measures might be needed to improve comparability with other countries in the region. Could the staff specify what additional measures it has in mind?

Structural reforms will undoubtedly need to continue, in order to ensure adjustment to a changing international economic environment. Further progress in this area would benefit greatly from the timely provision of data on those state enterprises that have undergone restructuring over the past five years, as the establishment of a comprehensive information system would therefore help in the design and monitoring of future policies.

Another important outgrowth of the structural reforms has been the proliferation of banks and the attendant increase in competition in the financial market. The authorities are clearly cognizant of the need to strengthen prudential supervision, and, in this context, I hope that the Fund's assistance will continue to be helpful to Bank Indonesia.

Although the authorities have been prudent in following moderate fiscal and monetary policies that have laid a solid foundation for growth, they may need to monitor carefully the recent acceleration in liquidity expansion. This increase has not yet led to liquidity overhang or inflationary pressures; nevertheless, the authorities should be ready to address these consequences--perhaps through an adjustment in interest rates. In this context, the authorities should be commended for reducing the availability of subsidized credit through central bank rediscounting under the liquidity credit operations.

Mr. Grosche said that the Indonesian authorities deserved commendation for their prudent macroeconomic and structural reform policies. Over the recent past, those policies had fostered the diversification of the economy and induced high rates of investment and growth while strengthening the balance of payments. One of the most positive aspects of that performance was its implication for the future, especially as, according to Mr. Ismael's opening statement, the authorities were resolved to continue with their policies of adjustment. It was additionally satisfying to note the authorities' growing awareness of the environmental and distributional aspects of Indonesia's rapid economic growth.

He broadly endorsed the staff appraisal, Mr. Grosche continued. In that connection, price stability should be especially singled out as being critically important to ensure sound and sustainable growth. The rapid growth of money and credit in 1989 had therefore given rise to some concern, and the envisaged phasing out of a major part of the liquidity credits during 1990--which should contribute to a necessary tightening of monetary policy--was welcome. Unfortunately, a number of exceptions for liquidity credits remained in place, which could undermine the tightening of the policy stance and reduce the efficiency of credit allocation.

Cost and price pressures could result from the envisaged reduction of subsidies on fertilizer and oil products, Mr. Grosche observed. Those measures were highly appropriate and most welcome in terms of alleviating the burden on the budget and reducing distortions, but vigilance was warranted to ensure that the price adjustments should not be cushioned by an expansion of the money supply. Against that background, he endorsed the staff's recommendation that interest rate policy should be used as a flexible response to any tightening of market conditions.

In the medium term, the policy goal of containing inflation near current levels rather than reducing it was a cause for concern, Mr. Grosche stated. Continuing inflationary expectations could hinder the optimal allocation of scarce resources and thus cloud the prospects for high and sustained growth. The staff had done an excellent job of describing the impact of inflation in the recently published World Economic Outlook, and it would have been helpful if the medium-term scenarios in the staff report on Indonesia had incorporated more of those assumptions in its assessment of inflation's impact on growth.

Cost developments and exchange rates were closely linked, Mr. Grosche commented. It was therefore somewhat disconcerting to read in the staff appraisal that it would be important "to continue flexible exchange rate management to support the goal of rapid export growth in the medium term."

As other cases had demonstrated, aggressive exchange rate policies could lead to domestic cost and price pressures that quickly eroded the devaluation gains. Alternatively, competitiveness could be improved through primarily domestic means that emphasized cost and price stability and increased efficiency, with the exchange rate instrument relegated to use as only a second-best, supporting device. However, the authorities could be trusted to manage that policy aspect as prudently as they managed the others.

Mr. Cassell made the following statement:

I am happy to congratulate the Indonesian authorities on the success of their macroeconomic and structural reform policies. Over the past seven years, Indonesia has given an admirable demonstration of sound policy reaction to adverse circumstances. It is now rightly benefiting from that response. As can be seen from the staff's medium-term projections, export-oriented GDP growth is expected to remain strong and to reduce the scale of the country's debt-service burden.

In the past year, growth has been rapid and broadly based. The fiscal balance has continued to strengthen, savings and investment have increased as shares of GDP, and structural reform initiatives have continued. Although this has been helped in part by higher than expected earnings from the energy sector, there is no doubt that the Indonesian economy is fundamentally stronger than it was when falling oil prices hit it so hard in the mid-1980s.

The staff's baseline medium-term scenario assumes that domestic policy will continue to foster rapid export-oriented growth. The first of the alternative scenarios illustrates the likely effects of inadequate macroeconomic policies. These results are not appealing. The obvious way forward is to build on the success so far achieved.

On the fiscal side, the stronger oil prices in 1989 were a helpful windfall. However, nonenergy revenues were also much higher, indicating that the skepticism that I had expressed about the target during the 1989 discussion on Indonesia was plainly unfounded. However, these revenue gains did not result in a reduction in the budget deficit; spending also increased beyond the budgeted level.

Given the fragility of energy revenues, it would be imprudent if higher spending were to become entrenched in the budget. The explosion in subsidy payments is disturbing, for efficiency as well as for budgetary reasons, and I welcome the authorities' intention to reduce them. In addition, the staff may have underplayed the inflationary consequences of the 10 percent salary and pension increment awarded to civil servants and the armed services in the 1990/91 budget.

The most telling argument for further budgetary restraint is the need to sustain the upward trend of national savings, which is heavily dependent on the public sector. I agree with the staff's view that public enterprises should play a significant role in this pursuit. The move toward privatization of enterprises through issues on the Jakarta Stock Exchange is therefore welcome for its likely contribution to the development of capital markets, as is the privatization of the stock exchange itself; however, it is difficult to see how far privatization can progress until fuller data on the performance of each enterprise becomes available.

Increasing efficiency in the public enterprises with a view to inducing a more effective use of resources is an essential component of structural reforms. So also is further progress in liberalizing the investment and trade regimes. Although foreign investment has increased sharply, in part no doubt reflecting the deregulation package of May 1989, there still seem to be significant restrictions on outright foreign ownership of enterprises. Moreover, the staff report highlights the continuing complexities of trade restrictions.

In the financial sector, the success of the authorities' liberalization policy can be seen in the growth of deposits, particularly time deposits. The growth of these potentially spendable funds, however, makes it increasingly important that interest rates remain attractive to savers. Unfortunately, the increased availability of preferential liquidity credits over the past year not only thwarted this objective, but also distorted the allocation of credit. Increasing subsidized credits while lowering reserve requirements therefore loosens the monetary stance twice over. The sterilization measures that were adopted may be an effective, if expensive response, but not one that should be relied on for too long; if emerging demand pressures are to be contained, growth in money and credit needs to be reduced.

The very rapid rates of monetary growth recorded in 1989 must be a cause for concern. The recent measures taken by the authorities to cut interest rate subsidies and restrict eligibility for liquidity credits are certainly welcome; however, it remains to be seen whether they are enough to impose the necessary restraint.

As the financial system becomes more competitive, the strength of banks, and in particular the quality of their assets, will be tested. Further progress in banking supervision and in enhancing capital adequacy is thus important.

On the external side, the importance of export growth and the strong competition in the region combine to make a real appreciation of the exchange rate undesirable. However, the increasing openness of the economy, in particular to foreign investment, requires that confidence in the rupiah must be present. Presumably, the decline in the demand for forward cover largely reflects the shift to a market-based premium; however, it might also be an indicator of excess domestic liquidity. Greater confidence in the currency must also have had some effect. It would be a mistake to endanger that confidence, and the authorities may need to pay careful attention to the recent trend in interest rate differentials illustrated in Chart 2 of the staff report.

There is also a pressing need to improve the quality of Indonesia's economic statistics. I note the staff's involvement in securing improvements here, but the delays in releasing data on, for example, oil production and the external sector are a source of continuing concern.

If Indonesia continues to follow the policy agenda that it has set for itself, including the further careful management of external debt, the significant improvement in the overall external position shown in the staff's baseline projection for the medium term should be feasible. However, as Mr. Ismael said in his opening statement, "continuation of the chartered course of actions will present major challenges to the authorities." The authorities' objectives are ambitious, as they properly embrace an emphasis on alleviating poverty and protecting the environment. However, the authorities have shown an outstanding commitment to the pursuit of those objectives that augurs well for their future endeavors.

Mr. Menda made the following statement:

Indonesia's economic performance has been impressive in recent years. In 1986, the Indonesian authorities reacted promptly to adverse external conditions by adopting a comprehensive set of measures. This package, which included strict macroeconomic policies and a comprehensive range of structural measures, led to a major diversification of the economy, strong growth of private investment, and a significant opening of the economy to international competition. In 1989, the performance was remarkable: the GDP growth rate exceeded 7 percent; real investment rose by 15 percent to one third of GDP; the inflation rate declined to 6.5 percent; and the current account deficit was reduced to 1.7 percent of GDP. The Indonesian authorities must be commended for these impressive achievements, which provide another clear example that adjustment and growth are not incompatible.

I agree with most of the conclusions in the staff report. The global strategy of the Indonesian authorities, which is aimed at diminishing poverty and unemployment, implies the maintenance of a high level of growth. In that context, the medium-term scenarios elaborated by the staff point to the necessity of maintaining strict macroeconomic policies and deepening the structural reforms, given the already high level of external indebtedness and the projected decline in external aid. These scenarios, therefore, clearly illustrate the fact that any other course of action would be costly in terms of growth and external equilibrium.

This situation implies that fiscal policy will play a key role in generating higher domestic savings and minimizing recourse to external financing. I share the staff's view that a further strengthening of non-oil revenues and a reduction of subsidies will be crucial. I welcome the authorities' commitment to the latter point, therefore, as expressed in the staff report and in Mr. Ismael's statement. Further reforms of the public enterprise sector will also be critical for fiscal policy, and the authorities' intention to carry out divestment proceedings in this area is most encouraging.

With respect to monetary policy, there seems to be some divergence of view between the staff and the authorities on the need for tightening. The authorities point to the necessity of reducing the already high level of interest rates; however, the staff is properly concerned about monetary developments during the past year, when domestic credit and money were estimated to have grown by 43 percent and 32 percent, respectively. In these circumstances, I believe that the authorities should not take the risk of allowing a resurgence of inflation and should therefore be prepared to raise interest rates, if necessary. Furthermore, the phasing out of subsidized loans--equivalent to one fourth of commercial bank credit at the end of 1989--is certainly an important step toward the promotion of a better allocation of resources.

Turning to exchange rate policy, I note that the staff warmly welcomed the success of the flexible regime and its positive effects on export diversification. Because Mr. Grosche has already expressed views quite close to ours, I will only add that, after a significant adjustment in 1986, subsequent adjustments to the rupiah have been moderate. In fact, Chart 3 of the staff report indicates that the nominal and real exchange rates have been fairly stable during the past two years, with no damaging consequences for exports.

I would also appreciate the staff's comments on the apparent contradiction, in a regime of flexible exchange rates, between two of their recommendations: on the one hand, to pursue a gradual depreciation of the exchange rate in nominal terms to maintain competitiveness; and, on the other, to implement a stricter monetary policy. If the latter objective were to be given priority, the authorities would seem to have no other choice than to allow an exchange rate appreciation.

Finally, I can endorse the additional steps proposed by the staff in the area of structural policies. Despite the considerable progress that has already been made, investment deregulation actions remain to be implemented; even after the introduction of the structural policy package in May 1989, this sector continues to be more restrictive than in neighboring countries. There also remains some scope for the further liberalization of imports, with a view to achieving the Five-Year Development Plan's goal of doubling non-oil exports by 1992/93.

Mr. Hubloue said that Indonesia was a model of successful adjustment grounded in the implementation of debt policies. One aspect of the Government's strategy that deserved special commendation was its high degree of coherence and continuity: all of the economic measures taken since 1983 had aimed at a gradual but very systematic deregulation of the productive sectors and a reduction of the role of the state in the economy. In his opening statement, Mr. Ismael confirmed that predictability would remain the watchword in the future by concluding that "because the direction of government policies has been clearly determined, the forthcoming adjustment measures will be complementary in nature and intended to strengthen the policies that are already in place."

Given that high degree of predictability, there was no reason for the productive sectors of Indonesia to wait on the sidelines until all the elements of the adjustment strategy were fully in place, Mr. Hubloue continued. On the contrary, both the systematic recovery of investment as a share of GDP and the rapid diversification of economic activity demonstrated that the productive sectors' confidence in the Government's policies was strong and likely to remain so in the years ahead.

The dynamic interaction between government policies and the expansion of the business sector had reached the point where future adjustment requirements could almost come automatically to the fore, Mr. Hubloue commented. It could also be expected that that dynamism would facilitate the construction of a national consensus with respect to future economic priorities. Three areas could be singled out for additional action in the near term: first, the strengthening of internal savings, in order to supply the investment resources needed for the country's further industrial development; second, the liberalization of the investment code, in order to promote a sufficient supply of external savings without jeopardizing Indonesia's external debt policies; and, third, the introduction of competitive money and capital markets, in order to assure sound resource allocation.

The reforms recently introduced in the third area were impressive and very welcome, Mr. Hubloue remarked, given that a year ago the Board had cautioned that the system of liquidity credits could increasingly distort Indonesia's transition toward market-based lending decisions and efficient financial policies. The Government's role in the allocation of credit flows, however, had not been wholly abolished, as the banks would still be required to allocate a certain percentage of their loan portfolios to cooperatives and small-scale enterprises. Although the staff appeared to have some reservations about the new requirement, one should perhaps not be too dogmatic about the inefficiency risks entailed by such a mild form of market regulation, as long as it played a useful role in facilitating the initial stages of Indonesia's industrial development. After all, other countries had also indulged quite extensively in preferential credit schemes at similar stages of their development, and there was no reason to believe that the Indonesian authorities would hesitate to reconsider their views as soon as it became clear that the present requirement had outlived its usefulness.

Indonesia was making rapid progress toward winning a place among the group of middle-income newly industrializing countries, Mr. Hubloue observed. It was important to ensure that, during that process, the large share of the population still living below the poverty line would not marginalized. Realizing that objective would require a continuation, and perhaps even an intensification, of the Government's current poverty programs. At the international level, it would require acceptance of the notion that Indonesia's progress toward middle-income status did not disqualify it for further development assistance on sufficiently concessional terms.

Mr. Posthumus said that the Indonesian economy was continuing to develop in a very satisfactory way. Over the years, financial and economic policies had been carried out cautiously, but, when necessary, adjustment had been bold. A consistent structural adjustment policy implemented over a number of years had resulted in a decreased reliance on net foreign borrowing. The debt-service ratio had decreased while real GDP growth had increased, and inflation had been kept under control. Furthermore, efforts to diversify and broaden the growth process had caused a decline in the incidence of poverty, which was a major accomplishment.

Significant opportunities for development existed in Indonesia, Mr. Posthumus continued. If the industrial countries were to open their markets as an outcome of the Uruguay Round, Indonesia could benefit substantially by increasing its exports and thus further accelerating its development.

Monetary developments in Indonesia were interesting but difficult to judge, Mr. Posthumus considered. Those developments were presumably characteristic of a country where the monetization of the economy was still in process. Table 5 in the staff report--which, incidentally, contained some interesting indicators of structural reform--pointed to the increasing share of broad money in GDP as a structural phenomenon. In addition, major financial deregulation measures had been enacted over the past few years that had led to an increase in the volume of deposits, and liquidity credits from Bank Indonesia to private banks had grown substantially up to the end of 1989. Interestingly, price increases over the past few years had been neither overly large nor demonstrated a pattern of acceleration.

The monetary picture emerging from the staff report was not very clear, Mr. Posthumus remarked. The monetary survey data in Table 3 certainly pointed to accelerating increases in domestic credit over the year ending March 1990, but the year-on-year changes for March 1989 and March 1988 had also been large. The staff report also indicated that excess liquidity in the banking system had put downward pressure on the interbank, money market, and short-term deposit rates during the past year, but the extent and effect of excess liquidity creation in earlier years had not been discussed.

Whatever had taken place, the authorities and the staff were now in agreement that monetary and credit expansion should be slowed down substantially, Mr. Posthumus commented. However, there seemed to be a slight difference of opinion between the two as to the extent of the liquidity surplus: the staff believed that the scope for further reduction of domestic interest rates was minimal, and that an increase in interest rates might even be acceptable if necessary for attaining the monetary targets; the authorities, on the other hand, felt that some scope for interest reduction might still remain. That difference, which was more of a difference in analysis of the monetary situation than of policy preference, should perhaps have been expressed more explicitly in the staff report.

There seemed to be an internal contradiction, Mr. Posthumus said, between the staff's advice on page 10 of the report to direct monetary policy to attain the monetary targets and the authorities' intention, supported by the staff, to place greater reliance on monetary policy to influence exchange rate movements. It did not seem possible that monetary policy could serve both aims at the same time. Staff comment on that point would be appreciated.

Mr. Ahmed said that, since the Article IV consultation report in 1989, the Indonesian economy had continued to perform well. The implementation of sound macroeconomic and structural policies had enabled the economy to grow at a fast rate and with a reasonable measure of price stability. Progress in developing the non-oil sector of the economy, the principal beneficiary of deregulation, had been good. In addition, the fiscal and balance of payments positions had improved. In the latter case, the dynamism of manufactured exports had made a particularly noteworthy contribution. The confidence engendered by the pursuit of sound economic policies had led to a surge of domestic and foreign private investment approvals that should help to expand production capacity, largely in the export sector. Overall, the authorities deserved to be commended for the persistent implementation of sound policies and the strength of their adjustment effort.

He broadly agreed with the gist of the staff appraisal and would therefore make only three specific comments, Mr. Ahmed continued. First, with respect to the discussion on medium-term prospects, he welcomed the comprehensiveness of the staff's presentation, which included macroeconomic indicators such as growth, inflation, the budget, savings and investment levels, in addition to the usual external sector indicators. However, although there obviously were limits to the number of alternative scenarios that could be presented in the staff report, perhaps an additional scenario indicating the impact of a 1 percent increase in international interest rates on the fiscal and current account positions would have been topical. Second, Indonesia's successful adjustment performance had set the stage for rapid growth in the 1990s, Mr. Ahmed stated. The policy challenge for the authorities was to provide sufficient resources to support growth while continuing to preserve macroeconomic stability by containing the level of public expenditures. In that regard, the medium-term projections indicated that, as the current account moved into balance and net foreign savings disappeared, domestic investment would need to be sustained by a rise in government savings, particularly through non-oil revenues. Although that outcome would necessitate vigorous policy efforts on the part of the authorities, development expenditures were projected to remain essentially unchanged--at about 8 percent of GDP--over the medium term. A stronger fiscal effort was therefore justified, insofar as it would permit a higher rate of development spending on basic infrastructure and essential social services while allowing Indonesia to achieve rapid growth and sustain the progress that had been made in reducing the incidence of poverty.

Finally, the staff's projection of a worsening in the incremental capital-output ratio was somewhat puzzling, Mr. Ahmed observed, given the assumption in the baseline scenario that strong structural policies would continue to be implemented. Perhaps the staff could explain why the productivity of capital was projected to worsen over the medium term, in contrast to the improvement expected in the 1989 staff report.

Mr. A. R. Ismael said that he joined previous speakers in commending the Indonesian authorities for their steadfast pursuit of adjustment policies and structural reforms, which, as Mr. Ismael had noted in his opening statement, continued to produce favorable results. The preliminary data for 1989/90 confirmed the merits of the approach followed by the authorities, as Indonesia continued to enjoy strong noninflationary growth with financial stability. Despite those gains, however, serious challenges remained, and the authorities' intention to maintain the thrust of the adjustment efforts and to strengthen them in key areas was therefore welcome.

The authorities' policies, as described in the staff report, seemed appropriate to achieve the objectives that had been set, Mr. A. R. Ismael continued. Therefore, he generally agreed with the staff's comments and recommendations. In the fiscal area, although important measures had already been taken to increase revenue and improve tax administration, new revenue-raising measures and other actions to contain expenditures were needed in order to generate additional savings. Further steps to improve tax administration and to widen the tax base should also be considered. On the expenditure side, outlays on subsidies appeared to have increased significantly over the past year; the authorities' intention to scale them back was therefore welcome. Moreover, in view of the potential adverse effects on the economy of a sudden change in policy, the cautious approach to the phasing out of subsidies that the staff had recommended was probably more appropriate. With regard to the public enterprises, the announcement of plans to reform that sector and convert many of the enterprises to mixed private and public ownership was welcome. In the context of the Indonesian economy, the gradual approach taken by the authorities toward the privatization process was also appropriate, given that the capital market was underdeveloped and that a more rapid approach might have an adverse social impact.

In the financial sector, the reforms that had been undertaken had made an important contribution to the economic development of the country, Mr. A. R. Ismael noted. Moreover, the staff was correct to emphasize that the large increase in the number of banks had made effective bank supervision essential; the technical assistance that Indonesia was receiving from the Fund in that area was therefore welcome. More generally, the Government's money and credit policies had been broadly appropriate, and the authorities were encouraged to follow a stance conducive to containing inflationary pressures while meeting the development needs of the country.

With respect to the external sector, the further improvement in the current account balance was welcome, Mr. A. R. Ismael commented; in fact, the value of non-oil exports currently exceeded that of oil exports. The trade deregulation measures introduced earlier had certainly contributed to that development, and the authorities were encouraged to take the additional measures in that area that the staff had suggested. Such steps would complement the investment deregulation package that had been introduced in 1989, further enhance the export prospects of Indonesia, and contribute to the reduction of the debt-service burden.

Mr. Clark made the following statement:

In 1989, Indonesia's economy surpassed the performance of previous years, which, only a year ago, was characterized by this Board as remarkable. Economic growth accelerated by almost 7 1/2 percent, the inflation rate further declined to about 6 1/2 percent, the fiscal current account surplus was maintained above 6 percent of GDP, and both the external current deficit and balance of payments deficit were further reduced. Underlying these developments were substantial growth in domestic investment and savings and continued progress in the diversification efforts. This impressive performance record is the result of the authorities' strong commitment to, and sustained implementation of, prudent financial policies and structural reforms over the past several years. Nonetheless, despite Indonesia's impressive record, the country remains vulnerable to external and domestic developments, and the authorities must continue to exercise caution in a number of key areas.

In the area of fiscal policy, we commend the authorities' efforts to improve the current balance, and in particular their efforts to broaden the tax base and improve the administration of the tax system. As a result of these measures--plus the windfall gain from higher oil prices and the stronger than expected economic growth--the fiscal deficit was expected to be reduced from about 2 1/2 percent of GDP to just under 2 percent. Nonetheless, like other speakers, we regret that the authorities did not take full advantage of the opportunity presented by the increase in revenues to further reduce the fiscal deficit and reduce Indonesia's rather extensive reliance on external financing. Instead, subsidies were more than tripled, and civil service pay was increased by 10 percent in January 1990, following increases of 10 percent and 5 percent in 1989. Despite the fact that government wages had been frozen since 1985, these increases seem somewhat excessive. Perhaps Mr. Ismael could explain the authorities' reasons for these increases.

In general we agree with the staff that, over the medium term, the authorities must strengthen the current fiscal balance in order to supplement domestic savings, which are not likely to rise much from an already high level of about 25 percent of GDP. We note the continued efforts to improve tax administration and the authorities' intention to reduce subsidies. Moreover, we agree with the staff on the need to improve the financial performance of the public enterprise sector, and particularly the need to develop an adequate data base for this sector that can be used as a basis for policy decisions.

With regard to monetary policy, the credit expansion in the past year appears to have been somewhat excessive; some questions also remain about the forces that have led to the recent decline in the inflation rate. I am reassured by the authorities' intentions to limit credit growth this year. However, in our view, a further reduction of credit would be advisable to contain any lagged impact of the previous year's large liquidity expansion and to reduce the inflation rate below the planned target of 6 percent, which is still uncomfortably high. In general, it would seem advisable to aim for a more rapid reduction in inflation than is projected in the medium-term scenario.

We welcome the most recent systemic reforms in the monetary sector, including the phasing out of most liquidity credits and other preferential credit mechanisms. Beginning in 1983, extensive measures have been taken to liberalize and deepen credit markets and reduce Bank Indonesia's reliance on direct monetary controls. We agree with the staff that the authorities must now allow the market to play the dominant role in determining interest rates, and that they should avoid any attempts to offset increases in interest rates resulting from the reduction in liquidity credits. I note the authorities' concern that interest rates have been too high in recent years; however, the very substantial increase in domestic investment over the past years would suggest that these rates have acted not to constrain growth, but rather to contain excess demand.

Indonesia's external performance has been particularly impressive. Its success in diversifying exports is illustrated by the fact that non-oil/gas exports now account for over 60 percent of total export earnings, despite the strengthening of oil prices in 1989. Part of this success is due to the continuing competitiveness of the rupiah. In this regard, we welcome the efforts of the authorities to move toward a floating exchange rate and urge them to accelerate this process to the extent possible. I note that non-oil exports are forecast to continue growing at a healthy pace, although somewhat more moderately than in the past few years. It would be helpful if Mr. Ismael or the staff could comment on whether Indonesia's growth prospects in this area are hampered by either the tariff or the import restrictions that are maintained by its trading partners.

The rapid export growth in the past year has contributed to a substantial improvement in Indonesia's external debt-servicing position. However, a debt-servicing ratio of about 32 percent is still uncomfortably high and leaves Indonesia in a very vulnerable position. Over the medium term, if developments continue to favor Indonesia, the debt-servicing ratio is expected to decline to just over 19 percent. Nonetheless, we would caution the authorities to refrain from any further external financing on commercial terms.

Indonesia has initiated and implemented an impressive list of structural reforms, which have been discussed at some length in the staff report and in Mr. Ismael's opening statement. These reforms have been aimed at the promotion of an export-oriented non-oil industrial sector. The authorities have been quite successful in this objective; nonetheless, considerably more structural adjustment is required to remove the remaining distortions, regulations and, in general, unnecessary governmental interventions that impede the efficient operation of markets and reduce economic growth.

Mr. Ghasimi said that the implementation of far-reaching structural adjustment measures aimed at deregulating and diversifying the Indonesian economy had strengthened the non-oil sector, enhanced financial activities, liberalized the trade system, promoted private sector activities, and substantially expanded non-oil exports. Those measures had been complemented by appropriate monetary, fiscal, and exchange rate policies to address the economic and financial distortions experienced during the 1980s. The authorities were to be commended for the favorable results achieved thus far; moreover, it was satisfying to note that they were firmly determined to continue their adjustment efforts and reinforce the structural policies that had already been implemented.

He broadly agreed with the conclusions contained in Mr. Ismael's opening statement and with the thrust of the staff report, Mr. Ghasimi continued. In advising on how to respond to further demand pressures, the staff and Mr. Ismael had correctly insisted that monetary policy should be strengthened, in order to foster economic growth and maintain stability through improvements in credit management and resource allocation and mobilization. In that respect, the measures already taken were definitely steps in the right direction. Moreover, the authorities were to be commended for enhancing the supervision of the competitive, market-oriented financial institutions that had rapidly expanded following the deregulation measures adopted in October 1988. In that context, wider application of the monitoring system recently established by Bank Indonesia would be very useful.

The authorities were correct to stress that fiscal policy could play a crucial role in promoting domestic savings by curtailing government expenditures, improving the financial situation of public enterprises, and effecting tax reforms, Mr. Ghasimi remarked. It was also vitally important to continue to strengthen non-oil revenue, in view of the related objective of diversifying the economy.

It could hardly be denied that developments in the exchange rate system had played an important role in maintaining export competitiveness in Indonesia, Mr. Ghasimi said. However, given that the recent expansion of exports had been primarily fueled by the quintupling of manufactured exports over the second half of the 1980s, further attention should be paid to non-price or marketing factors such as quality control, promotion, and distribution.

The deregulatory measures introduced by the authorities to improve the investment environment, particularly with respect to private foreign investment, were encouraging, Mr. Ghasimi commented. In addition, the Government's intention to further reduce trade restrictions in the near future warranted support.

With regard to the management of the debt situation, Mr. Ghasimi remarked, the authorities deserved to be commended for their timely servicing of the external debt, despite the heavy debt burden and the high debt-service ratio. Furthermore, it was heartening to note the authorities' success in reducing poverty, as the World Bank had estimated that the number of poor in Indonesia had decreased by about five million during 1984-87. It was also pleasant to note that the authorities were taking proper measures to address the environmental problems that affected living conditions in the country.

Mr. Alfiler said that the Indonesian authorities were again to be commended for another year of impressive economic performance. It was clear from the staff report that the authorities' perseverance in implementing prudent macroeconomic policies and important structural reforms had generated a wider and more stable economic base for sustainable growth. Indeed, the prospects for the Indonesian economy had improved considerably since the mid-1980s.

Mr. Ismael's opening statement had strengthened that perception in its assurance that the authorities, confident of eventual success, would continue with their efforts, Mr. Alfiler continued. Like Mr. Ismael, he agreed with the general thrust of the staff appraisal; the staff had rightly identified those areas where closer monitoring by the authorities was required, and those where more effort needed to be exerted.

Specifically, closer monitoring of the public enterprise sector was important, as weakness in that sector could be a source of leaking in the plan to control fiscal resources, Mr. Alfiler observed. Furthermore, it was essential that the authorities should project an image of forcefulness in their efforts to privatize those enterprises; the adoption of less than optimal decisions in that area on the basis of inaccurate information could undermine those efforts and should therefore be avoided.

In an increasingly deregulated financial system, closer monitoring through strengthened supervision was required, Mr. Alfiler considered.

As in the public enterprise sector, the effectiveness of financial policy instruments could be weakened by loose financial supervision.

He fully agreed with the staff that further liberalization of trade and investment could greatly enhance Indonesia's competitiveness, Mr. Alfiler said. The need for actions in that field was especially great, owing to the fierce competition for foreign investments among the newly industrializing economies surrounding Indonesia.

More efforts should also be made to generate domestic savings through fiscal reforms, Mr. Alfiler suggested, in order to ensure that the country's high level of external debt did not affect its progress.

Mr. Gronn said that the progress of the Indonesian economy, as described in the staff report and in Mr. Ismael's opening statement, was remarkable. High growth rates, inflation under reasonable control, and a manageable external account could be ascribed to appropriate economic policies of adjustment and deregulation, although a favorable external environment had also helped. However, Indonesia still faced formidable economic challenges. Because he broadly agreed with the staff appraisal, Mr. Gronn continued, he wished only to raise a point--similar to a comment that Mr. Posthumus had made--with respect to the financial sector and monetary aggregates. He welcomed the policy of financial liberalization, including the most recent deregulation measures taken in 1988, which had resulted in a proliferation of financial intermediaries and a strengthening of competitiveness. That policy would contribute to an improved allocation of resources. In addition, and as a result of the deregulation, the necessity of focusing on prudential supervision should be underscored.

The process of deregulation had naturally contributed to a deepening of financial markets that had been reflected in the sharp increases of credit and monetary aggregates, Mr. Gronn commented. Although inflation seemed to be contained, the actual magnitude of the credit and money growth rates over the past years might give rise to some concern; however, those growth rates might reflect a corresponding rise in demand for financial assets, owing to the deregulation. The statement on page 10 of the staff report that "money growth of 26 percent would be broadly consistent with the authorities' domestic and external objectives for 1990/91" could be seen in that light. Furthermore, the expected growth rate of financial assets in 1990/91, which was calculated on the assumption that there would be no measures to offset the phasing out of liquidity credits from Bank Indonesia, would represent a deceleration from the very high rate of the previous year. Nevertheless, the expected rate was still high compared to nominal GDP, even taking into account the continued, although difficult to judge, effects of the deregulation process. That development could lay the groundwork for future price pressures; it would therefore be helpful if the staff or Mr. Ismael could comment on the point, and particularly on the magnitude of the structural shifts in the demand for financial assets that had been caused by deregulation.

In view of that situation, he fully agreed with the staff appraisal that there was little scope for further reductions in interest rates, Mr. Gronn said. The staff appraisal had also correctly emphasized the need to tighten monetary policies. On exchange rate policy, he agreed with the views expressed by Mr. Grosche.

Mr. Lombardo noted that, during the discussion of the 1989 Article IV consultation with Indonesia, it was said that the country's adjustment effort had been impressive, and that Indonesia was on the verge of a new stage of development. Those statements remained true. Moreover, there had been further positive developments and correspondingly more encouraging medium-term expectations.

Real investment had reacted remarkably, overcoming the investment restrictions to double the domestic investment levels and triple the foreign investment levels of 1987, Mr. Lombardo observed. That performance would assure a strong GDP growth if sound financial policies were maintained.

He broadly agreed with the staff report, Mr. Lombardo continued. However, there seemed to be a disagreement between the Indonesian authorities and the staff on the desirability of resisting the short-run interest rate pressures. The staff argued that, given Indonesia's free exchange system, there was little scope for further reductions in the differential between foreign and domestic interest rates. On the other hand, the authorities considered that the rates had been unreasonably high in the past, and that there was room for maneuver.

Those conflicting viewpoints indicated that Indonesia was at a transitional stage where the pursuit of different objectives could lead to the adoption of contradictory measures, or, at a minimum, to the creation of an overdetermined system, Mr. Lombardo suggested. Achievement of the balance of payments objective would lead to a depreciation of the exchange rate and a subsequent increase in the interest rate differential. Attainment of the monetary objective would result in an increase in domestic interest rates that would also increase the differential. Reducing the interest rate differential was yet another policy objective. Furthermore, the goals of promoting interest rate flexibility as a response to market conditions and relying more on monetary policy to influence exchange rate movements had to be taken into account. It would be helpful to hear the staff's comments on how the transition toward more market-determined rates might best be effected in the context of the overall objectives of the Indonesian program.

Mr. Dai made the following statement:

> We continue to be impressed by Indonesia's economic performance and the broad efforts demonstrated by the authorities in implementing financial adjustment and structural reforms. As a result of these efforts, the non-oil/gas sector of the economy has developed remarkably, contributing greatly to sustained economic

growth, a controlled inflation rate, and an improved balance of payments position. The economic diversification resulting from structural reforms acts to shelter the economy from fluctuations in the terms of trade and other external shocks. More important, the structural reforms are supported by cautious monetary and fiscal policies and a flexible exchange rate policy, which have managed to hold domestic demand in check. Therefore, the liberalization process has been followed by neither an inflationary spiral nor a deterioration in the balance of payments position. Because the authorities are maintaining their commitment to the implementation of further structural reforms, it is important that the thrust of the present monetary, fiscal, and exchange rate policies be sustained.

I am in general agreement with the staff appraisal. With respect to fiscal policy, according to the staff, greater national savings have to be realized, in order to achieve the objectives envisaged in the authorities' medium-term economic development plan. I agree with the staff that this improvement will essentially need to come from the public sector.

On the revenue side, the increased contribution of non-oil revenue to GDP seems to indicate that, as the share of non-oil revenues has grown, dependence on oil revenues has lessened. In light of the vulnerability of oil revenues to world oil prices, it is essential for non-oil revenues to be strengthened through further improvements in tax administration and structural changes in the tax system.

On the expenditure side, I note from Mr. Ismael's opening statement that the Government will focus its attention on increasing development expenditure through a further intensification of the tax collection process. Although higher than budgeted revenue allows for an increase in development expenditure, I agree with the staff that current spending should also be contained to leave more room for development expenditure.

With respect to financing, the expected shortfall will need to be covered by foreign official sources. However, the remarkable increase in private saving cited by Mr. Ismael seems to indicate that a policy to promote domestic resource mobilization and reduce reliance on foreign financial sources over the medium term would be plausible and desirable.

In the area of monetary policy, Indonesia's financial system has developed rapidly in response to deregulation measures. According to Mr. Ismael, a range of reform measures have been taken to make the banks more competitive and market oriented. These developments allow for the replacement of direct restrictions on bank credit with an indirect system of control in monetary management. The open-market operation has proved to be useful and efficient in mitigating the expansionary or contractionary impact of exogenous factors on the monetary target.

The staff has correctly stated that, given the openness of the Indonesian economy, domestic interest rates are closely correlated to international interest rates, and a substantial divergence between the two could result in the destabilization of capital flows. In particular, in order to realize price stability while reducing the current account deficit, monetary policy has to be managed with the objective of allowing a depreciation of the rupiah sufficient to maintain competitiveness in the external sector while retaining enough restrictiveness to resist inflation and avoid capital outflows. It is important, therefore, to manage domestic interest rates in a flexible manner.

The Indonesian economy has benefited greatly from structural reforms in the trade area, and it is essential that the trade liberalization process, as well as a flexible exchange policy, be continued. I am interested in learning from the staff the extent of the contribution of the trade liberalization process to the achievement of shifting the composition of exports from primary products to semiprocessed and final goods, and what role the Government's industrial policy has played in the diversification of production and exports. It should be noted that the attempts to diversify export markets and widen the range of exporting firms have also been successful.

Turning to foreign borrowing policy, I welcome the authorities' continued prudent debt management strategy, and in particular the limits on new commercial borrowing. Given the heavy debt burden, it is vitally important, even in times of difficulty, to maintain a good reputation for servicing external debt.

I would like to join other speakers in commending the Indonesian authorities for their achievements in alleviating poverty. In a populous country like Indonesia, the current strategy, which is aimed at promoting rapid growth and employment creation while emphasizing rural development, is undoubtedly correct.

Mr. Dawson made the following statement:

My authorities continue to have a great deal of admiration for Indonesia's adjustment record. By pursuing cautious macroeconomic policies and undertaking far-reaching structural changes in the economy, Indonesia has been able to decrease its dependence on petroleum and natural gas significantly while achieving very respectable rates of economic growth--even in per capita terms--and maintaining generally moderate rates of inflation. At the same time, Indonesia has continued to service its sizable external debt in a timely manner. This is an enviable record from which some useful lessons could be drawn, especially by other countries that need to diversify their exports.

We agree with the staff's conclusion that the authorities' main task should be to ensure continued growth of the non-oil/gas economy by maintaining a prudent macroeconomic policy stance and continuing the major structural reforms. Indeed, there is every indication that the authorities are moving in this direction.

Fiscal performance, by and large, has been more than satisfactory over the past year, in part because of a fortuitous rise in petroleum prices, but also because of the Government's efforts to widen the tax base and improve tax administration. Stronger revenues permitted both an increase in expenditure and a larger than programmed decline in the overall government deficit. I have some reservations, however, about the types of additional expenditure that occurred. In particular, it seems unfortunate that a part of the revenue gain was dissipated in higher fertilizer and petroleum subsidies. We welcome the authorities' intention to scale back these subsidies and would hope, in fact, to see them eliminated. The 10 percent increase in government salaries in January 1990, following on the heels of the 15 percent cumulative increase in 1989, seems generous, even with the realization that salaries had previously been frozen since 1985. I hope that in the future the Government will be in a position to grant more frequent, and more moderate, increases.

In keeping with these concerns about the composition of current expenditure, the staff report comments on the need to restrain the growth in certain spending categories, in order to accommodate the increased outlays for operations and maintenance associated with higher levels of development expenditure. It would be interesting to know which spending categories the staff has in mind for cutbacks. Although, as I have already suggested, there is undoubtedly some room to improve the mix of current expenditure, a more fundamental question remains as to whether it might have been advisable to use the higher than expected revenues to achieve a larger reduction in the overall government deficit. Such an action could cushion the impact of a possible shortfall in future revenues in the event of an oil price fall or some other adverse exogenous shock.

Turning to monetary policy developments, we share the staff's concern about the impact that the rapid pace of monetary expansion could have on domestic demand. So far, demand pressures do not seem to have gotten out of hand, but we welcome the authorities' intention to aim for a substantially lower rate of monetary and credit expansion in the coming year. The phasing out of liquidity credits should be a helpful step in this direction. However, the accompanying decision to require banks to allocate at least 20 percent of their portfolios to cooperatives and small-scale enterprise represents a step backward from the point of view of efficient resource allocation.

Fiscal and monetary policies are on track, providing a relatively stable environment for savings and investment; therefore, the major policy tasks appear to be in the area of structural reform. The staff report highlights the principal areas where further reform would be especially beneficial. We strongly support the authorities' efforts to develop domestic capital markets, including an equity market, and agree that their efforts should be concentrated on providing appropriate prudential supervision and requiring adequate financial disclosure. Although the development of a capital market will take time, it would be unfortunate if the authorities were to delay plans to convert a number of public sector enterprises to mixed private and public ownership on the grounds that the capital market was still at an early stage of development. Indeed, with a ceiling of only 30 percent on the companies' total capital to be sold to private investors, and with only 3 of 52 targeted companies currently allowed to issue shares for this purpose, the Government's divestiture program seems to be off to a very slow start. In our view, substantially faster progress in rationalizing the state enterprise sector could lead to considerable productivity gains while having a positive impact on government finances.

We agree with the staff on the need for further liberalization of Indonesia's foreign direct investment regime. This is especially important for a country such as Indonesia, which needs to increase investment levels while reducing its debt-service burden. In particular, we would encourage the authorities to reduce the list of prohibited sectors and eliminate the performance and Indonesian equity requirements. We also support the staff's views on the need to accelerate the pace of trade liberalization in order to achieve the targeted increase in non-oil exports.

With respect to the medium-term outlook, the baseline scenario makes a convincing case for the benefits to be gained from the application of prudent macroeconomic and strong structural policies. The staff's assumption that official reserves will accumulate at approximately the same rate under either the favorable baseline assumption about oil prices or the much more negative assumption of alternative scenario II is particularly striking: if Indonesia is able to increase reserves at that rate when oil prices are relatively depressed, then, as a precautionary measure, it would be both feasible and wise to accumulate reserves at a faster rate when oil prices are relatively high.

I conclude by joining Mr. Grosche and Mr. Yamazaki in welcoming the authorities' consideration of environmental issues. Indonesia's performance over the past year has been commendable; we look forward to reviewing its further progress next year.

Mr. García said that the Indonesian authorities should be congratulated for the management of their economy, especially from 1983 onward. Real GDP had been growing at a significant rate while inflation had been kept low and the current account deficit had decreased. Those were the results of export-oriented policies that had boosted non-oil exports, particularly in manufacturing, while allowing for an improvement in the debt-service ratios.

He generally agreed with the recommendations contained in the staff appraisal, Mr. García continued. With respect to the process of deregulation, the authorities were encouraged to maintain the pace of liberalization of international trade and foreign investment, in order to avoid the sluggish export growth that some of the newly industrializing countries had experienced; those countries had failed to advance beyond the stage of industrialization characterized by successful competition in labor-intensive enterprises. Indonesia was not yet at that stage of development, but experience suggested that the earlier a country started on the path to a more advanced level of industrial production, the smoother its progress would be. Fortunately, Indonesia had built the economic and institutional framework to continue the deregulation process at a minimal cost.

It would be helpful to receive more information from the staff on the policies that were being implemented to combat the social problems connected with income distribution and poverty, Mr. García remarked. The staff and the authorities correctly emphasized that the most effective method of solving those problems lay in the continuation of measures aimed at creating export-oriented growth, fiscal balance, and low inflation; nevertheless, the picture emerging from the staff report of income distribution in Indonesia--although admittedly constructed from data more than ten years old--was shocking. Moral concerns aside, recent experiences in Latin American and Asian countries had demonstrated that the viability of current policies could be affected by a lack of social support arising from the income distribution problem.

Mr. Arora said that he congratulated the Indonesian authorities on their very impressive economic performance in 1989/90. As Mr. Dawson had noted, Indonesia offered many lessons for countries facing similar problems; in fact, Indonesia could be said to have created a model worthy of careful analysis.

Indonesia had had an evolving pattern of adjustment policies, Mr. Arora continued. In the introductory phase, from 1982 to 1985, the accent had been placed on stabilization and demand-side measures. As a result, growth had declined significantly, from an average of 8 percent over the preceding 14 years to an average of 4 percent for 1982-85. In addition, a sizable decline in per capita income had brought Indonesia--a country that had been approaching middle-income country status--closer to the World Bank's definition of a low-income country. In 1982-85, the pattern of income distribution had also worsened substantially, and the unemployment rate had risen.

During the second phase, from 1985 to the present, the accent had shifted to structural measures, Mr. Arora remarked. The authorities had taken actions to liberalize trade, deregulate investment, privatize public sector enterprises, and reform the financial sector and the tax system. The results had been very gratifying, as the supply-side measures had produced higher growth rates, a lower inflation rate, and a successful reduction of the current account deficit.

Although appropriate policy responses had played an important role in Indonesia's adjustment process, Mr. Arora noted, the sizable inflow of concessionary funds during that period had helped considerably to cushion the cost of transition. That fact should be remembered when the adjustment policies of other countries facing similar problems were being discussed.

In his opening statement, Mr. Ismael had noted that recent developments had ruled out a 6 percent rate of growth for the Indonesian economy, Mr. Arora observed. The medium-term scenario in the staff report, on the other hand, had suggested that it was still possible to achieve a high growth rate--6 percent for the overall economy and 6 1/2 percent for the non-oil sector. It would be interesting to discover the factors that had led Mr. Ismael and the Indonesian authorities to revise the growth rate downward.

He agreed with Mr. Grosche's remarks in the area of exchange rate policy, Mr. Arora said. To rely predominantly on exchange rate measures for maintaining competitiveness might be adequate in the short term, but, in the medium term, inflationary pressures would work to the disadvantage of the economy. Therefore, structural measures that reduced domestic costs and brought about a better macroeconomic environment for sustainable growth were preferable to maintain competitiveness.

The staff representative from the Asian Department remarked that the authorities' fiscal policy had not been markedly expansionary in 1989/90.

Certainly, the private sector had not been crowded out as a result of the fiscal deficit. There was, however, the broader question of the ability of fiscal policy to sterilize, when necessary, extraordinarily and unexpectedly large inflows of oil revenue. The long-standing policy in Indonesia had been to spend rather than save excess revenue, but the authorities had indicated that they would take measures to sterilize a part of the additional revenue if oil prices were to increase substantially. In that sense, the point made by several Directors on that score had been well taken, although it was not strictly applicable to the past fiscal year. It was interesting to note, in passing, that the staff's medium-term scenario had projected the gradual disappearance of the overall government deficit despite an expected increase in development expenditure.

With respect to monetary policy, the high rates of credit and money growth over the past several years reflected in part a substantial financial deepening, the staff representative said. However, the rapid growth of credit over the past four years also was evidence of an expansionary monetary stance. Specifically, credit expansion could be said to have been excessive in 1988/89, and again in 1989/90. However, as a result of the decision to phase out a large part of the liquidity credits, a decline in the credit growth rate for the fourth quarter of 1989 was projected. For that reason, the growth rates for both credit and money for the fiscal year ending March 1990 were projected to decline from their calendar year 1989 levels.

Because of the openness of the Indonesian economy, the monetary stance was not accurately reflected in the performance of broad money or any other monetary aggregate, the staff representative commented. To better understand the workings of the country's monetary policy, one had to look more closely at developments in domestic credit and the external sector. To the extent that real monetary holdings increased because of financial deepening, that should not be viewed as inflationary. The projected 25-26 percent increase in broad money for the coming fiscal year was considerably lower than the current fiscal year's.

The fact that interest rates had come down 3 percentage points over the past six months added an extra dimension to any discussion on monetary policy and interest rates, the staff representative remarked. It was difficult to say whether the rates had been unduly high in recent years, but the authorities felt that they were sticky downward, and they had therefore used credit policy to lower them. The authorities had indicated that, in the future, they would target credit growth and allow the market to determine the interest rate levels.

Exchange rate policy in Indonesia was closely linked with monetary policy, the staff representative said. The country's new policy stance, which emphasized deregulation and increased reliance on market forces, was exemplified by the two goals of phasing out the liquidity credit system and moving toward a more market-determined exchange rate. The strategy of placing greater weight on domestic policy--specifically, monetary policy--to maintain competitiveness in the external sector should be warmly supported; at the same time, it should be remembered that it would not have been possible to pursue that strategy in the past, given the expansionary nature of monetary policy. The exchange market was just beginning to develop in Indonesia, and the mission had been told that the commercial banks were still somewhat reticent to trade very actively among themselves.

The exchange rate and monetary policy objectives recommended by the staff were not inconsistent, the staff representative continued. The goal of monetary policy in Indonesia should be to adjust the supply of money in such a way that, over time, the rate of depreciation--currently 4 percent on an annual basis--would decrease. That outcome, in turn, would bring down domestic inflation; it should not lead to an appreciation of the exchange rate.

However, it was hypothetically possible, the staff representative observed, that, because of the openness of the Indonesian economy, a tightening of monetary policy could cause an appreciation of the exchange rate. In that situation, the authorities' desire to lessen dependence on petroleum would lead them to guard against an appreciation of the real exchange rate by increasing international reserves; faced with a choice between a weakened monetary policy and a weakened exchange rate policy, the authorities would choose the former.

To the staff's knowledge, no additional actions were being planned to align Indonesia's investment regime more closely with those of other countries in the region, the staff representative said. During the past two years, however, requirements affecting both the participation of local investors and time limits on divestiture by foreign investors had been eased, making the Indonesian system more similar to competitor countries such as Korea, Singapore, Hong Kong, and Malaysia.

Indonesia's efforts to increase its manufacturing exports had not been seriously hampered by protectionist actions taken in partner countries, the staff representative observed. However, the textile sector had encountered some difficulties. The authorities were attempting to solve the problem by modifying the form in which finished garments were being exported, thus adjusting to import market barriers, and by actively promoting the expansion of exports to Eastern Europe and other parts of the world.

With respect to the impact of trade and industrial policies on export diversification, the staff representative commented, the reduction in non-tariff barriers and in import duty levels had been instrumental in Indonesia--as in many other developing countries--in promoting exports on a more competitive basis. Furthermore, investment in the manufacturing sector had been facilitated by the decision to replace a long list of fields for which approval for both domestic and foreign investments had been required by a shorter list prohibiting investment in certain fields.

In the medium-term scenario, the incremental capital/output ratio was projected to worsen somewhat, rising from 3.9 percent in 1990/91 to 4.2 percent for 1991/92-1994/95, the staff representative noted. However, that increase was actually a reflection of the very rapid growth in the current fiscal year and should therefore be viewed as more of a technical phenomenon than a worsening. The absolute values for the ratio presented in Table 2 of Annex III of the staff report for fiscal years 1985/86, 1986/87, and 1987/88 were 7.1 percent, 4.4 percent, and 5.0 percent, respectively. The performance in those years, and in particular for 1987/88, should help to ease concerns about the 4.2 percent ratio that had been projected for 1991/92-1994/95.

The poverty eradication programs adopted by the Government could be divided into two broad categories, the staff representative from the Asian Department stated. The first group of programs encompassed increases in direct expenditure, as revenue permitted, to alleviate the living conditions of the most disadvantaged groups; accordingly, those programs had been the recipients of the higher than expected oil revenues in 1989/90. The second category of actions involved the relocation of people from the islands of Java and Bali--perhaps the two most heavily populated areas in the world--to outlying islands. Clearly, financial and environmental considerations hampered the implementation of that relocation project on a more massive scale; nevertheless, the actions that had been taken underscored the magnitude of the problem. Realizing that no short-term solutions were available, the authorities felt that the best overall strategy for eradicating poverty was to promote a high growth rate and a correspondingly large increase in employment.

Mr. Ismael said that government workers' salaries had been increased by 10 percent in January 1989, 5 percent in April 1989, and another 10 percent in January 1990. Although the total accumulated increase seemed substantial--namely, 25 percent within one year--nevertheless, in real terms, the salaries had only been restored to their 1985 level.

In the financial sector, the recent deregulations had led to the establishment of many new banks, thereby creating the need for improved banking supervision, Mr. Ismael noted. To establish a framework of prudent bank supervision, Bank Indonesia was currently preparing a new set of soundness criteria that included an early warning system. The new system would be more comprehensive, encompassing such aspects as financial considerations, the quality of risk assets, the degree of adherence to prevailing regulations, and the quality of bank management.

With regard to the environmental concerns expressed by Mr. Grosche, Mr. Cassell, and Mr. Dawson, his authorities felt that the international concern about Indonesia's environment had focused narrowly on the impact of the deterioration of the tropical forests on global warming and, therefore, on the need to rehabilitate the forests, Mr. Ismael remarked. Various actions had been proposed by different segments of the international community, including, inter alia, the replanting of trees and the boycotting of tropical forest products. His authorities felt that such approaches took too limited a view of the problem and disregarded the interests of developing countries. The complexity of the issue--which went beyond concerns about the reduction of the tropical forest cover and the damage to tropical forests--should not be forgotten.

Furthermore, Mr. Ismael said, the Indonesian authorities had pointed out that, in utilizing the forest, the country had given due consideration to preserving the forest's function as a natural resource and as a component of the ecosystem. To that end, a satisfactory environmental impact assessment was a prerequisite for new commercial activity in the rain forest. Furthermore, to ensure sustainable utilization, only selective cutting techniques could be used for logging enterprises, and a substantial area had been strictly maintained in its virgin state as a conservation forest.

Because of its role in the global climate, the international community seemed to view the tropical forest as a "global commons," Mr. Ismael commented. However, the Indonesian authorities believed that both the tropical rain forests and the forests in the temperate zones constituted an integrated system, both components of which were under great stress. In that context, the international community was urged to focus its attention not only on the tropical rain forest, but also on the global forest system as a whole. The burden of responsibility for safeguarding the world's forests should be allocated fairly among developing and industrial countries alike.

The Acting Chairman made the following summing up:

Executive Directors expressed their admiration for Indonesia's implementation of major structural reforms, which, together with pursuit of sound macroeconomic policies, had greatly reduced the country's dependence on the oil sector and paved the way for a striking upturn in investment and growth. The past year had witnessed a further strengthening in output growth, some moderation in inflation, and a narrowing in the fiscal and external deficits. These accomplishments reflected the authorities' perseverance with their adjustment efforts, as well as continued strong support from aid donors.

Noting the importance attached by the authorities to continuity, predictability, and coherence of policies, Directors were confident that Indonesia would continue building on these gains. Several Directors urged Indonesia to make still greater efforts to ensure price stability in order to strengthen the prospects for balanced growth. Fiscal policy would be crucial to generate the higher domestic savings necessary to keep the economy on a rapid growth path. Directors welcomed the ongoing efforts to broaden the tax base and to improve tax administration and compliance, and some speakers expressed concern about the continued upward trend in current expenditure, including public sector salaries and subsidies. A further strengthening of the overall public sector balance was seen as desirable, in view of the high level of government debt and the need to provide more savings to the private sector. Directors also urged the authorities to improve the monitoring of public enterprises and their accounting systems. Noting that recent moves to diversify and expand the capital base of certain enterprises could contribute to the goal of increasing the efficiency of the state enterprise sector, Directors encouraged the authorities to continue efforts to improve their efficiency.

Directors expressed concern over the rapid monetary and credit expansion. Although to an extent this reflected a surge in financial savings in the wake of deregulation, it also was the product of rapid credit expansion by Bank Indonesia, in the form of subsidized liquidity credits. Directors therefore welcomed the decision to phase out a significant portion of liquidity credits as a move to bring domestic credit growth under control, while ensuring a more efficient allocation of financial resources. Directors also stressed the importance of an active interest rate policy, with a view to achieving monetary objectives. They commended Indonesia on the steps taken to reduce Bank Indonesia's role as market maker for exchange transactions. Noting Indonesia's policy of allowing the rupiah to depreciate steadily against a basket of currencies, in order to preserve the competitiveness of non-oil and gas exports, Directors generally reiterated the importance of export diversification and reduced reliance on the energy sector. However, a number of speakers urged the authorities to improve competitiveness mainly through domestic costs measures and monetary policy actions that would strengthen the structure of the economy, and maintain the objective of greater price stability.

Directors commended the authorities for their program of structural reforms to deregulate the economy, increase competition and efficiency, and promote private sector initiative, as well as for their increased attention to environmental concerns and distributional aspects. They stressed the importance of sustaining the reform momentum in the economy. Directors encouraged the authorities to strengthen, for example, reforms in the financial sector, including banking supervision and capital adequacy, and to pursue the continued development of domestic money and capital markets. While considerable progress has been made in restructuring the trade and investment regimes, Directors saw considerable scope for easing the remaining restrictions and simplifying the regulatory environment. Together with appropriate macroeconomic policies, trade and business reforms should contribute to maintaining strong growth in the non-oil part of the economy in the medium term. The recent surge in foreign investment approvals was encouraging and attested to the role that foreign direct investment could play in Indonesia's development process. The need to improve Indonesia's access to export markets was also emphasized.

Directors commended Indonesia's consistent record of prompt and orderly debt servicing. Indonesia's external indebtedness and debt service burden, however, remained large, underscoring the need for both continued prudence in external debt management and further diversification and growth in the economy. Continued donor support would also be crucial to Indonesia's adjustment effort over time.

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

2. CHAD - 1989 ARTICLE IV CONSULTATION; AND STRUCTURAL ADJUSTMENT FACILITY - REQUEST FOR THIRD ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Chad and Chad's request for a third annual arrangement under the structural adjustment facility approved on October 30, 1987 (EBS/90/72, 4/19/90). They also had before them a policy framework paper for the period 1990-92 (EBD/90/121, 4/19/90) and a statistical annex (SM/90/75, 5/1/90), and a statement of the Managing Director.

The Managing Director's statement read as follows:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole on the Executive Directors of the Bank and IDA in their meeting on May 15, 1990:

1. The Bank's Executive Directors met as the Committee of the Whole on May 15, 1990, to consider the third-year policy framework paper for Chad, covering the period 1990-92. Directors commended the Government of Chad for its sustained efforts in implementing the second-year policy framework paper and its current IDA-financed adjustment program. The progress to date in reforming the cotton sector was particularly commended.

2. There was general support for the program objectives and measures set out in the third-year policy framework paper. The following seven policy issues were discussed: (i) the design of

the reform program; (ii) the public finances; (iii) Chad's growth prospects; (iv) the cotton sector; (v) public enterprise reforms; (vi) the social dimensions of adjustment; and (vii) the environment.

3. Design of the program. Executive Directors emphasized the importance of both maintaining a disciplined fiscal policy and implementing appropriate adjustment measures to enhance the competitiveness and growth potential of the economy. They noted, however, that the Government's capacity to implement reforms was limited, and careful program design and monitoring were therefore needed. They also noted the large number of studies under way to prepare future reform measures and urged that these lead to action as quickly as possible. Increased donor support for capacity building in economic management was identified as a priority need.

4. The Chairman noted that Chad's security situation presents additional problems for implementing an adjustment program. Several Executive Directors expressed concern that government expenditures be reallocated from military to more productive purposes as soon as feasible. In light of the security situation, the Chairman stressed the importance of a program with clear objectives that focused on easy-to-implement, priority measures.

5. Public finances. With respect to public finances, the Executive Directors emphasized the importance of increasing government revenues, which are low relative to GDP, and of containing the current budget deficit. They noted that the Government is committed to correcting the fiscal slippages that occurred in 1989 and to stepping up implementation of the tax reform. The Executive Directors stressed the importance of limiting the civil service wage bill and security-related outlays while expanding priority current expenditures for development-oriented sectors. Furthermore, all government expenditures need to be consolidated into the general budget. Directors also underscored the need to ensure sound programming and effective implementation of public investments.

6. Growth prospects. Regarding growth prospects, the Executive Directors noted that Chad's economy is extremely underdeveloped, undiversified, and vulnerable to external factors such as climate and world market prices for its main export, cotton. They stressed that, although petroleum production could add some impetus to Chad's growth, it would take time to develop. In the near term, Chad's growth would continue to be closely linked to the ability to increase agricultural production. In this respect, particular emphasis should be put on measures to improve food security and expand exports, including livestock production. Directors also noted the importance of price and trade

liberalization to enhance the responsiveness of the private sector. They welcomed the Government's readiness to begin addressing the financial sector issues. Financial sector reforms should receive high priority since they would hopefully lead, in the medium term, to a more attractive environment for private sector development.

7. Cotton. Several Executive Directors commended the Chadian Government for its successful implementation of the cotton reform program. They noted that, after several years with huge operating deficits, COTONTCHAD had now reached the break-even point. Continued reforms at COTONTCHAD are crucial to improve international competitiveness further and to permit the cotton sector to realize its full potential to contribute to the growth of Chad's economy.

8. Public enterprise reforms. The Executive Directors recognized that, although relatively small, the public enterprise sector in Chad offers considerable scope for improvements. They noted that reforms are under way for several enterprises and encouraged the Government to speed up the reform process for the main parastatals.

9. Social dimensions of adjustment. Directors commended the Chadian Government for taking special steps to protect allocations for the social sectors in current budget expenditures. However, provision for basic social services remains extremely low in Chad, and Directors emphasized the need for the Government to increase expenditures for basic health and education services. The Directors noted that the Social Development Action Program, supported by IDA and other donors, will provide financing for some of these priority outlays, but additional government efforts are required in this area.

10. The environment. The Executive Directors observed that the Government recognizes the importance of preserving the country's natural resource base. They urged the authorities to attach high priority to formulating specific measures for this purpose.

Mr. Mawakani made the following statement:

The staff report for the 1989 Article IV consultation with Chad and its request for the third annual arrangement under the structural adjustment facility emphasize the authorities' firm commitment to the pursuit of the structural adjustment program despite the security-related problems. Progress during the second annual arrangement was satisfactory; as mentioned by the staff, most of the quantitative objectives and benchmarks were met, and the program's major structural policies were implemented.

My authorities are in general agreement with the staff appraisal of economic developments in 1989 and the policy recommendations for 1990-92. Although real GDP in 1989 is estimated to have grown by about 1 percent, compared with a program target of 3 percent, the apparently weaker performance of GDP was due to an overestimation of performance in 1988, when the harvest was exceptionally favorable. In fact, during 1988-89, average real GDP was about 9 percent, compared with the program target of 7.4 percent. Inflation, as measured by the GDP deflator, dropped to 2.3 percent from 9.2 percent. In the fiscal sector, while revenues attained the program target of CFAF 28.8 billion, security-related expenditures caused the current outlays to overshoot the program's objective by 15 percent. As a result, the current budget deficit, on a commitment basis, deteriorated. In the external sector, the 1989 external current account, including grants, registered a deficit of 3.2 percent of GDP, bettering the program target of 8.5 percent. The overall balance of payments recorded a large surplus of SDR 20 million as a result of larger capital inflows, and gross external reserves rose to the equivalent of 20 weeks of imports at end-1989.

With respect to structural reforms, the Chadian authorities continued their efforts to improve the cotton sector performance and rehabilitate other state enterprises. The activity of the cotton parastatal (COTONTCHAD) picked up, and the total operating deficit was significantly reduced. Substantial progress was also made in restructuring other state enterprises: the rehabilitation of the electricity and water company was continued; the monopoly of the transportation company was abolished; transport tariffs were liberalized, and the quarry operation was privatized. In addition, studies were initiated to prepare the reform of the National Post and Telecommunications Office. In the livestock sector, the authorities pursued a strategy aimed at increasing the country's livestock production through a further extension of services.

The authorities intend to continue the economic adjustment measures set forth in the original policy framework paper, which has been updated to take into account the additional efforts required to achieve the medium-term objectives. The program for 1990-92 has been designed to consolidate and reinforce the gains achieved since the adoption of the adjustment program. The macroeconomic program targets are to sustain an average annual rate of growth of real GDP of 3 percent, to contain the annual inflation rate, as measured by the GDP deflator, at 3 percent, and to reduce the external current account deficit, excluding official transfers, to about 23 percent of GDP by 1992. To this end, the medium-term policies will be concentrated on public resource management, cotton sector restructuring, and export incentives.

In the public sector, fiscal policy aims at sharply reducing the current budget deficit and suppressing inflationary pressures. The comprehensive tax reform begun in 1988 will therefore be continued, as the Government expects to cover an increasing share of current expenditure from domestic revenue. In this regard, new measures will be put in place to upgrade significantly the tax administration. The 1990 budget law already includes provisions for increasing the yields for company, motor vehicle, and domestic sales taxes. Also, special incentives will be granted to collection personnel, in order to boost the tax collection effort. Meanwhile, tax system simplification and rationalization will continue. As a result, revenues are expected to increase to 10.1 percent of GDP by 1992. Meanwhile, the authorities' resolve to contain budgetary expenditure will remain unchanged. The policy of wage restraint will remain in force, as well as that of limiting recruitment to the level of departures and retirements. Moreover, the progressive integration of extrabudgetary operations into the Treasury will make public finance operations more transparent and facilitate overall expenditure controls.

In the area of monetary policy, the Government will attempt to stem money supply growth and to reduce net bank claims on the Treasury and the Caisse Autonome d'Amortissement (CAA) by CFAF 2.2 billion in 1990. Owing to the economic reconstruction, claims on the private sector and state enterprises are expected to increase by CFAF 2.6 million; however, COTONTCHAD will not need to seek recourse to the banking system because of its favorable financial performance. In addition, the Government will undertake a study of financial sector reform with technical assistance from the World Bank.

Regarding the public enterprise sector, the authorities will continue their efforts to rationalize and improve this sector, as well as to implement the measures envisaged in the policy framework paper. On the basis of the 1988 performance contract, COTONTCHAD's restructuring will also continue.

In the external sector, major improvements are expected over the medium term, resulting mainly from increased cotton and cattle exports. Imports are projected to increase by 6 percent during 1990-92, but the share of food and military imports are projected to be scaled down. As to the medium-term debt service, the Government intends to pursue a cautious debt management policy; it has already indicated that it will contract or guarantee external borrowing only at highly concessional terms.

The Chadian authorities would like to reiterate their commitment to the adjustment process that is under way and emphasize that they are striving to achieve their economic development objectives. The authorities are very appreciative of the support of the international community and hope that further progress will be made during the third annual arrangement under the structural adjustment facility.

Mr. Serre made the following statement:

Despite a difficult environment, the Chadian authorities have orchestrated a spectacular economic recovery based on both financial and monetary discipline and comprehensive structural reforms. Real growth in GDP reached 9 percent during 1988 and 1989 while the rate of inflation was limited to 2.3 percent in 1989--substantially lower than the program's objective of 5 percent. In the agricultural sector, progress in cotton production and steady international prices have paved the way for an increase in farmers' revenues, which has largely compensated for an inferior crop yield caused by insufficient rainfall. The satisfactory performance of the cotton and livestock components of the agricultural sector--reflecting the return to equilibria in the public sector--has in turn stimulated production in the beer, sugar, tobacco, and textiles industries, resulting in a 15 percent rise in industrial production in 1989. This economic recovery has been coupled with an even greater improvement in the monetary sector, which has been characterized by a stable money stock and large increases in net foreign assets, including a 50 percent increase at end-1988. In external sector developments in 1989, the current account deficit, projected to increase to 27 percent of GDP, was limited to 25.8 percent, and the balance of payments recorded a surplus of SDR 20 million.

We commend the Chadian authorities for the progress already achieved and support the proposed decisions. However, the situation remains precarious. As the staff report has emphasized, adjustment efforts must maintain their momentum. In this regard, the authorities should focus their attention on the macroeconomic policy and structural reform objectives of the program.

Concerning macroeconomic policies, the recovery of public finances clearly remains a priority objective. The budget deficit rose to 4.1 percent of GDP in 1989, instead of the 2.6 percent envisaged in the program. This tendency must be reversed. In the revenue area, even if the 1990 target of CFAF 28 billion is surpassed, the revenue/GDP ratio of 8.8 percent to GDP will still be low compared with other African countries. Viewed in the context of the improving economic situation, the widening of the fiscal base to encompass the informal sector, as well as the reallotment of funds earmarked for the war effort, should allow for a strengthening of the revenue base.

Expenditures, on the contrary, have tended to exceed the program targets, owing mainly to the increased internal security burden. A better grip on the budget deficit can be secured by tightening controls and by improving the flow and monitoring of public expenses. Finally, we strongly encourage the authorities to adhere to a cautious policy in the area of salaries and manpower levels, in order to avoid any further slippages.

We concur with the monetary policy objectives specified in the program. The main goal, based on the maintenance of a 3 percent inflation rate and the attainment of a 3 percent increase in real GDP, is to limit monetary expansion to 6 percent. A secondary goal is to increase the level of reserves to four months of imports by increasing net foreign assets by 15 percent. These goals are predicated on three assumptions: first, domestic credit will expand by 4.25 percent; second, net credit to the government will decrease by 25 percent; and, third, external assistance will ensure the complement. The second assumption is also a quantitative benchmark of the structural adjustment arrangement.

It is apparent that, under these assumptions, the goal of stabilizing the monetary supply is more dependent on sustaining a high level of external support than on domestic efforts. These assumptions with respect to the attainment of the money supply objective raise two questions. First, in view of the trend toward a reduction in domestic credit, is a growth rate of 4.25 percent for domestic credit feasible in 1990? Second, can the target of stabilizing the money supply be reached through a more moderate reduction of net bank claims on the Government--the Treasury and CAA combined--in conjunction with a decrease in external financing? Comments from the staff on the rationale for the strategy that was adopted, and on the merits of other possible options, would be welcome.

In the domain of structural reforms, we fully agree with the staff's analysis. We note the successes registered in rehabilitating the cotton industry, improving the livestock sector, restructuring public enterprises, and liberalizing the transport sector. However, in the area of administrative organization, the roles assigned to the Ministers of Planning and Finance, respectively, in carrying out economic policy must be better defined. Furthermore, any increase in the activity of the Chadian Development Bank should be viewed with caution; other, more adaptable, solutions must be found to reinforce the financial intermediation system. Finally, the informal sector, which has been growing since 1987, should be watched more closely. Failure to do so could endanger the progress that has already been achieved in the area of trade and price liberalization.

The authorities' efforts deserve the encouragement and support of the international financial community. Thanks to the French initiative in the area of debt cancellation, the Chadian authorities have been able to reduce their outstanding debt by nearly 20 percent. However, because staff projections indicate that outstanding debt will continue to increase, prudent management of the external debt and recourse to concessional financing will be required to ensure that future growth will not be compromised.

Mr. Monyake made the following statement:

This chair fully supports Chad's request for a third annual arrangement under the structural adjustment facility. Despite some slippages, reflecting administrative weaknesses and, more important, the deteriorating security situation, the authorities have generally demonstrated a strong commitment to the implementation of the adjustment program under very difficult conditions. During the second-year arrangement, almost all of the agreed measures were implemented, and most of the program's benchmarks and targets were observed. The authorities have made substantial progress toward establishing relatively stable economic and financial conditions, including, inter alia, comparatively low rates of inflation. Therefore, we support the proposed decisions.

The current program builds upon the success achieved thus far. For instance, an important element for the successful completion of the program--fiscal consolidation--has been given due emphasis in the third year of the facility. Although extrabudgetary military expenditures caused slippages in 1989, the authorities were able to contain growth in other areas of the budget. The Government appears to have addressed this problem in 1990 by appropriating adequate amounts for security operations, with a view to preventing further recourse to extrabudgetary outlays. In these or any other circumstances, it is essential for the authorities to integrate extrabudgetary operations into the budgetary process, in order to exercise effective control over government expenditures. In addition, the authorities' intention not to grant a general salary increase to civil servants is a significant step toward containing the budget deficit within the prescribed limits; however, the sustainability of this objective will require a more vigilant monitoring and control of expenditures. In that context, a cessation of hostilities would greatly help, as resources currently used for security operations could be redirected toward the ongoing World Bank-supported efforts to promote greater efficiency in the fiscal sector through the restructuring of government expenditure.

Given the track record in the implementation of the program to date, I am confident that the current arrangement will be successfully completed. However, the economy of Chad will basically remain fragile, even after the successful completion of the program. As the staff has clearly outlined, the medium-term outlook has improved somewhat--partly because of strong donor support--but the heavy dependence of Chad's external sector on cotton, which accounts for a large proportion of its export earnings, renders it weak and highly susceptible to external shocks. This fragility will necessitate the continued implementation of structural reforms through appropriate fiscal and monetary policies. Against this background, we cannot expect that the role of the Fund will end with the completion of the present arrangement. Although questions about medium-term viability will still be relevant, continued Fund support is critical, not only for providing an appropriate macroeconomic anchor, but also for catalyzing external support at adequate levels.

As in many other low-income countries, the emphasis in Chad should be placed on diversification of the economic and export base as the most efficient means of strengthening the external sector. Although the reform of the traditional cotton sector should form an integral part of these efforts, the rehabilitation of the cattle industry and the exploitation of the petroleum deposits surrounding Lake Chad should also be encouraged to the extent warranted by their economic feasibility. In this connection, It would be helpful if either the staff or Mr. Mawakani could elaborate on the prospects for establishing a domestic-based petroleum industry.

With respect to the possibility of continued Fund involvement, it is important to note that the external debt-service ratio, although rising somewhat in 1990, is expected to remain below 10 percent for the remainder of this decade, even under the worst-case scenario. By current international standards, debt-servicing outlays remain modest, thanks to the debt forgiveness extended under the Toronto terms. Chad, however, will continue to require considerable amounts of assistance on highly concessional terms. Meanwhile, given the structure of the economy and the potential for export earnings, the authorities are well advised to continue pursuing prudent external borrowing polices. The Fund should be expected to play an active and important role in the period ahead.

Mr. Yoshikuni said that, as one of the world's poorest countries, Chad had experienced very severe economic hardships during most of the 1980s because of the prolonged civil war. It was therefore pleasant to note that, under the current structural adjustment arrangements, the Chadian authorities had implemented far-reaching adjustment measures with the help of the Fund, the World Bank, and other creditors. As a result, there had been favorable changes in the economy, including liberalization of the price system, diversification of production, and an improvement in the key industry--the cotton sector. Moreover, it was encouraging to note recent price developments; after wide fluctuations, the growth rate had stabilized at 2-3 percent since 1989.

Despite those developments, however, there was no sign that the plight of the Chadian economy would improve in the foreseeable future, Mr. Yoshikuni continued. Because of its current account deficit of more than 20 percent of GDP, excluding official transfers, the country continued to be dependent on the concessional flow of funds from external creditors. In that situation, adherence to sound fiscal policies was an essential precondition for maintaining and strengthening the confidence of the international financial community. Against that background, therefore, the large slippages in the fiscal area in 1989, caused by higher than expected security-related expenditures, were a serious cause for concern, and the success of the 1990 program would depend crucially upon efforts in that area.

In addition to maintaining tight control on defense expenditure, Mr. Yoshikuni commented, the authorities should rein in the wage bill. Although the decision to delay temporarily a general government salary increase was welcome, that action should be complemented by measures to streamline public employment, such as the continuing U.S.-supported reform of the civil service.

On the revenue side, further efforts were needed to widen the tax base and simplify the tax brackets, Mr. Yoshikuni noted. In view of the authorities' weak administrative capacity, the request for further technical assistance from the Fund in that area should be supported.

With respect to monetary policy, the unexpected decline in credit to the private sector in 1989 had helped to contain the growth of money stock within the parameters of the program, Mr. Yoshikuni recalled. A cautious stance should be maintained in 1990--particularly with respect to credit to the public sector--in order to achieve the target for money growth.

In the area of structural reform, special importance should be attached to the reform of public enterprises, Mr. Yoshikuni asserted. In particular, there was an urgent need to introduce a transparent accounting system; in this connection, the reporting requirements for public institutions initiated in the 1990 budget was a step in the right direction. Also, reform of the banking sector should be expedited, in order to facilitate the efforts aimed at increasing domestic savings and to enhance resource allocation.

There was no room for an active exchange rate policy in the CFA franc zone, Mr. Yoshikuni observed. Accordingly, a cautious monetary policy was essential to maintain the competitiveness of the Chadian economy. In fact, stable domestic prices had led to a depreciation of the real effective exchange rate between 1988 and 1989, despite the lack of movement in the nominal rate.

He supported the proposed decisions, Mr. Yoshikuni remarked. Furthermore, upon the successful conclusion of the third-year structural adjustment, his chair would be in a position to support a request from the authorities for an enhanced structural adjustment facility program.

Mr. Enoch made the following statement:

Chad's impoverished economy has made the beginnings of a welcome recovery in the past two years, helped by firmer world cotton prices and by improved economic management by the authorities. After a succession of bleak years, per capita consumption has grown strongly while inflation has generally remained subdued. In addition, the authorities have made useful progress in clearing the overhang of external and domestic payment arrears without excessive recourse to external borrowing. Indeed, Chad's debt/GDP ratio remains relatively low by African standards, at less than 40 percent.

The most significant development over the past year has been the authorities' success in strengthening the all-important cotton sector. Production costs have been reduced substantially, and COTONTCHAD'S financial position has been turned around after several years of operating deficits.

Despite these first signs of economic recovery, Chad's medium-term prospects look parlous. Even if the authorities' program is implemented fully, the diversification process runs smoothly, and there is no recurrence of drought or civil war, the staff projections imply that per capita income will rise only marginally over the medium term. In addition, Chad's current account deficit looks set to remain above 20 percent of GDP for the foreseeable future, while the debt/GDP ratio is projected to double over the next decade. Moreover, the debt-service ratio will rise markedly, despite the authorities' welcome intention not to incur any further nonconcessional borrowing.

To improve the country's longer-term growth performance and to reduce its overwhelming dependence on external inflows, the authorities must seek to enhance domestic savings over the next few years. This will require action on two fronts: further fiscal consolidation, and increased efforts to harness private sector savings.

In analyzing the fiscal position, the staff stresses the need to establish control over extrabudgetary expenditures. It also rightly puts the spotlight on Chad's high level of military spending, which accounted for nearly one fourth of total current expenditure in 1989. Over the medium term, military spending has to be reduced if Chad's slender resources are to be put to productive use.

The other main component of current spending is the wage bill. Here, too, the authorities will need to look more closely at where savings can be made. The wage bill has nearly doubled over the past four years, despite the significant fall in the price level. While the staff projections imply that spending on wages and salaries will grow by an additional 15 percent over the next three years, it would be disappointing if the authorities' ongoing civil service reform program did not identify some areas where considerable manpower savings might be made.

Nevertheless, the main effort over the medium term must be directed to raising the level of government tax receipts. With the tax/GDP ratio currently at less than 9 percent, there would seem to be considerable room for additional progress--a point underlined by the experience of other low-income countries in the region, such as Mali, where government revenues now amount to over 16 percent of GDP. In this context, I welcome the indication in Mr. Mawakani's opening statement that revenues will be raised to 10.1 percent of GDP by 1992, but I would urge his authorities to seek to do substantially more.

In addition to fiscal reform, the authorities should focus on ways to increase private sector saving. Financial sector reform has proceeded much less quickly in Chad than in many other franc zone countries, despite the growing perception in Africa that this is a key prerequisite for private sector-led recovery. Chad's small financial sector is in very poor shape, as a substantial proportion of private sector credit is under moratorium and more than one fourth of commercial bank deposits are frozen. Clearly, the pace of monetization in the economy will have a major bearing on the speed with which private sector saving can be increased; however, the authorities must also ensure that interest rates are sufficiently attractive to make saving worthwhile. Table 30 in the statistical annex suggests that the current level of deposit rates may be appropriate, but the table also indicates that interest rates are highly insensitive to market conditions--a sure sign that the banking sector is not competitive.

An increase in domestic savings should allow increased investment over the medium term without recourse to even higher levels of foreign assistance. However, in recent years, the continuing high level of short-term outflows from Chad has been a further drain. The staff attributes this phenomenon to the repatriation of bank notes, but the detailed figures presented in the statistical annex imply that these outflows are nonmonetary. I would be grateful if the staff could comment on what portion of this outflow is capital flight, and why it is projected to persist over the medium term.

I support the proposed decision. Furthermore, I note the authorities' interest in negotiating an enhanced structural adjustment arrangement. Certainly, if the authorities continue to maintain their performance during the third-year arrangement, there is no reason why Chad should not be eligible for Fund resources under the enhanced structural adjustment facility. However, before such an arrangement could be agreed, the many studies and reviews currently in progress should be completed. At the least, I would hope that any succeeding program will be used to support concrete steps in the field of parastatal, tax, and financial sector reform.

Mr. Grosche said that he joined the staff and previous speakers in welcoming the progress that Chad had made in its second-year arrangement under the structural adjustment facility. Most of the benchmarks and program targets had been observed, thus improving, albeit at a rather slow pace, the prospects for a better economic future.

However, the slippages in the fiscal area were rather disappointing, Mr. Grosche continued. The benchmarks for the current fiscal deficit and net bank credit to Government had been exceeded by wide margins, primarily because of military expenditures. Those occurrences demonstrated the fragility of the country's situation and underscored the staff's concern that the security situation could jeopardize further progress under the program. In that context, fiscal consolidation remained the key to progress, especially given the alarmingly negative level of domestic saving. The envisaged structural reform measures in the fiscal area were welcome, as were the plans to restrain civil service wages; however, it was reasonable to anticipate that substantial savings could also be generated quickly by cutting unproductive expenditure. The balance of payments remained extremely vulnerable, Mr. Grosche remarked; the slow progress projected for the medium-term reduction of the large current account deficit was not encouraging. However, the currently favorable conditions for the main export item, cotton, together with the prospects for further substantial debt relief, should make it possible to aim at somewhat more ambitious external targets. The implementation of plans for domestic oil production could also help to alleviate the import burden on the balance of payments.

The continued high dependence on external financing underlined the need for a cautious approach to debt, Mr. Grosche stated. Therefore, he agreed with the staff that new debt should be contracted only on highly concessional terms. Moreover, in order to stimulate domestic savings, real positive interest rates should be maintained, and the financial sector, which would soon be the subject of a special study by the authorities, should be restructured.

The progress made thus far in reducing domestic and external arrears was welcome, Mr. Grosche continued; however, the expeditious elimination of the remaining arrears would not only convey a positive signal to external creditors and aid donors, but also offer reassurance with respect to the Fund's financial involvement in Chad. In that context, it might also be useful--the staff's optimistic assessment to the contrary--to place part of the next structural adjustment arrangement disbursement in a special account as insurance that Chad's obligations to the Fund would be repaid promptly.

He agreed with Mr. Enoch on the possibility of an enhanced structural adjustment arrangement for Chad upon the conclusion of the current program, Mr. Grosche said. He endorsed the proposed decisions.

Mr. Dai said that he joined previous speakers in commending the authorities for the satisfactory results achieved in 1989. The staff report showed that performance under the second year of the structural adjustment arrangement was broadly successful. Average real growth in 1988-89 was about 9 percent, compared with the program projection of 7.4 percent. The rate of inflation, as measured by the GDP deflator, was only 2.3 percent, against the program target of 5 percent. Most of the quantitative objectives and benchmarks had been met, and most of the program's structural policies had been implemented. Indeed, substantial progress had been made; however, there had been some slippages, particularly in the fiscal area, owing to substantial security-related extrabudgetary outlays. Overall, however, he broadly agreed with the staff appraisal and recommendations and supported the proposed decisions.

Nonetheless, fiscal performance must be improved if the medium-term objectives were to be realized, Mr. Dai continued. The authorities should be encouraged to effectively implement the program's revenue and current expenditure measures. Moreover, the staff was correct to emphasize that progress in diversification was an important medium-term objective. The authorities' effort to encourage livestock production and to liberalize the transportation sector were welcome.

It was encouraging to note that the authorities had demonstrated their strong commitment to the structural adjustment program, and in particular to completing the process of liberalizing the economy, Mr. Dai observed. Because the measures that the authorities had already taken were adequate to achieve the program's objectives, he agreed that Chad deserved the continued support of the Fund and the international community.

Mr. Shrestha said that, as the staff report had clearly shown, Chad's economic performance had improved considerably after the implementation of the Fund-supported structural adjustment program in 1987. The performance during the second-year structural adjustment arrangement continued to be broadly successful. Despite some slippages on the fiscal front, most of the quantitative objectives and benchmarks for 1989 had been met. Similarly, most of the program's structural policies had been implemented.

While discussing the proposed second annual arrangement under the structural adjustment facility in 1989, the Board had emphasized the need for a more vigorous implementation of policies to restore competitiveness in the cotton sector, Mr. Shrestha continued. Encouragingly, the performance of the cotton sector had improved in 1989, as all the measures envisaged in the program had been effectively implemented, resulting in a substantial reduction in the overall operating deficit of COTONTCHAD.

Despite its commendable performance, Mr. Shrestha remarked, the economy was still vulnerable in the external sector. The GDP growth rate had barely kept pace with population growth, and fiscal performance had remained weak. In the latter area, a significant increase in current expenditure had helped to maintain Chad's heavy dependence on foreign assistance, as those inflows had been used not only for investment purposes, but also for meeting current administrative expenditures.

In those circumstances, it was important that the Fund-supported structural adjustment program be continued, Mr. Shrestha said. The emphasis of the program should be on directly increasing productive investment, effectively implementing the program's revenue and expenditure measures--in particular through a widening of the tax base--expanding the external sector by taking measures to promote the efficiency of the trade sector, and implementing an appropriate financial sector reform program. The policy framework paper had correctly underscored those priorities.

He broadly agreed with the thrust of the staff appraisal, Mr. Shrestha confirmed. Therefore, he supported the proposed decisions.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/75 (5/14/90) and EBM/90/76 (5/16/90).

3. SOMALIA - TECHNICAL ASSISTANCE

In response to a request from the Somali authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/147 (5/15/90).

Adopted May 15, 1990

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/127 (5/14/90) is approved.

APPROVED: April 1, 1991

LEO VAN HOUTVEN
Secretary