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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/40

5:30 p.m., March 19, 1990

R. D. Erb, Acting Chairman

Executive Directors

M. R. Ghasimi

J. E. Ismael

J.-P. Landau

K. Yamazaki

Alternate Executive Directors

L. E. N. Fernando

M. E. F. Jones, Temporary

G. C. Noonan

Yang J., Temporary

B. S. Newman, Temporary

J. Prader

J. M. Jones, Temporary

S.-W. Kwon

F. E. R. Alfiler, Temporary

P. O. Montórfano, Temporary

M. A. Fernández Ordóñez

R. Marino, Temporary

A. Fanna, Temporary

T. S. Allouba, Temporary

I. H. Thorláksson

B. Goos

T. Sirivedhin

G. Bindley-Taylor, Temporary

J.-F. Cirelli

N. Toé, Temporary

M. Al-Jasser

M. Eran, Temporary

S. Yoshikuni

C. Brachet, Acting Secretary

B. J. Owen, Assistant

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Also Present

Asian Department: K. Saito, Deputy Director; J. E. Ceglowski,
B. Nijathaworn, J. Saito, R. S. Teja, H. Vittas. Exchange and Trade
Relations Department: A. Basu, P. Leeahtam. Legal Department:
R. H. Munzberg, Deputy General Counsel; T. M. C. Asser, P. L. Francotte.
Research Department: P. Isard. Treasurer's Department: D. Williams,
Deputy Treasurer; W.-C. Chong, A. R. Gluski, D. Gupta, D. K. Kar,
T. M. Tran, G. Wittich, B. B. Zavoico. Advisor to Executive Director:
J.-L. Menda. Assistants to Executive Directors: C. Björklund,
B. R. Fuleihan, M. A. Ghavam, S. Gurumurthi, A. Hashim, H.-J. Scheid,
M. J. Shaffrey.

1. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

At Committee of the Whole on Review of Quotas Meeting 90/13 (3/19/90), the Chairman proposed that the discussion of the staff paper on the review of Liberia's overdue financial obligations, which was being issued that day (EBS/90/51, 3/19/90) be held on March 30, 1990. He noted that the Board might be placed in the position of having to take the serious step of issuing a declaration of noncooperation with Liberia, and Directors might wish to have additional time to consider the staff paper. Despite the absence of further indications of a change in attitude on the part of the Liberian authorities, it also seemed appropriate to give them sufficient notice to enable them to send a representative to the Board meeting, if they so wished.

The decision was:

Paragraph 4 of Decision No. 9336-(89/169), adopted December 22, 1989, shall be amended by substituting "not later than March 30, 1990" for "not later than March 22, 1990."

Decision No. 9388-(90/40), adopted
March 19, 1990

2. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR MARCH-MAY 1990

The Executive Directors considered a staff memorandum setting out, with explanatory comments, the proposed designation plan for the quarterly period March-May 1990 (EBS/90/39, 3/5/90), and a staff memorandum on the proposed operational budget for the quarterly period March-May 1990 (EBS/90/40, 3/5/90).

The Deputy Treasurer said that as indicated in the introductory paragraph to the staff memorandum on the operational budget, the staff would issue in the near future a paper on methods to calculate the distribution of amounts of currency among members that sufficiently strong to be included in the budget and plan. That paper, together with the staff paper issued in October on the principles for calculating the amounts of currency under the operational budget (EBS/89/201, 10/17/89) and the statement made by Mr. Fernández Ordóñez at EBM/89/162 (12/13/89), could be considered by the Board in time for the staff to take into account the Board's conclusions on the methods of calculation in preparing the operational budget for the quarterly period June-August.

Mr. Fernández Ordóñez said that he was satisfied with the procedure proposed by the staff.

Mr. Kwon said that his chair could support the proposed decisions on the operational budget and designation plan for March-May 1990. However, he wished to take the opportunity to remind the Board of the issues raised earlier by Mr. Fernández Ordóñez in conjunction with the burden-sharing arrangement.

Table 2 on page 8 showed that if the operational budget was fully used as proposed, the Fund's holdings of Korea's currency would be reduced to 47.6 percent of quota, which was far lower than the equivalent percentage for Canada, France, Germany, Italy, the United Kingdom, and the United States. He fully understood that that position reflected short-term phenomena only and would be balanced over time. However, such an unbalanced currency distribution was partly attributable to the existing basis on which the currencies to be included in the operational budget were calculated--namely, the levels of official gold and foreign exchange holdings of members with strong balance of payments positions, irrespective of their quota size. That mechanism generally tended to rapidly reduce the Fund's holdings of the currencies of members with small quotas relative to their reserve levels until they reached the upper limit.

Such an unbalanced distribution of currencies would pose a more serious problem if the existing burden-sharing arrangement was to be extended, as was currently being proposed in connection with the strengthened arrears strategy, Mr. Kwon added.

Finally, Mr. Kwon remarked that he welcomed the assurance of the Deputy Treasurer that the matter would be brought before the Board in the near future.

The Executive Board then took the following decisions:

SDR Department - Designation Plan For March-May 1990

The Executive Board approves the designation plan for the quarterly period beginning March 19, 1990 as set out in EBS/90/39 (3/5/90).

Decision No. 9389-(90/40) S, adopted
March 19, 1990

Operational Budget For March-May 1990

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/90/40, page 2, footnote 1 and the operational budget for the quarterly period beginning March 19, 1990 as set out in EBS/90/40 (3/5/90).

Decision No. 9390-(90/40), adopted
March 19, 1990

3. THAILAND - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Thailand (SM/90/46, 2/21/90). They also had before them a background paper on recent economic developments in Thailand (SM/90/49, 3/5/90).

Mrs. Sirivedhin made the following statement:

My authorities are in broad agreement with the staff's policy recommendations, and I would like in this statement to highlight the more noteworthy features of recent developments and the outlook, and to discuss some of the salient policy implications.

1. Recent developments

The main features of Thai economic performance in 1989 were strong growth with continued improvement in the external position and in fiscal performance. Thailand's economic growth rate in 1989, although moderating slightly compared with the previous year, remained high at 10.8 percent. Investment, exports, and private consumption were the major forces propelling the rapid expansion.

On the supply side, agricultural production expanded at a normal pace while nonagricultural production continued to grow strongly. Supported by the continued, though decelerated, growth in industrial countries, together with the relatively stable international climate--including interest rates, exchange rates, and prices of oil--manufactured exports performed exceptionally well. Strong competitiveness of domestic producers and exporters, coupled with foreign investors' confidence in Thailand's economic development, also contributed to the rapid growth.

In line with these developments, the economy continued to experience sharp growth in both domestic and foreign investment.

The growth in consumption, spurred mainly by the increase in farm incomes and incomes from capital gains, however, is expected to slow down, as the share of farm incomes in GDP declines toward its long-run trend.

Gains in household savings ensued as a result of both income growth and various measures to promote savings. This, together with strong savings by the public sector and by businesses, led to a sharp rise in gross domestic savings.

In the presence of such rapid economic growth, there were some pressures on infrastructure and productive capacity in certain sectors of the economy. The cost of labor and imported raw materials began to rise. Consumer price inflation accelerated.

On the external front, import growth slowed noticeably while exports continued to be strong. The strength of exports is mainly attributable to the competitiveness of manufactured exports, which at present account for 65 percent of the total, and continue to grow in importance despite some reduction in GSP privileges and some protectionist pressures. The trade balance registered a deficit of about \$5 billion. However, large surpluses in the services and capital accounts resulted in an overall balance of payments surplus of \$4.3 million. International reserves reached a record high of \$10.5 billion, equivalent to about five months of imports, while the debt-service ratio fell further to 11 percent of exports.

Despite an increase in investment expenditure, the Government recorded a cash surplus, almost double that achieved in 1988, thus providing an effective stabilizing force.

During the first half of 1989, monetary policy continued to be supportive of economic growth. Commercial bank credit expanded at a high rate, supported by the accelerated growth in deposits which resulted from the rise in incomes, deposit mobilization efforts among commercial banks, and the expansionary effect of large capital inflows. In the subsequent period, however, the authorities placed attention on averting the signs of instability. Signals have been given to the financial institutions regarding the authorities' wish to tighten monetary policy. The authorities formulated a comprehensive menu of policy measures in December 1989, with the dual aims of restraining demand and increasing supply and productive capacity. Many of these measures have already been implemented, as elaborated in paragraph 3.

As for the most recent developments, the latest available data show that the manufacturing sector is continuing to expand strongly. In January 1990, the manufacturing production index

was 11 percent higher than a year earlier. In terms of baht, imports rose by 32 percent, above the projected growth rate for 1990 of 20 percent, while exports were growing at 23.5 percent, also exceeding the projected 19-20 percent growth rate. Commercial bank credit to the private sector grew by 31.4 percent from January last year while commercial bank deposits also expanded at a high rate of 28.6 percent. The consumer price index was 6.1 percent higher than in January 1989, somewhat decelerated from the 6.2 percent year-on-year rise in December. My authorities believe that it is reasonable to expect that the forecast of 5.5-6 percent inflation for this year can be achieved. By and large, however, demand remains strong, which my authorities realize may call for further tightening of monetary policy during the course of the year.

2. Outlook for 1990 and the medium term

The pace of economic activity in 1990 is expected to converge at a more sustainable level. Real GDP growth is expected to moderate to 8.5 percent, in line with both the expected slowdown in the world economy and the implementation of policies to stabilize demand growth. Growth in manufacturing will remain strong, as new capacity gradually increases. Moreover, some infrastructure projects will come on stream. Private consumption is expected to slow down while investment remains strong. Overall, domestic demand will moderate, although some imbalance between demand and supply will remain to be dealt with. Exports, especially manufactured exports, will remain buoyant while imports will continue to grow further in order to meet the increased demand.

For 1991-94, my authorities expect the growth rate to average about 7.5 percent. The manufacturing sector will remain strong, gaining even greater prominence in the economy and assuming the role as the main driving force of medium-term growth. Stability will be maintained, with inflation tapering off at about 4 percent. The external position, with the narrowing of the investment/saving gap, will strengthen, the current account deficit declining to the equivalent of 2 percent of GDP in 1994. Foreign investment is expected to continue at a high rate. The debt-service ratio will also decline further.

3. Economic policy stance

The thrust of economic policy is aimed at achieving two interdependent objectives--first, the immediate objective of dampening inflation to provide a stable economic environment; second, the mobilization of savings, especially long-term savings, to support investment and ensure a sustainable growth over the medium term.

On the immediate objective, the authorities have begun implementing, or will be implementing shortly, a number of policy measures to simultaneously restrain domestic demand and alleviate supply constraints.

Monetary policy is being directed at: (i) absorbing liquidity via the repurchase market for government securities and issuance of government bonds, state enterprise bonds, and in particular, a sizable amount of Bank of Thailand bonds; (ii) eliminating the incentive to borrow abroad in order to restrain the expansionary effect of capital inflows on the money supply. The exemption from withholding tax of interest on long-term foreign borrowings was allowed to expire as of the end of February 1990; raising the ceiling on commercial bank lending rates by 1.5 percentage points effective by the end of March; special arrangements are being considered in order to minimize the effect on small borrowers; (iii) eliminating the ceiling on short-term commercial bank deposit rates. Further measures may be considered in the light of developments.

The present flexible exchange rate policy will be continued.

On the fiscal front, a balanced budget (after allowing for debt repayments) is being considered for fiscal year 1990/91. Work is continuing on the plan to introduce a value-added tax by early 1991, as well as on the rationalization of the import tariff structure.

To improve supply conditions and facilitate the expansion of production, the authorities have lifted import restrictions and lowered import tariffs on a number of important inputs. The Government's spending on investment will concentrate on infrastructure.

In order to curb speculation on land and in the securities exchange, certain regulations are being revised, and a capital gains tax is under consideration.

In support of the long-term savings mobilization effort, the freeing of interest rates on long-term bank deposits has already resulted in a rise in the ratio of savings and time deposits to demand deposits. Work is being carried out to list certain profitable public enterprises on the securities exchange in order to increase the supply of saving instruments. In addition, the authorities are also actively promoting various other means, including the expansion of financial intermediaries to the rural areas. Mutual funds and a provident fund are under consideration.

At the same time, my authorities are cognizant of the urgent need to pay attention to infrastructural bottlenecks in order to support medium-term development. As noted by the staff, this need limits the scope for any substantive increase in the fiscal surplus in the near future. However, my authorities intend to limit strains on the budget by continuing to encourage participation of the private sector insofar as possible, e.g., through subcontracting arrangements, joint ventures, and privatization. Human resources will receive keen attention, both at the primary and secondary school level and at the technical level.

To support the country's medium-term requirements, the Bank of Thailand is in the process of adopting a three-year financial development plan focusing on four major areas: liberalization of interest rates, credit allocation measures and exchange control regulations; improvement in regulation, supervision, and examination of financial institutions; broadening the scope of financial services and development of new financial instruments; and the development of the domestic payments systems. Details will be worked out in due course.

4. Conclusion

In concluding, I would like to underline my authorities' determination to pursue the policy measures outlined above. Barring any unexpected deterioration in the external environment, there is a firm basis on which to be confident of Thailand attaining continued strong economic performance over the medium term.

She had just received word from her authorities, Mrs. Sirivedhin added, that the interest rate ceiling measures to which she had referred had already been implemented.

Mr. Fernando made the following statement:

The record speaks for itself amply in regard to Thailand's economic performance. I need only to strongly commend the authorities for their farsighted and skillful management. If I single out one feature for special mention, it is that the sustained period of growth with stability has provided the necessary latitude for the authorities to carefully articulate and sequence structural reform. Of course, the process of structural reform has no end. And even in the best-run economy there is always room for improvement--and for policy advice.

We have not noticed any divergences of opinion between the authorities and the staff. Hence, we would confine our comments on economic matters to the external surplus and the potential for

inflation. Fund policy prescriptions have their best record of success in the area of inflation. But the analyses, as far as we know, have been in the context of Fund-supported adjustment programs, associated with large external and internal imbalances. In the case of Thailand, the inflation concern is associated with an enviable surplus in fiscal conditions. Externally, although there is a balance of payments current account deficit, it is fully covered by a combination of foreign direct investment and medium- and long-term capital--the typical aspiration of a developing country. But to go beyond this happy situation, the over-fulfillment on the capital account and its effect on domestic monetary aggregates presents an unusual problem, which argues for caution in defining the instruments to be used to neutralize the problem as well as for careful timing. Gross inflows of nonmonetary capital, particularly last year, are closely linked to the tax incentive for private long-term borrowing. The reversal of this incentive is the essential and first step for the correction of the problem. The authorities stand ready to support this measure through further acceleration of trade liberalization. The authorities and staff should carefully monitor the results. We are reluctant to stampede the authorities into a variety of actions.

Actions that could lead to a general rise in interest rates should be carefully considered. For one thing, further progress in improving the working of the domestic financial and capital market is necessary to ensure that interest rates are truly the outcome of market forces. Another aspect for consideration is that certain components of investment expenditure, for instance, in infrastructure, are highly sensitive to interest rates. Maintaining the growth potential of the economy and relieving certain emerging bottleneck requires investment in infrastructure. The private sector is expected to play a major role here. Infrastructure, by definition, calls for large amounts of loan capital; there is a long gestation period before a payoff begins. These aspects should be carefully balanced when acting directly on the interest rate. Mrs. Sirivedhin, in her statement, has confirmed that the authorities are taking some steps in this direction. Their past record makes us confident that they will judge their movements carefully.

We welcome the emphasis placed by the authorities on human resource development, and we stand ready to accept such expenditures even if they have to be funded from higher taxes. It is creditable that the authorities are spared such a dilemma.

In an otherwise excellent staff report, the only section that left me uncertain and groping is the one on social and environmental issues. Both are indeed very complex subjects. I do not

know whether the staff has made a judgment, or wishes to convey a particular message--although it has reported, and rightly so, that the Government is concerned about income distribution, poverty, and the environment. Of course, these are matters of concern for practically every government.

Let me take up social issues separately. We are familiar with staff comments on these, and particularly poverty issues, in the context of Fund-supported adjustment programs. As much as we have the welfare of the population at heart, equally we have in mind the need for resolute implementation of the program so as to assure the repayment of Fund credit; and program implementation is facilitated to the extent that it avoids social tensions.

In the case of Thailand, no doubt this subject is treated as part of Article IV surveillance. We welcome this in a general context as applicable to the entire membership. However, I cannot say that I agree fully with the staff appraisal in calling on the authorities to address the problem of inequity. We do not see any specific analysis to validate this call. A study which purports to provide evidence that poverty has deteriorated is outdated. According to Table 5 of the background paper, farm incomes showed a phenomenal increase in the last two years--which is striking if one recalls that poverty is essentially a rural phenomenon. Even income distribution provides no hard evidence. In fact, we would suggest that in Asian agrarian societies, such as Thailand, family expenditure data are a better indicator of living standards than measures of income distribution.

Turning to the environmental issue, I see a novelty here in the sense that the environment is being given attention under an explicit heading in the staff report. I recall the Managing Director's memorandum of January 26 on the budgetary outlook, which referred to the increasing interest of concerned and vocal groups regarding the impact of the Fund's work on the environment. For Thailand, whose last Fund arrangement expired nearly four years ago, I cannot quite see the linkage. To the extent that structural constraints are embedded in environmental factors, I can see a clear need for analysis. And this would usually be in the context of medium-term Fund programs with a large structural content. But outside of that context, environmental factors are a general problem affecting every member. Citing merely the work done in the World Bank, we would think that Thailand must trail far behind others in terms of the intensity of the problem. The treatment of the subject is too shallow, and like the section on social issues, I cannot see sufficient grounds to make a specific call on the authorities to revise environmental deterioration--as suggested in the staff appraisal--unless the coverage becomes standard material in concluding all Article IV consultations.

Mr. Yamazaki made the following statement:

The economic performance of Thailand for the past several years has been quite satisfactory. The remarkable rate of real growth--one of the highest in the world--was brought about by strong exports and exceptionally high investment activities. Furthermore, the high rate of savings helped sustain brisk investment without leading the economy into an overheated stage. In my view, as in the other Asian countries that are enjoying high economic growth, the strong performance of Thailand's economy should be credited to the outward growth strategy based upon export promotion rather than import substitution. In retrospect, it appears that the economic adjustment program that was embarked upon in 1985, supported by the Fund stand-by arrangement, further consolidated the strength of the Thai economy through appropriate exchange rate management and fiscal retrenchment. At any rate, the Thai authorities should be greatly commended for their outstanding achievements.

Having said this, as the staff rightly notes, the sustainability of balanced economic growth rests upon two conditions, namely, the containment of inflation in the short run, and the provision of adequate public infrastructure and human resources in the medium term. Since I am in broad agreement with the thrust of the staff paper and Mrs. Sirivedhin's statement, I will concentrate on these two issues.

First, the problem of inflation is the most important threat to the Thai economy. In this connection, I am somewhat concerned about the short-term economic prospects envisaged in the paper. As suggested by the medium-term scenario, the staff apparently thinks that the sustainable growth rate of Thailand is about 7-8 percent. If this is correct, the expected growth rate in 1990 is still on the high side, particularly in the context of the exceptional growth in the previous two years. More important, the inflation rate is expected to rise to 6 percent, which will be the highest rate since 1981 and, in my view, cannot be considered to be sustainable over the medium term.

On the other hand, there seems to be a certain optimism about the current rate of inflation. Certainly, I agree with the staff's observation that the inflation rate for nonfood items is more modest and the situation in the labor market remains stable. Nonetheless, I am wondering whether the unexpectedly high real growth rate in 1989 and the subsequent high growth in 1990 might not lead to strong inflationary pressure, in which case the slowdown in economic activity and the rate of inflation after 1991

envisaged in the medium-term scenario will require a somewhat drastic adjustment in contrast to the staff's safe landing scenario. I would appreciate it if the staff could elaborate on this point.

My next caveat with regard to the problem of inflation is the lack of a clear orientation for anti-inflationary policies. In this connection, the staff paper alluded to the dilemma for monetary and exchange rate policy of reducing excess liquidity caused by the unexpectedly high surpluses in the overall balance of payments. Apparently an orthodox remedy would be to reduce domestic credit expansion through higher interest rates while at the same time discouraging capital inflow by allowing the exchange rate to appreciate. In the view of the staff, on the other hand, the appreciation of the exchange rate is not consistent with the other policy aim of reducing the current account deficit. However, in my view, such ambiguity in the course of macroeconomic policy itself would undermine the credibility of the monetary authorities. Moreover, once inflation gets out of hand, its adverse effect on competitiveness could easily offset the benefits of the low exchange rate. To some extent such a phenomenon has already been observed in relation to regional competitors as evidenced by Chart 4 of the background paper. All in all, if the authorities seek to forestall inflation as the first priority of economic policy, I would strongly suggest that monetary and exchange rate policy be clearly oriented in that direction. Specifically, I would suggest that, to the extent that the interest rate should be kept competitive in real terms to contain domestic credit, subsequent upward pressure on the exchange rate should not be resisted. Meanwhile, if domestic demand is successfully curtailed as the consequence of anti-inflationary policy, it would partly--if not entirely--offset the adverse impact of possible exchange rate appreciation on the current account.

That being said, let me briefly touch upon the medium-term issues. First, in view of the need to provide the economy with sufficient infrastructure and human resources, the role of fiscal policy is important. While I fully support the staff's view that the role of the private sector should be emphasized further, I also think that the relatively low level of public infrastructure justifies the recent upward trend in public expenditures. Given the relatively small size of the public sector in relation to GDP, and the apparent need not to add to the liquidity in the economy, revenue enhancement should parallel the increase in public expenditure. In this connection, I am much concerned about the delay in introducing the value-added tax and request the authorities to expedite the legal procedures for its early implementation.

Next, in many respects the rapid increase in prices for urban land is a strong cause for concern, not only for its possible effect on the general price level but also for the direct implication of such a relative price change in the context of social and environmental issues, particularly the distribution of wealth between rural and urban areas. I welcome the authorities' intention to contain speculative price hikes. At the same time, it should be noted that to address the problem of land prices, due attention should be paid to supply incentives, in addition to the need for curtailing speculative demand. In this connection, I would attach particular importance to legislation pertaining to the rezoning of large areas and to a municipal tax on unutilized land, referred to in the staff paper.

Before concluding, I would once again commend the Thai authorities for their success in economic management. Under the circumstances, I agree with the authorities' view that there is no reason why Thailand should not accept the obligations of Article VIII.

Mr. Landau made the following statement:

Thailand has just recorded three years of outstanding economic success. The combination of strong nominal depreciation and effective wage restraint has produced great beneficial effects: it has boosted profitability and investment, increased competitiveness and exports, thus making possible a marked increase in consumption and a high, double-digit rate of growth. In the process, external debt has been greatly reduced as a percentage of GDP. So there is no exaggeration in the staff's statement that, by virtually any criteria, Thailand's economic performance continues to be exceptional. There is no reason, as underlined in the report, that it should not be so in the future. The high rate of capital formation has raised the growth potential, and the authorities seem keen to address the rigidities and bottlenecks which could impede the development of public services and infrastructure. The Thai authorities are to be highly commended for their remarkable achievements.

In this context, I would like to focus my remarks on one single issue which is at the centerpoint of the staff's report, namely, the link between the current account, capital flows, and inflation. Indeed, Thailand's dilemma in recent years has been a very strange and unusual one: spontaneous capital inflows tend to be higher than the current account deficit the authorities are willing to run. Over the past year, this contradiction has been solved through a surge of inflation; monetary policy was constrained by the need to stabilize the exchange rate and an

insufficient amount of external capital inflows has thus been sterilized. So the necessary--and unavoidable--increase in the real exchange rate has been achieved through internal price increases rather than through nominal exchange rate appreciation.

Both the authorities and the staff recognize the fact that this process should not be allowed to develop. Alternative sets of measures are considered in the staff report. I will examine some of them:

First, the elimination of tax incentives to foreign borrowing is most welcome. But it cannot, alone, solve the problem of excess capital inflows; although these flows are certainly sensitive to tax and regulatory measures, Thailand is in itself such an attractive country for investment that they are likely to be sustained in the future.

Second, the liberalization of capital outflows should also be considered. The authorities are reluctant to do so, considering that the country is still capital deficient. In that case, they would have to accept a current account deficit as a necessary counterpart.

Third, there would be good reasons to accept nominal exchange rate appreciation: it would alleviate constraints on monetary (interest rate) policy; adequately reflect the improvement in terms of trade taking place in recent years (although this could be partially reversed in the coming years); and act as a powerful tool against inflation. I understand that the authorities are reluctant to accept this approach, which should nevertheless be kept under review, especially in case other measures fail to produce the necessary effects on inflation.

Fourth, the staff makes a strong and convincing case for immediate and drastic trade liberalization, which would certainly yield beneficial microeconomic effects and improve resource allocation. But, in the case of Thailand, it would also have macroeconomic benefits: namely, it would increase the current account deficit without any appreciation of the real exchange rate, thus allowing for capital inflows without deteriorating the competitiveness of exports.

Measures should be taken now, seizing the opportunity of the Uruguay Round to gain reciprocal concessions from trade partners.

In the longer run, a lot will depend on the increase of domestic savings: only this would enable the authorities to reconcile their two main objectives of strong growth and investment,

on the one hand, and a small current account deficit, on the other. The fiscal consolidation which has occurred is greatly welcome in this regard. It remained to be seen whether private savings would develop as expected.

Mr. Jones said that he wished to join other Directors in commending the Thai authorities for the impact of their stabilization and adjustment measures over the past few years. Nonetheless, the danger signs that had cropped up could not be ignored. In particular, the price trends and the associated exchange rate appreciation in relation to regional competitors, which were illustrated in Charts 2 and 3 of the staff report, were of considerable significance in an economy which had owed its success in part to its competitiveness within the region.

The staff quite rightly recognized that those problems did not stem from fiscal laxity, Mr. Jones noted. The authorities' fiscal stance had been appropriately tight, at least on an ex post basis, although it was unfortunate for both budgetary and resource allocation reasons that revenue had been foregone through reductions in the petroleum excise tax. The Government's emphasis on investment expenditure was appropriate, given the infrastructure and human capital constraints that were beginning to bite on the economy. And he very much welcomed the role seen for the private sector in infrastructure development. Although the apparent abandonment of the plans to privatize public enterprises remained a disappointment, the partial flotation of some enterprises on the stock market was a significant step in the right direction.

Referring to the monetary difficulties, Mr. Jones observed that the authorities needed to restrain the impact or the scale of large capital inflows. He concurred with the staff view that a real appreciation of the baht would not be appropriate in the present circumstances, whether through official changes to the nominal rate or as a result of inflation. To reduce the impact of the inflows, the authorities had taken steps to effect domestic sterilization. But as the staff noted, that presented the dilemma that the associated higher interest rates might themselves attract more inflows.

He had been interested to note from Annex III to the background paper on capital movements and monetary policy that while there was an element of that risk, it was not necessarily sufficient to make the authorities' actions completely ineffective, Mr. Jones said. However, beyond that there would seem to be other, very good, reasons for accepting that risk and allowing the full interest rate consequences of tighter liquidity conditions to come through. Higher interest rates would encourage higher domestic savings with which to finance investment. Experience with liberalized term deposit rates over the past year had indicated that savings would respond to incentives, and he welcomed the news that liberalization had been extended throughout the spectrum of deposit rates.

A general liberalization of interest rates would allow the effects of monetary tightening to come through, and on the lending side would improve credit allocation. He greatly welcomed the authorities' apparent recognition of that fact, and hoped that the increase in lending rate ceilings would be a precursor to their abolition but to be effective a competitive financial sector was essential; the removal of barriers to entry for foreign banks could play an important role in progress toward that end.

To supplement the limited impact of sterilization, there were other structural reforms identified by the staff, which would not only serve to counter the scale of inflows but were appropriate in their own right, Mr. Jones continued. The authorities had already removed the tax incentive to foreign borrowing, and a useful supplementary measure would be the removal of all artificial incentives to investors, both domestic and foreign. As his chair had so often said in the past, the best incentive to investment was an appropriate macroeconomic environment.

As a balance to the free inflow of capital, liberalization of capital outflows would appear to be a logical step, Mr. Jones added. He found it difficult to believe that such liberalization would initiate an outflow of such magnitude as to undermine entirely the balance of payments position. While Thailand might still be a capital-deficient country in stock terms, as the authorities claimed, there was no shortage of capital flow. It would be interesting to hear if the staff had any view of the likely scale of private sector potential capital outflows.

In addition, the staff placed considerable emphasis on accelerated trade liberalization as a way to control domestic inflationary pressures, and at the same time restrain the overall external balance, Mr. Jones said. He agreed with the staff view that the strength of the overall external position presented a rare opportunity to benefit from such a move, if combined with the appropriate restraint on demand through a tighter monetary stance. In the short term, the current account might suffer, but in the long term it would suffer far more if inflationary pressures were not quickly eliminated.

Taken together, those various measures, and the situation with which they were intended to deal, were representative of the emergence of Thailand as a strong market economy, ready to participate in an international environment without artificial incentives to or constraints on economic activity, Mr. Jones concluded. It was to the credit of the authorities that their policies in the 1980s had brought their economy to that point. In that context, he very much welcomed the recognition by the authorities that there was no reason why they should not accept the obligations of Article VIII, and he urged them to do so in the near future.

Ms. Yang observed that Thailand's economic performance continued to be remarkable in 1989. Economic growth remained strong while the overall balance of payments position stayed at a relatively sustainable level, with

gross international reserves rising rapidly. The most important achievement, which guaranteed a stable macroeconomic environment for economic development, was the continued positive balance in the fiscal account. The favorable fiscal performance of recent years ensured consistent growth in private investment and steady industrialization of the economy. That, in turn, laid the foundation for sustainable growth over the longer term. Her chair was very impressed with the Thai authorities' ability to adapt the economy to changes in the external environment by timely adjustment. Like other successful Asian economies, Thailand's experience had provided worthwhile example for small open economies of how to adjust the economy to external shocks in ways that kept macroeconomic performance on track.

Along with those general observations, she wished to make a few remarks on three specific issues, Ms. Yang continued. First, regarding the sustainability of economic growth in the medium and long term, it was natural to raise such a question when an economy continued to grow at relatively high rates for a considerable period of time. In the case of Thailand, which enjoyed a high degree of openness, the medium-term scenario was also heavily dependent on foreign demand, particularly from Thailand's major trading partner countries. It seemed to her that that condition was not merely an assumption in the staff's projections regarding the medium-term prospects for Thailand. Another related point was the impact of capital inflows on the domestic economy. She would imagine that, with a relatively small domestic market in Thailand, domestic demand was generated in large proportion to correspond to foreign demand. For example, capital inflows since the start of industrialization might have been well integrated into domestic investment and production activities, which had been structured in such a way as to meet the conditions of those capital inflows. Because of the close association between the domestic economy and the world economy, both demand and supply-side effects of capital inflows on domestic economy needed to be taken into account when economic growth prospects were assessed.

Second, concerning strategies for dealing with inflation, the authorities were to be commended for their cautious and timely anti-inflationary policy measures, Ms. Yang considered. Whatever the causes of inflation, it was of the utmost importance to address the problem of emerging inflation at an early stage before it became acute. She agreed with the authorities and the staff that current inflation was not primarily a symptom of cost-push pressures, but rather a monetary phenomenon driven by large capital inflows. It was of a temporary nature, therefore, and should be tackled mainly through monetary instruments such as sterilizing the monetary impact of capital inflows while adopting a flexible interest rate policy to resist excess demand for bank credit. In that respect, her authorities welcomed the authorities' intention to issue central bank securities and to adjust the ceiling on commercial bank lending rates. However, as she had noted from the staff report, first, that Thailand was still a capital-deficient country, and second, from the medium-term scenario, that a large part of the

current account deficit would be financed by capital inflows, she wondered how measures to reduce capital inflows in an attempt to curb inflation could be reconciled with those conditions.

At that point, she wished to ask if it was understood that there had already been excessive foreign capital inflows, which had induced an inflationary effect rather than a supply-side effect, Ms. Yang said. If that was the case, she wondered if it had anything to do with the direction of foreign capital investments or other issues related to utilization of foreign capital.

It was also very encouraging to note the authorities' efforts to raise adequate domestic savings to sustain investment and meet infrastructural needs, Ms. Yang stated. That would provide a fundamental solution to alleviating supply constraints and eventually to help ease inflationary pressures in the drive to industrialization.

Third, concerning external policies, she welcomed the authorities' intention to liberalize current and capital transactions, Ms. Yang observed. According to Mrs. Sirivedhin's statement, the authorities had lifted import restrictions and lowered import tariffs on a number of important inputs in an attempt to curb inflationary pressure in the economy, and they intended to restructure the tariff system. While the authorities should be encouraged to tap the potential for further liberalization in the trade system, it was more important that protectionism against Thailand's exports of goods and services be rolled back so that the Thai authorities could enjoy a comfortable external environment for structural reform in the external sector. In that context, she had noted with interest on page 13 of the staff report that Thailand's experience showed how important it was to have not only a diversified export base, but also a diversified export market so that the external sector--and hence economic growth--could be protected from changes in the external environment.

Finally, Ms. Yang stated that her chair shared Mr. Fernando's view concerning social and environmental issues.

Mr. Toé said that it was heartening to read about Thailand's economic success story which, in a sense, had been brought about by the sustained implementation of structural adjustment measures and appropriate macroeconomic policies since the mid-1980s. Those had enabled Thailand to succeed in reversing the deteriorating economic situation experienced during the first half of the decade. As a result, the basis for sustainable growth had been established, and he wished to join previous speakers in commending the Thai authorities for the continued satisfactory performance of the economy. Indeed, the buoyant economic growth recorded during recent years had proved broad based, and had continued at an even stronger pace in 1989, with real GDP expanding by nearly 11 percent. Moreover, both the fiscal situation and the external position had improved, and the debt service ratio had been further reduced.

Since he was in broad agreement with the staff appraisal, Mr. Toé said that he would confine his remarks to the two challenges facing the authorities in the short as well as in the medium term, namely, reducing inflationary pressures in the economy and mobilizing long-term savings in order to lessen the economy's dependence on foreign capital inflows and ensure sustainable growth over the medium term.

First, on inflation, it was clear from the staff report that the major driving forces of the Thai economic boom, namely, strong investments, private consumption, and a steep rise in exports, carried a potential inflationary risk, Mr. Toé commented. Moreover, large external capital inflows and their monetary impact were exerting pressures on domestic prices, as evidenced by the recent acceleration in the consumer price index. Under those circumstances, his chair was of the view that, in the short run, strong measures were needed to arrest the acceleration in the rate of inflation and provide strong signals to prevent inflationary expectations from taking hold. In that respect, he had been pleased to note from Mrs. Sirivedhin's statement that her authorities' immediate objective was to dampen inflation in order to create a stable economic environment. He endorsed the measures taken aimed at reducing domestic demand and alleviating supply constraints. With respect to the latter, he concurred with the staff that the authorities would need to address the human resources and the infrastructural needs of the economy in order to contain the inflationary pressures stemming from the effects of sectoral bottlenecks. He had been pleased to note that the required budgetary outlays could be accommodated through a restructuring of expenditures and alternative arrangements with the private sector, without weakening the authorities' fiscal stance.

Second, on the mobilization of long-term savings and the reduction of the economy's dependence on foreign capital inflows, Mr. Toé noted that as the staff had rightly pointed out, in the case of Thailand, the topical question was that of the sustainability of the country's exceptional economic performance. He agreed with the staff that a number of key policy issues would be of critical importance for establishing the conditions conducive to a sustainable growth path. Among those were the authorities' efforts to mobilize long-term savings to meet the investment needs of the economy. The measures taken to free interest rates on long-term bank deposits and to extend banking services to rural areas, and those under consideration for introducing new saving instruments, would go a long way in promoting and mobilizing domestic savings.

Also of critical importance to the achievement of a sustainable growth path would be the authorities' ability to reduce the economy's dependence on foreign capital inflows and neutralize the monetary impact of those inflows, Mr. Toé said. As indicated in the staff report, those inflows had reached unprecedented levels in 1989, fueling inflationary forces and contributing to a weakening of the effectiveness of monetary policy. That situation had provided some degree of urgency to the issue of the adaptation of the domestic financial system and to the need to bring into play other

supporting policy instruments. In that regard, his chair welcomed the authorities' intention to put in place a three-year financial development plan. He endorsed the short-term measures already taken to mop up excess liquidity and to reduce some of the distortions in deposit and lending rates. He had noted also that those measures had been supplemented by the tightening of external borrowing regulations and by the promotion of capital outflows through the prepayment of external debt. However, should the current pressures continue unabated, he would encourage the authorities to be prepared to use other available instruments, including fiscal and exchange rate policy, as well as accelerating structural reform measures to ensure that their objectives of stabilizing the financial environment and reducing reliance on foreign capital inflows remained on track.

Mr. Ghasimi said that he had been pleased to note that Thailand's economic performance continued to be remarkable and in many ways exceptional. He certainly supported and commended the authorities' initiatives and efforts at sustaining such impressive economic progress. Indeed, many developing countries could learn a great deal from the successful experience of Thailand in achieving fundamental and sustainable strength in the economy.

During 1989, despite the continuation of previously accomplished economic gains, including the further expansion of investment in the manufacturing sector as well as accelerated growth in bank deposits, Mr. Ghasimi continued, the outstanding rate of economic growth of 10.8 percent had naturally strained resources and certain infrastructural bottlenecks had emerged in the economy. Under the circumstances, it was heartening to note from Mrs. Sirivedhin's statement that the authorities were committed to pursuing appropriate policies to deal with the overheated Thai economy and to sustain noninflationary growth and diminish the existing pressures on infrastructure and productive capacity as far as feasible.

With respect to trade policy, the intended trade reform measures to restructure the tariff system, and thereby improve the efficiency of the industrial sector, were welcome, Mr. Ghasimi stated. The export sector, especially manufacturing exports, which now accounted for 65 percent of total exports, had been the engine of growth in Thailand. However, the recent expansion of exports of manufacturing goods had been attributed to some extent to developments in Thailand's trading competitors, including increases in wages, exchange rate movements, and other adverse exogenous circumstances. In those circumstances, diversification of Thailand's exports was not only susceptible to the challenge of rising protectionism, but the maintenance of a rapid and sustainable rate of growth in exports would necessitate devoting considerable attention to nonprice or market factors, such as packaging, product development, and quality and promotional aspects of international markets.

As for monetary policy, the authorities' plan was well designed to control inflationary pressures, Mr. Ghasimi commented. Indeed, reducing the

growth of the money supply and credit, and especially limiting the expansion of credit to nonproductive activities, were definitely steps in the right direction. Moreover, it was encouraging to note that the Central Bank of Thailand was playing a more active role in absorbing excess liquidity through open market operations. Furthermore, the envisaged financial plan of the Bank of Thailand would definitely facilitate attainment of the country's medium-term objectives, and its emphasis on improving the supervision of financial institutions would play a crucial role in achieving an efficient banking system in order to encourage household savings. It appeared that appropriate interest rate measures to augment private savings had been taken. Needless to say, the further promotion of private savings would be essential to narrow the prolonged gap between savings and investment in the private sector that could not be filled through public sector savings, which would be badly needed to finance future infrastructural investment needs.

The authorities' fiscal policy had led to successful achievements, Mr. Ghasimi noted. However, while the surplus generated was gratifying, he shared the staff's view that public investments should be boosted in order to finance infrastructure, health, education, and training, which were badly needed in Thailand. Fortunately, the authorities intended to devote considerable resources to those areas.

Finally, as indicated in the conclusion of Mrs. Sirivedhin's statement, Mr. Ghasimi noted, the authorities were to be commended for their firm commitment to pursuing the necessary adjustment measures aimed at achieving strong and sustainable growth.

Mr. Prader observed that economic trends in Thailand had changed little since the Board's discussion of the 1988 Article IV consultation. The rate of growth, the inflation rate, fiscal and balance of payments surpluses, and the country's attraction for foreign investors were generally as satisfactory as they had been during the previous year.

At present, the agenda of the Thai authorities was dominated by the need to combat a rise in the inflation rate, Mr. Prader commented. The staff's and the authorities' conclusions concerning the causes of and countermeasures against inflation had become focused on the need for sterilization of the monetary expansion stemming from the surplus in the capital account. They further agreed that except for the upward trend of business profitability, changes in the cost of the factors of production had not contributed significantly to inflation, and that that was also true of exchange rate and terms-of-trade effects.

Where inflation could be regarded as a straightforward reflection of the demand and supply relationship, that containment could be approached from the demand side, Mr. Prader noted. But in Thailand's case, consumption trends still sailed along below investment trends: it was rather the fiscal surplus and the emerging needs for infrastructure and human resource enhancement that would exert some upward pressure. For that reason, he did

not believe indiscriminate demand management to be the most appropriate policy response. Especially in terms of their distributional effects, the further liberalization of imports and the antispeculative taxation of land, luxury housing, and equity were preferable to the losses which the Bank of Thailand would incur by issuing bonds for sterilization purposes. The elimination of the tax incentives for foreign borrowing was also a needed step in the right direction.

As to the comparative merits of an appreciation in the exchange rate versus further import liberalization, it was his view, Mr. Prader continued, that Thailand's comfortable reserve position and external viability still provided plenty of room for further liberalization. He saw that as the preferable course in terms of its effects on the medium-term sustainability of efficient growth.

On trade policy, he did not share the Thai authorities' concern about "the challenge of rising protectionism" posed by European developments in general or by East European efforts at market integration and reorientation in particular. As long as the flows of capital and trade in the world economy were not "Pareto optimal," and did not even complement one another, a reversal in the direction of capital flows could well create better trading opportunities for Thailand. At the moment when various countries in Asia were beginning to feel the effects of the new wave of democratization and market reorientation, Thailand would be one of only a few major beneficiaries. The argument concerning the external account deficit ran along the same lines as that already elaborated several times in the case of the United Kingdom.

On investment policy, he noted that the number of applications received by the Board of Investment had declined steeply in 1989, while the investment value per application had risen substantially, Mr. Prader said. He asked whether the smaller number of applications was due to saturation, or whether it reflected a trend toward capital intensive investments. The staff's assistance on that point would be most helpful.

Mr. Al-Jasser stated that the economic performance of Thailand continued to be remarkable, as indicated in the staff report and in Mrs. Sirivedhin's statement, and has persistently surpassed every expectation. Moreover, the potential to sustain that impressive performance existed because Thailand did not face any insurmountable economic challenges. Since he was in broad agreement with the staff report, he would restrict himself to a few comments for emphasis.

The main potential difficulty facing the economy was the rising, albeit moderate, inflation rate, Mr. Al-Jasser noted. The danger lay in the fact that the rate was higher than that of Thailand's major competitors, which could translate into a loss of competitiveness in the future. Moreover, unless inflation was nipped in the bud, it could infest the whole economy, rendering its reduction terribly costly. He was therefore encouraged by the

fact that inflation had become a public issue commanding wide media attention and domestic debate. That was clearly a crucial ingredient for any successful, anti-inflationary policy.

It was obvious that sterilizing the monetary impact of capital inflows would help contain inflation, Mr. Al-Jasser remarked. But the tightening of monetary policy that would be required, in the context of a small open economy with a fixed exchange rate, could further encourage capital to flow into Thailand. While he recognized that the possibility of a sustained differential between domestic and international interest rates existed in Thailand, he cautioned against overplaying that policy tool. The need for caution was reinforced by the fact that persistently high interest rates could, in and of themselves, eventually contribute to inflationary pressures.

Consequently, it was crucial for the authorities to maintain their tight fiscal stance and to substantially reduce the concessions granted to direct foreign investment, Mr. Al-Jasser considered. Domestic and foreign investment should be awarded equal treatment. He also welcomed the authorities' intention to prepay their external debt, and to adopt a liberal policy regarding direct investment abroad.

More significantly, it was important for the authorities to speed up and broaden their trade liberalization efforts, Mr. Al-Jasser observed. The economy continued to suffer from high tariffs and numerous nontariff barriers. Such a broad liberalization would not only help contain inflationary pressures, but would also provide substantial long-term efficiency gains to the economy. It would also facilitate efforts to sterilize the inflow of foreign capital. Hence, he urged the authorities to implement broad trade liberalization, especially since the balance of payments and reserve positions were comfortable. Furthermore, it was imperative for a growing economy that was rapidly becoming a noticeable international exporter to reduce its own trade barriers if it intended to maintain market access for its own products.

Finally, Mr. Al-Jasser said that he was confident that a diligent implementation of the above measures would succeed in containing inflation. However, if those measures generate pressures for slight changes in the exchange rate policy, one need not be dogmatic about maintaining a rigid nominal exchange rate.

Mr. Goos said that he could associate himself with the commendations expressed by previous speakers for the remarkable performance of the Thai economy. He could also support the thrust of the staff appraisal.

To comment briefly on the issue of inflation, Mr. Goos noted that the causes and risks of the rising trend of inflation had been discussed by previous speakers. He wished just to welcome the recent adoption by the authorities of the anti-inflation package of December 1989, which appeared to be highly appropriate and timely, although he would have liked to see a

somewhat more ambitious inflation target for 1990 than 5.5 percent to 6 percent and also a more ambitious medium-term target than the 4 percent mentioned by Mrs. Sirivedhin. But there was no doubt that the authorities' anti-inflation strategy, as well as the strategies discussed in the staff paper, pointed in the right direction. At the same time, however, and similar to the comments of previous speakers, his concern was that monetary policy might have to shoulder a disproportionate share of the burden, the more so since he shared the concern that a substantial further tightening of the monetary policy stance and a further increase in interest rates might induce offsetting capital inflows. If that were to happen, he feared that the staff's bold recommendations for import liberalization as a supplementary device for reducing inflation would not be without risks. While highly desirable for its beneficial effects on economic efficiency, import liberalization could compromise the authorities' current account objective if it took place in an environment of insufficient financial restraint. And in that respect, the figures mentioned in the staff report for monetary and credit expansion appeared to be on the high side again. Of course, that did not mean that the authorities should not liberalize imports, which he certainly would encourage them to do. But he believed that that liberalization needed to be supported by restrictive fiscal policies. In that regard, he was quite worried that the reduction in the fiscal surplus originally budgeted for 1990 and the fiscal budget for the following year, which was supposed to be balanced, if he was correct, reflected a budgetary approach that led in the wrong direction. He certainly recognized the policy constraints arising from the need to step up investment expenditures, but in view of the still relatively low tax/revenue ratio, he wondered whether that constraint could not be overcome by revenue enhancement measures.

Aside from fiscal policy, exchange rate policy could be used somewhat more actively in support of the stabilization effort, Mr. Goos noted, joining his view for obvious reasons to those of Mr. Landau and Mr. Yamazaki. He failed to see an immediate threat to external competitiveness from a further strengthening of the exchange rate, the more so since there were repeated references in the staff report to the wide margin of competitiveness that still existed following the 1984 depreciation. It was probably no coincidence that the rate of inflation was estimated to have decelerated in 1989, notwithstanding the continued strong monetary expansion, but it was noteworthy that at that time the effective exchange rate had appreciated markedly.

In concluding, Mr. Goos considered that the authorities would be well advised to enlist all available instruments to contain inflation, in particular since the most recent developments reported in Mrs. Sirivedhin's statement seemed to indicate that the strength of domestic and external demand might once again have been underestimated. For that reason, he also believed that the authorities should liberalize the existing restrictions on portfolio investment and other capital outflows and remove the remaining ceilings on domestic bank deposits and lending rates. The observation in the staff report that the Bank of Thailand reacted only with considerable

delay to the marked monetary expansion in the course of the past year would suggest that the authorities should perhaps adopt a stronger medium-term orientation for the conduct of their monetary policy.

Mr. Alfiler made the following statement:

The basic situation of the Thai economy has not altered to any degree since the time of the last Article IV consultation--1989 was one more in a recent succession of vintage years with the only major cloud on the macroeconomic horizon being the upward trend in inflation. However, in absolute terms, inflation is not high. For all this, the authorities deserve our commendation, although it does not mean that all is perfect in the Thai economy. I consider that the staff appraisal identifies the challenges faced by the Thai authorities and how these challenges might best be met. It is not difficult to concur with the staff's assessment that inflation, although moderate, needs to be dealt with, and that as the upward trend in inflation appears to be primarily a monetary phenomenon, the authorities should aim at re-establishing monetary restraint.

The measures that the authorities intend to introduce to offset the impact of the accumulation of foreign reserves are certainly a step toward regaining control over liquidity. As an additional measure, the incentives for capital inflows should be reduced. Also, I would strongly endorse the staff's call for the raising, or preferably the removal, of the ceiling on bank lending rates. I am therefore encouraged to learn from Mrs. Sirivedhin that the first important step to this end has been implemented. By the time the authorities can ascertain that the ceiling is a binding constraint on the banks, some of the deleterious effects referred to in the staff report may have occurred already. Also, moral suasion as a means of limiting lending to certain sectors is a rather blunt weapon; realistic interest rates are far more effective.

Monetary policy questions aside, I consider that the excellent condition of the Thai economy provides the opportunity for the authorities to undertake the structural reforms and policy liberalization which could ensure the sustainability of a high growth path for the economy. The staff refers to this opportunity also, in the context of trade liberalization and the benefits that it would bring. I can endorse the staff's call for reducing the remaining quantitative restrictions on imports and lowering tariff protection. These moves would have both a beneficial effect on prices and maintain pressure on Thai producers to remain competitive. I might mention here that current plans to lower tariffs on luxury goods do not seem to square with the desire to limit credit for luxury housing.

Again, on capital flows, concessions on direct foreign investment could well be reduced, or eliminated. Thailand's record of economic management should be sufficient to attract investors, and the restrictions on outward capital flows should be re-examined as they have no demonstrated beneficial effect and their removal would probably not be disruptive.

With trade liberalization and tighter monetary policy going a long way toward reducing inflationary pressures, the burden on fiscal policy would be reduced. The authorities would then be in a position to direct "surplus" revenue toward developing the infrastructure of the economy, education and training, and tackling environmental problems. Annex IV to the background paper on recent economic developments paints a depressing picture of the environmental havoc wreaked by rapid development, and Thailand's economic achievements will be somewhat hollow if the deterioration of the environment is not reversed. A relevant point here is that the artificially low prices for petroleum products must surely encourage overuse and thus contribute to both congestion and air pollution. More important, the authorities would do well to appreciate that oil prices are beyond their control and that to commit fiscal revenues in an attempt to control them may not be consistent with their striving for efficiency in the use of fiscal resources.

Mr. Thorláksson remarked that as there was little to add to the analysis by the staff and Mrs. Sirivedhin's statement, he would comment briefly only on two areas that were a cause for concern, namely, the short-term problem of inflation and the medium- or long-term issue of structural difficulties.

First, on inflation, it was evident that the rise in the rate could be seen as a threat to the positive development of the economy, Mr. Thorláksson noted. His chair fully agreed with the staff that, in the prevailing situation, monetary restraint, supported by trade liberalization, was the appropriate anti-inflationary tool. In viewing other objectives of economic policy, the measures chosen should in no way harm economic growth and they should also provide incentives for increased domestic savings. He also supported the staff's view that an appreciation of the baht was not advisable at the present time. Furthermore, in view of the importance of foreign trade, and the need for Thailand to restore and sustain competitiveness to counteract its recent decline, it was debatable how much of an appreciation in the real exchange rate, due to rising inflation, was acceptable. Some clarification would be welcome regarding Mrs. Sirivedhin's comment on the authorities' continuing use of a flexible exchange rate policy.

Notwithstanding the positive medium-term outlook discussed in the report, the staff and the Thai authorities seemed to agree on the existence

of structural weaknesses that could prove harmful to future growth prospects, Mr. Thorláksson noted. He therefore welcomed the authorities' intention to concentrate their investment spending on infrastructure and urged them to pay special attention to the development of human resources, particularly in the context of education. The relatively strong economic position of the country should now be used to support a long-term structural policy that tackled those as well as social and environmental issues.

Regional imbalances in economic development and the distortions in income distribution--partly as a result of those imbalances--were other matters that called for policy attention, Mr. Thorláksson observed. The proposed tax measures and other steps to restrain the speculative price increases in urban areas were welcome, since they could contribute to the reallocation of resources to the rural areas and reduce inflationary pressure due to speculation. However, further measures were necessary to strengthen the infrastructure and promote economic development in rural areas, and thereby improve income distribution. A comment from the staff on how the substantial rise in food prices had influenced the economic situation of the rural areas would be welcome.

Besides those structural issues, changes in the financial market and tax reform were needed to support savings and growth, Mr. Thorláksson said. The introduction of a value-added tax system, as planned by the authorities, was, however, not a simple matter, especially if there were to be exemptions from the tax base. As such exemptions were expensive for the budget and inefficient as a means of income redistribution, he recommended that the authorities look for a more effective income policy approach--for instance, direct transfers within the framework of the income tax system.

Finally, in reference to the Board's discussion of the 1988 Article IV consultation, and the question of Thailand accepting the obligations of Article VIII, he would appreciate an indication from Mrs. Sirivedhin or the staff of when the authorities might be willing to accept Article VIII status.

Mr. Newman made the following statement:

Thailand continues to reap the benefits of earlier economic adjustment and reform efforts which have resulted in a truly impressive economic performance. Growth has increased to roughly double-digit levels and the domestic and external imbalances normally associated with such a boom have been avoided to a large extent. In part, this reflects the very substantial rise in national savings, complemented by large inflows of foreign savings, which have financed a rapid increase in investment that is transforming the economy and expanding the productive base. However, the recent rise in inflation points to the need for increased caution to ensure that the problem remains contained.

We would agree with the staff that the primary focus of the effort to curb inflation pressures should be on monetary measures to sterilize capital inflows. Having delayed the tightening of monetary policies last year, however, we are concerned that the authorities may still be underestimating the potential inflation problem. While supporting reliance on open-market operations to limit credit expansion, I am concerned that the effectiveness of such an approach is constrained by the lack of suitable debt and savings instruments. Therefore, we welcome the introduction of new monetary instruments, such as securities being issued by the Bank of Thailand, but would urge more active use of reserve requirements and interest rates, including a more aggressive approach to financial market reforms, as anti-inflation tools.

The improved fiscal position of the public sector will help to complement monetary policy in restraining domestic demand. However, the authorities are planning for very substantial increases in expenditure to meet the legitimate infrastructure and human needs requirements of a rapidly developing economy. At a time when inflationary pressures are rising, and in view of the restraints on monetary policy, the planned reduction in the fiscal surplus could prove ill timed. In this connection, we would be interested in knowing the status of the often-delayed plans to introduce the value-added tax and to reform customs tariffs.

On the external side, we welcome the decision to withdraw tax incentives for foreign borrowing which should help to slow capital inflows. The early debt repayments, including the early repurchase of drawings on the Fund, should also facilitate capital outflows. However, we would certainly agree with the staff that a more ambitious program of trade liberalization is feasible and desirable as a means of reducing price pressures and improving resource allocation. Thailand has benefited enormously from an open, growing international trading system and should contribute to preserving it by opening its markets while respecting the intellectual property rights of others.

With regard to exchange rate policies, the staff acknowledges that an appreciation would complement monetary policies in bringing inflation down. However, the staff and the authorities are unwilling to take such a step owing to concerns about the growing current account deficit and the possible impact on Thailand's competitive position. We wonder whether such a cautious approach is warranted in current circumstances. The Thai deficit in large measure reflects the real resource counterpart of large-scale foreign investment which is expanding the productive base and export capacity of the economy. As such, the financing would appear to be more sustainable than the compensatory flows arising from a deficit based on excessive consumption. Furthermore, the

strength of Thailand's reserves and low debt ratios provide greater room for maneuver than is the case with most deficit countries. Finally, Thailand has enjoyed substantial gains in competitiveness since 1986 against other countries in the region, owing both to exchange rate changes and the loss of tariff preferences by other newly industrializing economies. Consequently, allowing the exchange rate to appreciate in response to market forces might be less of a risk to the long-run prospects of the economy than accepting a higher inflation rate.

Mr. Marino said that he wished to join other Directors in commending the Thai authorities for the remarkable performance of their economy over the past four years. During that period, Thailand had managed to record very high rates of growth, keep inflation under control, generate large external surpluses, strengthen public finances, increase considerably national savings, maintain a stable exchange rate, and boost export competitiveness and investor confidence. Admittedly, the country had benefited from a favorable external environment, but the authorities had wisely taken the opportunity to lay solid foundations on which to sustain a high growth rate.

As in all success stories, the rapid expansion in some sectors had tended to create shortages and put pressure on prices and on the balance of payments, Mr. Marino observed. Fortunately, in Thailand's case, the authorities had been able to implement some measures to help alleviate infrastructural bottlenecks, and had been able to mobilize labor from rural areas having a labor surplus, thus helping to ease the surging cost pressures present in such a dynamic economy.

The salient feature of the Thai experience was the steep rise in the national savings rate, led by the increase in government savings and the unprecedented levels of foreign capital inflows, Mr. Marino noted. Capital inflows had been further stimulated by the granting of temporary tax incentives, and to some extent by the increased political uncertainties elsewhere in the region. Not less important was the buoyant performance of manufactured exports during the previous four years. Given the volatility of capital flows, not only in Thailand but in general in the world economy, the Thai authorities had done well to base their development efforts on increased national savings and not on the continuation of external saving flows. Additionally, it would be difficult for Thailand to sustain the rapid growth in manufactured exports, particularly if the trade dispute with the United States was taken into consideration.

In the opinion of his chair, there were many lessons to be learned from the Thai experience, Mr. Marino continued. In particular, the authorities had been able to bring into operation a virtuous circle in which vigorous growth led to increased government revenues, which in turn increased government savings and investor confidence, producing capital inflows that assured

adequate financing of investment opportunities and therefore renewed vigorous growth and a resumption of the upward cycle.

So far, the Thai Government had taken advantage of the valuable opportunities provided by the favorable internal and external environment to implement economic reforms, Mr. Marino commented. They should continue in and push for a comprehensive trade liberalization. It was gratifying to learn from the staff report that the Thai authorities were considering an acceleration of the planned reduction in tariffs on capital goods in the context of the gradual restructuring of the tariff system. Their intentions to liberalize the financial sector and the recent lifting on ceilings on interest rates on all bank deposits were also welcome. However, for Thailand to avoid distortions arising from financial restraint, it was important that the authorities liberalize all interest rates in the financial system, to include the market determination of interest rates on government securities and equal tax treatment of the various financial instruments.

To conclude, his chair believed that the Thai authorities had done an excellent job in managing the economy, and therefore that they faced a great challenge since it would be difficult to improve upon current performance. However, having put the economy on a stable high growth path, they could turn to addressing the important problems of unbalanced growth between the urban and rural areas, the deterioration of the environment, and the distribution of income. It was worrisome to note from the staff report that in Thailand there was a perception of inequity in the midst of prosperity.

The staff representative from the Asian Department said that as indicated in the staff report, the staff believed that sterilization of the monetary impact of external inflows was a viable option in the circumstances that Thailand currently faced. That judgment was based primarily on two factors. The first was the current substantial fiscal surplus, which in itself neutralized a large part of the monetary impact of the balance of payments surplus. Second, the study that the staff had been able to make on the so-called offset coefficient indicated that while it could be anticipated that a tightening of domestic monetary conditions would lead to some further capital inflows, the offset was by no means complete. Thus, on a net basis, there would be room for a more restrictive monetary policy. It was also worth mentioning in that context that the recent firming of interest rates internationally was helpful to Thailand insofar as it increased the room for a tightening of monetary policy without increasing the risk of offsetting capital inflows.

The exchange rate policy being pursued by the authorities was not one of rigidly pegging to a basket of currencies, the staff representative continued. In fact, during 1989, the baht had appreciated in nominal effective terms by about 3 percent, and some further appreciation had taken place so far in 1990. That limited flexibility was helpful in the overall effort to address the problem of rising inflation, but was not in itself likely to

deter capital inflows. In fact, a small gradual appreciation could arguably have a perverse effect on capital inflows by generating expectations of further appreciation in the future. A substantial one-step appreciation might be necessary to avoid that type of problem, but, in the view of the staff, such an option was not particularly desirable in current circumstances. Trade liberalization offered many of the same advantages as a substantial appreciation of the baht from the point of view of combating inflationary pressures without damaging the export sector.

By conventional definitions, Thailand remained a capital deficient country in the sense that domestic savings were still not adequate to finance domestic investment, the staff representative continued. Of course, as some Directors had indicated, at present Thailand was attracting a much larger capital inflow than it needed to close the investment/savings gap. From that perspective, the staff agreed that there was room for a relaxation of controls on capital outflows, although it was perhaps unclear how significant an effect it would have in the short run in reducing the balance of payments surplus. For that reason, as well as on grounds of efficiency, the staff considered liberalization of the capital account of the balance of payments as a less urgent objective than liberalization of the trade side.

The staff had no estimates of the effect of a liberalization of controls on portfolio investment on the balance of payments, the staff representative added, but again, it would not be surprising, at least in the short run, if the effect would be small.

As for inflation and growth projections for 1990 and the extent to which they could be regarded as consistent with the medium-term scenario that provided for a soft landing, the staff representative noted that in making the projections for 1990, account had been taken of the rapid rate of monetary growth over the past year or so and of the fact that the measures being implemented to restore monetary restraint were not likely to be effective very quickly. In fact, Thai officials expected significant lags of as long as a year or so before those measures took effect. However, if (as had been assumed in the projections) the measures that were announced in December were fully and promptly implemented, the staff would expect a significant deceleration in both the rate of inflation and the rate of growth of GDP in 1991.

Regarding the question of whether there was room for further revenue enhancement, it might be useful to mention that the incentives that Thailand provided to attract foreign investment were quite costly, the staff representative stated. According to official estimates, the revenue foregone as a result of those incentives was close to 2 percent of GDP. Therefore, the phasing out of such incentives could increase significantly revenue generation in the future. Another promising area, apart from the aspects of tax reform discussed in the staff reports, was the excise tax on petroleum products; the reduction in that tax had also been costly to the budget, and the liberalization of petroleum prices could restore some of the revenue loss.

Foreign investment had played a significant role in increasing export capacity in Thailand and in contributing to the rapid growth of exports, the staff representative said. But the composition of capital flows in the recent past had changed in a significant way. In 1989, direct investment had not accounted for a substantial part of the increase in the overall capital inflows, which in large part had been related to borrowing by domestic enterprises abroad, encouraged by the tax incentives provided by the authorities.

The authorities' announcement that they would be targeting a balanced budget for the next fiscal year should not be taken as implying a relaxation of fiscal policy, the staff representative commented. In Thailand, the budget balance was defined on a different basis than in the staff papers; in particular, it took into account debt repayments. If Government Financial Statistics concepts were applied, what was understood by the budget balance concept in Thailand would imply a substantial surplus, at least as high as the one expected for the current fiscal year.

Finally, as Mr. Fernando had pointed out, the staff had discussed social and environmental issues in greater detail in the report before the Board than in previous reports, the staff representative from the Asian Department commented. The reason for that was that both sets of issues had received considerable attention in Thailand in the recent past and were of serious concern to the authorities. Indeed, economic policy had begun to reflect social and environmental concerns as indicated, for instance, in the decision to impose a moratorium on commercial logging. However, the staff's recognition of its lack of expertise in those areas and resource constraints had led it to confine itself for the most part to straight reporting of some relevant information. No attempt had been made to undertake research on those issues, nor had the staff intended to express any strong views on the appropriateness of government policies to address environmental issues. For the future, a case could be made for undertaking some analytical work, for example, on the macroeconomic implications of the depletion of natural resources associated with economic growth or on the balance of payments implications of policies to address the environmental issues.

Mrs. Sirivedhin thanked Executive Directors for their comments, which she would communicate to her authorities.

Directors had correctly noted that restraining domestic demand should be the top priority at the present time, Mrs. Sirivedhin said. That view was consistent with the view of her authorities, who were of course already taking a number of restrictive monetary policy measures.

With respect to exchange rate policy, the authorities intended to monitor developments closely and to take additional measures if that appeared necessary, Mrs. Sirivedhin noted.

The budget for 1990/91 was the outcome of a delicate balancing of the desire to provide a restraining effect on domestic demand, and the need to address the bottlenecks in infrastructure and skilled labor, Mrs. Sirivedhin observed. The Government still needed to undertake much investment in infrastructure, despite the policy of encouraging private sector participation, while the shortage of engineers and technicians also required a substantial outlay by the Government. In principle, the authorities would like to liberalize petrol prices and eliminate the need for tax concessions to keep prices down. However, the issue was viewed in Thailand as a politically sensitive one, and it was a matter of seeking the proper timing.

The central bank's medium-term financial plan had been formulated with the objective of attaining a financial system that was conducive to Thailand's attaining sustained economic growth with a satisfactory degree of stability and consistent with Thailand's increasing role in the world economy, Mrs. Sirivedhin stated. To that end, the Thai authorities intended to review various elements of the financial system in order to improve its efficiency and stability, so that it could respond appropriately to domestic economic changes, as well as to global economic and financial developments. As she had mentioned in her statement, four areas had been targeted, of which she would mention only two.

First, the measures to liberalize the financial system included the eventual freeing of all interest rates, the promotion of market-determined credit allocation, and the liberalization of exchange controls, Mrs. Sirivedhin said. With respect to the latter, current transactions, as had been noted by the staff, were already free from restrictions. Capital transactions were also being liberalized gradually, and the eventual elimination of exchange controls could not be ruled out.

In that connection, she was happy to report that her authorities had asked her to convey to the Board their early intention to initiate, with the Fund, the procedures aimed at accepting the obligations of Article VIII.

A second area of the central bank's medium-term financial plan was the development of financial services and monetary instruments in order to improve the efficiency of financial institutions and to support savings mobilization, Mrs. Sirivedhin noted. Included would be a review of the scope of services offered by each type of financial institution and a review of the role of each type of monetary instrument. For example, it was considered desirable to reduce the role of bank overdrafts as opposed to outright loans, and to make rates on government bonds a market reference rate.

To conclude, Mrs. Sirivedhin said that Thailand's policies would remain cautious, with the emphasis on simultaneously achieving macroeconomic stability and setting the stage for sustained growth.

The Acting Chairman made the following summing up:

Directors were impressed with the strong performance that the Thai economy has continued to post, both internally and externally, during 1989. They commended the authorities for the outward orientation of their growth strategy and their commitment to sound management of macroeconomic policies, including maintenance of a strict fiscal stance and of a high level of domestic savings, which had allowed the economy to benefit fully from the recent favorable international environment. They nevertheless noted with some concern that strains on resources had intensified and carried the potential to undermine price stability. They therefore emphasized that priority had to be given to addressing the problem of rising inflation so as not to undermine the chances for sustainable growth over the medium term. In this respect, Directors supported the initiatives that the authorities had recently announced to curb demand and contain inflation but stressed that speedy implementation was of the essence.

Directors believed that the upward pressure on prices was associated mainly with large capital inflows and rapid monetary growth. They therefore agreed that the burden of containing inflation should be borne primarily by monetary policy. They welcomed the steps that the authorities had begun to implement to absorb excess liquidity and the significant increase in the ceiling on lending rates just announced. Most speakers, however, were of the view that a complete liberalization of interest rate controls was desirable to allow the tightening of monetary conditions to be transmitted more fully throughout the economy and ensure both the growth of financial savings and a more efficient allocation of resources.

Directors also thought that use of external policies could assist in the anti-inflation effort. In this context, they welcomed the withdrawal of the tax incentive to long-term foreign borrowing, which had been a contributing factor to the large capital inflow and the high rate of monetary growth; several Directors also encouraged the authorities to ease regulations on outward capital movements. It was noted that such capital liberalization would facilitate integrating the domestic and foreign financial markets and support the counterinflationary stance of monetary policy.

Directors also urged the authorities to accelerate trade liberalization and reduce the level and dispersion of tariffs, in order to alleviate short-run pressures in the goods market and, more importantly, allow the economy to benefit from the efficiency gains that could be expected to accrue over the medium term. This, of course, would have to be conducted in the context

of restrained financial policies. Regarding exchange rate policy, a few Directors thought that an appreciation of the baht should be avoided at the present time in view of the need to preserve external competitiveness. On balance, however, Directors tended to think that exchange rate policy could play an active supportive role for other policies to control inflation. It was noted that some appreciation of the baht would alleviate the burden on monetary policy.

Directors commended the authorities for maintaining a strong fiscal position. They unanimously agreed that the recent step-up in capital expenditure to increase infrastructural capacity was appropriate to prevent the emergence of severe bottlenecks. However, Directors regretted the subsidization of petroleum prices that had imposed a burden on the public finances and had adverse consequences for resource use and the environment. They urged the authorities to adjust these prices promptly. Directors also encouraged the authorities to speed up progress in enhancing the role of the private sector in activities hitherto dominated by state enterprises and to accelerate in general the agenda for structural reforms.

With respect to the medium term, Directors noted the need to allocate increased public and private resources not only to improving infrastructure but also developing human resources. They also stressed the desirability of promoting further mobilization of domestic savings, particularly in the household sector, which could be done through further reforms of the financial and tax systems. In this regard, the importance of introducing the value-added tax was emphasized by several speakers.

Directors welcomed the authorities' intention formally to accept the obligations of Article VIII in the near future.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/90/39 (3/19/90) and EBM/90/40 (3/19/90).

4. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the Chinese authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/83 (3/13/90).

Adopted March 19, 1990

APPROVED: January 22, 1991

LEO VAN HOUTVEN
Secretary

