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Minutes of Executive Board Meeting 90/147

10:00 a.m., October 10, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	A. Raza, Temporary
	G. C. Noonan
	Zhang Z.
	S. B. Creane, Temporary
	M. E. Hansen, Temporary
J. de Groote	
	L. B. Monyake
	S.-W. Kwon
	M. Hepp, Temporary
	G. Montiel, Temporary
	B. Bossone, Temporary
	M. A. Ahmed, Temporary
	I. H. Thorláksson
M. R. Ghasimi	
G. Grosche	B. Goos
J. E. Ismael	T. Sirivedhin
	L. I. Jácome, Temporary
	J.-L. Menda, Temporary
	G. Serre, Temporary
	C. V. Santos
	J.-C. Obame, Temporary
	P. Wright
	G. P. J. Hogeweg
	R. Meron, Temporary
K. Yamazaki	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

O. Kaba, Director, Foreign Exchange Department, and Advisor to the Governor of the Central Bank of Guinea. IBRD: J. Walters, Africa Regional Office; R. de Silva, Asia Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; P. Beaugrand, J. P. Briffaux, P. Dhonte, P. L. C. Hilbers, I. Kapur. Asian Department: H. Neiss, Deputy Director; K. Saito, Deputy Director; L. D. Dicks-Mireaux, M. J. Fetherston, R. P. Kronenberg, S. Lam, K. Lee, L. Lee. Exchange and Trade Relations Department: A. Basu, S. Eken, K. M. Huh. Fiscal Affairs Department: K.-Y. Chu. IMF Institute: A. Camara, M. Camara, Participants. Legal Department: D. Asiedu-Akrofi, H. Elizalde, P. L. Francotte, R. B. Leckow. Research Department: R. D. Haas. Advisors to Executive Directors: A. Gronn, Z. Iqbal, P. O. Montórfano, Y. Patel, A. M. Tanase, N. Toé. Assistants to Executive Directors: T. Berrihun, B. A. Christiansen, B. R. Fuleihan, M. A. Ghavam, O. A. Himani, K. Ichikawa, K. Ishikura, F. Moss, M. Mrakovcic, M. Nakagawa, S. Rouai, Shao Z., D. Sparkes, C. M. Towe, S. von Stenglin, Wang J.

1. GUINEA - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

The Acting Chairman remarked that under the procedures for surveillance, the three-month period for completion of the 1990 Article IV consultation with Guinea had ended between the August informal Board recess and the Annual Meetings. The heavy schedule of Board meetings during that time had necessitated a postponement of Board consideration of that item until the present meeting. He proposed that the decision required to extend the period for completion of the consultation be approved and that the Secretary's understanding of the decision be incorporated in the minutes of the meeting.

The Executive Directors accepted the Acting Chairman's proposal without discussion.

> Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Guinea to not later than October 10, 1990.

Decision No. 9556-(90/147), adopted
October 10, 1990

2. SOUTH AFRICA - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

The Acting Chairman observed that under the procedures for surveillance, the three-month period for completion of the 1990 Article IV consultation with South Africa had ended between the August informal Board recess and the Annual Meetings. He proposed that the decision required to extend the period for completion of the consultation be approved and that the Secretary's understanding of the decision be incorporated in the minutes of the meeting.

The Executive Directors accepted the Acting Chairman's proposal without discussion.

> Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with South Africa to not later than October 10, 1990.

Decision No. 9557-(90/147), adopted
October 10, 1990

3. KOREA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Korea (SM/90/184, 9/18/90; Sup. 1, 10/9/90; and Cor. 1, 10/4/90). They also had before them a background paper on market liberalization and macroeconomic policies in Korea (SM/90/188, 9/26/90).

Mr. Kwon made the following statement:

My Korean authorities are in general agreement with the staff appraisal and appreciate the policy recommendations put forward by the staff. As usual, they value the Article IV consultation with the Fund as an excellent opportunity to review current policies by examining the state of the economy and its prospects. My authorities wish to commend the staff for the skill and professionalism with which it conducted the consultations.

As the staff report spells out so eloquently, the Korean economy underwent a dramatic adjustment process over the past year after having experienced exceptionally high economic growth and substantial current account surpluses in 1986-88. In 1989, the rate of real economic growth fell by almost one half to 6.7 percent from 12.4 percent recorded in 1988, while the current account surplus in the balance of payments was reduced by nearly two thirds to \$5 billion--2.4 percent of GNP--from \$14 billion--8.2 percent of GNP--in the previous year. Such a remarkable adjustment was achieved mainly through the mix of fiscal, monetary, and exchange rate policies as well as the effect of sharp increases in wages in recent years. The slowing of the pace of economic growth was particularly evident in the manufacturing sector and, consequently, in exports, as earlier gains in external competitiveness were rapidly eroded owing to exchange rate appreciation and wage increases, coupled with a slackening of domestic demand in Korea's major trading partners. Thus, the real economic growth rate of 6.7 percent for 1989 was entirely attributable to domestic demand, while the contribution of the external sector to the economy was negative.

This trend continued into the first half of 1990, although there were signs of recovery in some sectors. For the six months ended June, the current account registered a deficit of \$1.6 billion, reflecting a continued decline in export volumes and a rise in imports. Overall economic growth for this period is estimated at about 10 percent in real terms on an annual basis, led mainly by exceptionally strong activity in the construction and service sectors. Under such circumstances, the authorities took some temporary measures to boost investment in export-oriented sectors, which included some easing of credits, some fiscal stimulus, and voluntary wage guidelines.

At an annual rate of 10 percent, growth in the first half of this year appears to be very satisfactory. However, the distribution among various sectors of the economy is somewhat unbalanced. As indicated earlier, the recovery was led by an exceptional boom in the construction sector and high levels of consumption, which have resulted in high levels of capacity utilization and increasing inflationary pressures.

As the staff rightly points out, the question is how to reduce inflationary pressures while at the same time not discouraging the recovery of those sectors which are relatively subdued. In this situation the authorities have exercised great caution in respect of macroeconomic policy. However, two unexpected events have emerged which have a bearing on short-term policies: the Middle East crisis and a great flood that hit the central part of the Korean peninsula in mid-September. The flood is the most severe in recent history and took hundreds of lives, left thousands homeless and caused great damage to rice and other agricultural products as well as to infrastructure.

Korea is entirely dependent on imported oil and hence is highly sensitive to changes in international oil prices. According to calculations made by the Government, an increase of $1 per barrel in the international oil price adds approximately $330 million to Korea's import bill. Aside from this direct impact, the Gulf crisis is likely to have a negative effect on foreign exchange receipts, including reduced export earnings and construction receipts from countries in the Middle East. Taking all these points together and on the assumption that the average international oil price remains in the range of $25-30 per barrel throughout the remainder of this year, the direct impact on Korea's current account is expected to be of the order of $1.5-2.0 billion for this year as a whole. The impact of the crisis on the economy in 1991 will, of course, depend very much on developments in the situation in the Middle East.

In view of the uncertainties created by the Gulf crisis and the urgent need to ease domestic inflationary pressures, the short-term policy response has focused mainly on energy conservation, while sheltering the domestic economy from the full impact of oil price rises for the time being through the buffer of the Petroleum Business Fund and a reduction of import tariffs and levies on certain petroleum products. Fortunately, the Petroleum Business Fund was able to accumulate a substantial amount of resources for this purpose during recent years by not passing on entirely to consumers the benefits of the lower international oil price of the recent past. However, shielding the domestic market through the buffer of the Fund should only be seen as a short-term and temporary measure. If the Middle East crisis is prolonged and the price of oil remains high for a long period of time, the Government will review its energy pricing policies with a view to bringing domestic prices more into line with import costs.

Korea has maintained a good track record of prudent fiscal policies in recent years as part of the Government's effort to lay the foundations for sustained noninflationary growth. However, the Government has been under pressure to accommodate the increased demands for social infrastructure that have accompanied the rapid growth of the economy, and the political environment no longer allows the Government to ignore such demands. Nevertheless, the original budget for FY 1990 was formulated with the aim of containing the deficit in the overall balance within a small range. Even with the first supplementary budget, which was approved by the National Assembly in August, the overall budget was intended to limit the deficit to the equivalent of 0.4 percent of GNP.

The Gulf crisis and the floods led the Government to propose a second supplementary budget for FY 1990. This second supplementary budget has been submitted to the National Assembly for approval together with the FY 1991 budget. The bulk of the supplementary budget is to be used for emergency expenditure in connection with flood damage and for transfers to the Fiscal Investment and Financing Special Account to make good the shortfalls in revenue in that Account resulting from both a further delay of sales of Government-owned enterprises in the face of unfavorable capital market conditions and the unavailability of borrowing from the Petroleum Business Fund owing to the recent oil price increase.

The supplementary budget is to be financed entirely by an expected excess of revenue collection for FY 1990, but nonetheless its net effect would be somewhat expansionary, resulting in a higher deficit in the overall balance, now estimated at some 1.5 percent of GNP. Again, this is only a temporary fiscal measure to address a short-term difficulty arising from unexpected factors and appropriate monetary and credit policies are to be implemented to mitigate the adverse effect on domestic prices. The proposed budget for FY 1991 envisages a substantial reduction of the deficit in the overall balance to less than 0.5 percent of GNP.

Notwithstanding the short-term policy response to the changing internal and external economic environments, Korea has continued to pursue structural reforms in the financial sector and in trade and exchange policy. Since this issue has been extensively covered in the background paper, I do not feel it necessary to go over it again in any detail here. Nevertheless, several points are worthy of mention.

On March 2, 1990, my Korean authorities introduced a new market average exchange rate system (MAR) under which the won is allowed to float daily within margins--±0.4 percent against the U.S. dollar, and ±0.8 percent against other currencies--and to move more in line with market trends. The new system was the first step in the direction of increasing the role of market forces in the determination of the exchange rate. Therefore, the recent depreciation of the won against the U.S. dollar reflected in large part the market perception of the economic fundamentals of Korea.

With respect to the trade regime, Korea has eliminated the quantitative restrictions on virtually all import items other than some agricultural and fishery products. On January 1, 1990, Korea disinvoked Article XVIII:B of the General Agreement on Tariffs and Trade (GATT) agreed to phase out, or bring into GATT conformity, all remaining restrictions on agricultural imports by mid-1997. The five-year tariff reduction program is also well under way, aiming at reducing the average tariff rate to 8 percent by 1993, similar to the level that prevails in industrial countries. The average tariff rate in 1990 stands at 11.4 percent.

As for capital market liberalization, my authorities have reaffirmed their decision to adhere to the 1988-92 Capital Market Internationalization Plan, which was announced in 1988. At the moment, foreign investors are allowed to invest in Korean capital markets through a number of offshore funds available to foreigners, and in early 1989 the limits on foreign participation in domestic security firms were raised. Direct portfolio investment in Korea by foreigners will be allowed from 1992, although on a gradual basis. Some steps have also been taken to liberalize investment in foreign securities by Korean firms and individuals.

The Korean economy is in transition toward a more sustainable growth path from the unusually rapid growth experienced in the past several years. The policy measures taken recently were designed to counter short-term cyclical problems, and should not be considered as a drastic policy turnaround. The clear policy objective is to give priority to price stability, while allocating resources to achieve balanced growth across all sectors of the economy, thus benefiting all segments of society more equitably. In this context, the authorities are committed to continuing with the necessary structural reforms.

My authorities also recognize fully the increasing role of Korea in the world economy, and in this connection I would like to inform the Executive Board of the announcement made by the Government that Korea would favorably consider helping the most seriously affected frontline countries in the Middle East by providing financial assistance up to $100 million, in close collaboration with other donors. This announcement, which was made in the face of economic and political difficulties arising from the recent oil crisis and natural calamity, demonstrates the Korean Government's strong determination to work with the international community.

Mr. Yamazaki made the following statement:

I commend the Korean authorities for the skillful way in which they managed and supported the economy during the abrupt slowdown in output growth in 1989. At the 1989 Article IV consultation with Korea (EBM/89/132, 10/6/89), this chair noted that a dramatic adjustment process was under way toward a more sustainable growth path and external payments position, thanks to the implementation of an adequate policy strategy since 1987. It is encouraging to see that the authorities are continuing to proceed strongly in the same direction through the skillful use of fiscal and monetary policies. Owing to timely and appropriate policy implementation, including a cut in the discount rate, a supplementary fiscal budget late last year, and the introduction of voluntary wage guidelines, it is now evident that a recovery in the Korean economy is under way.

At the same time, the staff is right in pointing out the concerns facing the authorities. The acceleration of inflation since mid-1989, together with capacity constraints and a tightening of the labor market, is definitely a major disturbance that has to be tackled in the coming months. In this connection, I agree with the staff that the question is how to reduce inflationary pressures while at the same time supporting a continuation of the economic recovery. It is therefore essential for the authorities to keep a subtle balance between more restrained policies to reverse the inflationary trend and supportive measures to continue the economic recovery that is now under way.

In this regard, the proposed second supplementary budget, which is oriented toward growth, combined with the proposed 1991 budget, which provides for a significant deficit reduction, are in line with the balance required. Because the net effect of the supplementary budget will be somewhat expansionary, it will be necessary to mitigate the adverse effect on domestic prices if the appropriate monetary and credit policies are to be implemented.

I note that the Korean authorities are concerned that significantly tighter policies than those being pursued at present could disrupt the recovery, particularly in the export and manufacturing sectors, and undermine an already weak stock market. Taking into account the uncertainties connected with the oil price hike in the wake of the crisis in the Middle East and the complete dependency of the Korean economy on imported oil, it seems more appropriate to take a gradual approach on this issue, combined with careful vigilance on the inflationary trend.

As to energy pricing policies in Korea, Mr. Kwon is right in saying that shielding the domestic economy from the full impact of oil price rises through the buffer of the Petroleum Business Fund should only be seen as a short-term and temporary measure. From the Japanese experience during the first and second oil shocks, the direct and full exposure of the domestic economy to the impact of the international oil price rise turned out, after all, to be a major incentive for the private sector to adjust itself in order to reduce its vulnerability to external disturbances. In the same vein, the Korean authorities should also make the most of the current situation to promote structural adjustment in the private sector, if the domestic price situation permits.

As to external policies, I am greatly impressed by the substantial adjustment that has been made in the large external surpluses and by the fact that the current account is now close to balance. I also note that Korea's external position is considerably stronger than in the past. Korea currently maintains enough international reserves to cover the imports of two and a quarter months. In this connection, I welcome the staff's view that current account considerations need no longer be the major focus of short-term policy.

At the same time, I congratulate the authorities for their market-opening efforts, together with the other measures taken so far to reduce the current account surplus, including the appreciation of the won. In particular, I welcome the introduction last March of a new market-average exchange rate system. Under this new system, the exchange rate is expected to move more in line with market trends. In this connection, I support Mr. Kwon's statement that the recent depreciation of the won reflects market perceptions. It was also encouraging to hear from Mr. Kwon that the new system was the first step toward increasing the role of market forces in the determination of the exchange rate.

As regards trade policies, the step taken by the authorities last January to disinvoke Article XVIII:B of the GATT is also welcome as an expression of the authorities' intention to move toward a more open and liberal trade structure.

At the 1989 Article IV consultation with Korea, this chair encouraged the authorities not only to sustain Korea's excellent economic performance but also to contribute to the further development of the world economy. Today, it is gratifying to review Korea's most recent economic performance, and I am very much encouraged by Mr. Kwon's comments on the Government's strong determination to work with the international community. With these remarks, I support the staff's appraisal.

Mr. Wright made the following statement:

Clearly, the main challenge facing the Korean authorities is that of reducing inflation after several years of unsustainably fast growth and a slowdown, which in retrospect seems to have been less severe than the authorities had at first feared. The slowdown certainly seems to have been insufficient to ease capacity constraints significantly, so that the Korean economy still seems to be operating near the limits of its capacity.

The most conspicuous symptom of overheating is an inflation rate which some forecasters expect to rise to 12 percent by the end of the year, with the impact of higher oil prices--which will not be passed through to consumers until next year--still to come. The authorities are nonetheless hesitant about tightening policy for fear of undermining the economic recovery and weakening the stock market. Indeed, policy this year seems on balance to be expansionary.

As the medium-term scenarios in the staff report make clear, Korea has far more to lose from allowing high inflation to become embedded in the system than from a temporary slowdown in growth. This year's disappointing export performance largely reflects several years of rising wage inflation and, in the past two years, a rapid acceleration of unit labor costs. Measured competitiveness has stabilized somewhat in the past year, but only because of an offsetting depreciation in the nominal exchange rate. This will not provide a lasting solution to the problems of competitiveness and is unhelpful in the fight against inflation.

If inflationary expectations are not punctured quickly, Korean exports risk a further loss of competitiveness, and the inevitable adjustment will be all the more painful for being postponed. With Korea's sustainable growth rate estimated to be about 8 percent, a period of below-trend growth would still allow output to rise at a respectable rate, while the external position is strong enough to weather a period of temporarily slower export growth.

As I have implied, I have doubts about whether policy is sufficiently tight. Projected monetary growth of 15-19 percent this year looks high in relation to the authorities' aspirations concerning nominal income growth unless there is a good reason to expect a fall in velocity. Perhaps the staff could comment on this point. On the fiscal side, the projected deficit is modest, and Mr. Kwon has drawn attention to the need for emergency relief in the wake of September's flood. I agree with the staff, however, that any stimulus to demand from the budget is unwarranted at present, and I note that the fiscal stance was projected to be expansionary even before the second supplementary budget was introduced.

It is clear that developments in the labor market are of central importance. Although it is too soon to be sure, it would be surprising if the 1987 reforms to industrial relations--welcome as they were in many respects--and the introduction of a minimum wage had not increased the "natural" rate of unemployment, with important implications for the sustainable rate of growth. Perhaps the staff could comment on this. In any event, a narrowing of the gap between labor costs--both wage and nonwage elements--and Korea's still enviable rate of productivity growth is imperative.

As regards the stock market, the authorities may be oversensitive to developments in this area. While large swings in stock prices may have some effect on real activity and can, in extreme cases, have systemic consequences within the financial sector, the lesson that many countries drew from the 1987 stock market crash was that these effects may be much smaller than had earlier been thought. Indeed, with many countries now acknowledging that the policy relaxation that followed the 1987 crash was misjudged, it is surprising that the authorities felt it necessary to respond in a similar fashion to the decline in Korean stock prices at the end of last year. This seems to have complicated considerably the subsequent conduct of monetary policy.

I wonder whether in fact the volatility of the Korean stock market stems from its relatively small size, the very rapid turnover of stock--I am told that the average holding period is 13 days--and the fact that it still remains largely closed to overseas investors. If so, further structural reforms to broaden and deepen Korean capital markets could be the best way to make the stock market less susceptible to changes in domestic investor sentiment, rather than the increasingly aggressive attempts by the authorities to stabilize the market by other means. I would welcome the staff's comments on this point and urge the authorities to bring forward the timetable for opening their capital markets to direct foreign portfolio investment.

Let me join Mr. Yamazaki in congratulating the authorities on the substantial progress they have made in recent years to open up the Korean economy. Their first steps to increase the exposure of the exchange rate to market forces are particularly welcome. The corollary, of course, is that if a tightening of policy or the opening up of the capital market were to lead to an appreciation of the won, this should not be resisted. Indeed, this could be a helpful development in the fight against inflation. The authorities are also to be commended for their decision to disinvoke Article XVIII:B of the GATT, as many Directors urged last year. Trade liberalization has played a crucial role in reducing Korea's large external surplus and will help to support the counter-inflationary strategy. As the authorities recognize, considerable scope for further reform remains, and I warmly welcome in particular their plans to liberalize agricultural imports.

The new format of the background paper is welcome. Its issue-based nature, the liberal use of headings, and the use of summaries make it a valuable background document when considering the main paper.

Mr. Al-Jasser made the following statement:

The rapid adjustment of the Korean economy to the large external current account surpluses should be commended. This adjustment has been accompanied by important structural changes. In particular, progress has been made toward opening Korea's markets through the disinvocation of Article XVIII:B of the GATT and a commitment to a timetable for phasing out all remaining restrictions by 1997. A market-based exchange system has been put in place, and financial sector reforms have been implemented despite an economic slowdown. Progress has also been made toward balancing growth and social welfare objectives.

The rapid adjustment and related steps have, however, posed new policy challenges for the authorities. The large appreciation of the won--which was instrumental in the recent rapid adjustment--and wage increases have weakened external competitiveness. At the same time, notwithstanding contracting external demand, the increased domestic demand, combined with capacity constraints, has intensified inflationary pressures. This happened at a time when economic growth was already slowing down. The authorities are currently faced with the dual task of reducing inflationary pressures and restoring external competitiveness, so that growth can be sustained with an appropriate mix of domestic and external demand without pushing against supply bottlenecks. During 1988-89, however, growth impulses emanating from the external sector became negative. It would be counterproductive to allow this trend to continue. Hence, the choice of policy package should be such that it would place Korea on a medium-term growth path, as envisaged by Scenario I of the staff forecasts.

For the pursuit of these objectives, I am in broad agreement with the staff appraisal and recommendations. However, I have sympathy for the authorities' preference to be cautious to avoid perpetuating suboptimal growth, especially in the emerging weaker international economic environment. In view of the importance of Korea to the world economy, an adjustment that excessively suppresses growth would be unhelpful.

Clearly, fiscal and monetary policies should be directed primarily at reducing domestic demand so as to reduce inflationary pressures, while wage and exchange rate policies should ensure that external competitiveness is not weakened. Monetary policy should aim at containing monetary expansion to a rate somewhat below the upper limit of the official target range. An appropriately tight fiscal policy and wage restraint would, of course, need to complement such a monetary policy in order to avoid a severe cutback of credit to the private sector or a sharp rise in interest rates. Some restraint in growth will probably be desirable in order to eliminate inflationary pressures. A continued moderation of growth at about 6 percent should therefore not be a matter for concern. Fiscal policy, which accorded greater weight to meeting social objectives and supporting domestic economic growth in 1989, would henceforth need to become neutral. Any expansion in expenditures on social programs should be met by a redirection of expenditures from other activities.

Concerning external competitiveness, the market-based exchange system should be allowed to support domestic financial policies in ensuring competitiveness and a proper mix of domestic and external demand. It is also essential that monetary policy should be tight enough to avoid the need for a policy-induced depreciation of the exchange rate. In this context, as long as the market-based system is allowed to operate freely, the staff's concerns about an excessive focus on the current account consideration underlying the exchange rate policy would become less important.

In the final analysis, Korea's export performance and competitiveness depend upon fundamentals, including technological and skill endowments. A stable exchange rate for the won, combined with prudent domestic financial policies, a freer multilateral trading system, and appropriate exchange rate policies abroad, would lay the foundation for sustainable long-term growth. In this context, Korea should endeavor to move quickly toward specializing in advanced technology-intensive activities and permit activities with known technologies to migrate to other newly emerging developing economies.

The Korean economy has come a long way over the past decade. Korea deserves and should play a commensurate role in the world economy. There are a number of avenues through which this could happen. In certain areas, tentative measures have already been initiated, which should be commended. It is to be hoped that steps will be taken to accelerate the opening up of the capital market as planned. However, such internationalization should not simply be aimed at encouraging an inward flow of direct portfolio investment. Moreover, such internationalization would need to be complemented by a liberalization of domestic financial markets. In this context, the freeing of domestic interest rate determination will be highly desirable. Korea should also provide technical and financial support to developing countries so that they can benefit from its commendable experience. It is also hoped that, given Korea's interdependence with countries affected by the crisis in the Middle East and its role in the world economy, the authorities will participate actively in alleviating economic costs to such countries.

I would like to commend the staff for an effective application of the Board's guidelines for an issue-specific background paper as a substitute for the usual paper on recent economic developments.

Mr. Menda made the following statement:

During the past few years, Korea registered a remarkable growth performance. Since 1985 the authorities have shown their ability to adapt to a rapidly changing environment, shifting their concern from the repayment of a heavy external debt to the persistence of a large external surplus, and of an overheating economy. Developments in 1990 demonstrate that Korea has met the latter challenge. The strong appreciation of the won in recent years, as well as large wage increases, have contributed to reorient the economy toward domestic markets and improve the standard of living of the population.

However, despite a significant slowing down of growth--from 12.4 percent in 1988 to 6.7 percent in 1989--the economy is still confronted with high inflationary pressures, spurred by the strength of domestic demand and high wage increases. The key issue now for the authorities is how to secure a high growth--of 7 1/2 percent in the staff's medium term compatible with a low rate of inflation. I share the staff's view that a prompt tightening of financial policies is the appropriate answer. I would also like to reiterate the advice given by this chair and others at the previous consultation with Korea, namely, that policies avoid a stop-go approach and instead be formulated in a medium-term framework.

From this perspective, exchange rate policy could play an important role in stabilizing the current economic situation. The appreciation of the currency in past years has played a major role in reducing the current account surplus. The authorities should now avoid a depreciation of the currency as a response to the current situation. I understand that, indeed, Korea's external competitiveness, in terms of unit labor costs, fell by 41 percent between 1987 and 1989, thereby reversing the improvement registered between 1985 and 1987. The current exchange rate, however, appears compatible with external equilibrium. A depreciation of the exchange rate that would validate wage increases and spur inflationary expectations would certainly be the wrong approach, and would provide the wrong signal to economic agents.

On this issue, the staff approves the evolution of the exchange rate system toward a floating system. In the circumstances, I would instead recommend that the currency be kept stable in nominal effective terms and, like Mr. Wright, that a real appreciation of the won not be resisted because of its positive role in reducing inflation.

I agree with the staff that demand-management policies should be tightened in order to break the momentum of inflation. The recent rise in oil prices adds an additional argument in support of such a course of action. It is indeed important that the authorities send the appropriate signal and continue the fight against inflation.

As regards fiscal policies, the additional stimulus provided by the supplementary budgets is not appropriate in view of the present strength of domestic demand. I agree with Mr. Kwon, however, that the authorities had to react to the consequences of the recent floods. But this stimulus should be temporary. In this area also, a medium-term perspective seems warranted and a broadly neutral stance should be adopted, which implies increasing revenues to finance further expenditures. Considering Korea's stage of development, I fully agree with the authorities' emphasis on social goals. Social security and welfare programs as well as health and education expenditures should contribute to improve the quality of life and should contribute to develop a consensus in the population. They should also help make social dialogue easier and moderate wage claims. It must also be recognized that the expenditure/GNP ratio is still moderate and leaves some room for maneuver.

The reduction of the external surplus should now ease the heavy burden that was weighing on monetary policy. The authorities have therefore regained some room for maneuver. I fully agree with the staff that monetary policy should be tightened and that a more neutral budget would avert the countereffect of a substantial rise in interest rates.

Structural policies have played, and will continue to play, a significant role in consolidating a more inward-looking growth process and improving the quality of life and social equity. I can endorse most of the staff's recommendations on this matter and will only mention two areas.

First, I would like to commend the authorities for the significant progress registered in trade policies. Most restrictions on manufactured imports have been lifted, and the authorities have now embarked on a new tariff-reduction program which will lower the average tariff to a level comparable with that of industrial countries.

Second, the comprehensive study of the 1980s financial liberalization clearly shows that the process is far from complete. In particular, short-term interest rates remain under control, and restrictions have been maintained to avoid a shift of funds between the liberalized and regulated sectors. Furthermore, the internationalization of capital markets is still incomplete. As a result, the conduct of monetary policy has been complicated, the use of indirect instruments has sometimes been impossible, and recently, the authorities had to reintroduce quantitative controls. I therefore agree with the staff that the authorities should focus on this issue. In sum, Korea's performance has been impressive, and I wish the authorities well.

Mrs. Hansen made the following statement:

My authorities continue to have a great deal of admiration for Korea's record of economic growth, which has proceeded at a particularly impressive pace over the past five years. Indeed, the characterizations of the Korean economy in the staff report as undergoing a "slowdown" in 1989, or a "recovery" in 1990 are striking. Real GNP growth rates of 6.7 percent in 1989 and 9.9 percent in the first six months of this year would be the envy of most other countries represented in this room. Notwithstanding the recent rise in world oil prices, my authorities join with the Fund staff in projecting continued strong economic growth in Korea over the medium term.

They agree with the staff's conclusion that the main task for the Korean authorities is to control inflation through monetary restraint, while sustaining the underlying forces for expansion. However, my authorities would emphasize some points with respect to how to go about this task, as well as some particular concerns about policy developments over the past six months.

On monetary policy, while my authorities agree with the staff on the need to keep monetary growth within target ranges to control inflation, they would also stress the importance of developing instruments for indirect management of the money supply, such as a more active government bond market. They note with concern the continuing heavy reliance over the past year on direct monetary controls. Notwithstanding steps to liberalize lending rates and make greater use of reserve requirements, the Government has continued to issue guidance to banks concerning credit allocation and interest rates. Such direct controls hinder market forces and create distortions in the economy.

This chair agrees with the staff that it is appropriate for the authorities to maintain a prudent stance on fiscal policy. However, in light of the fiscal restraint that has been exhibited to date, and the need for greater investment in physical and social infrastructure, it is doubtful that additional fiscal restraint can play a significant role in reducing inflation. As a means of controlling inflationary pressures, the emphasis should be instead on more market opening in both the financial and trade sectors, as well as increased reliance on market mechanisms in the Korean economy.

As for exchange rate policy, the introduction of the "market average rate" system last March was an important step toward increasing the role of market forces in the determination of the exchange rate. It is gratifying that the authorities no longer regard the exchange rate as a direct instrument of policy, but rather as reflecting the stance of financial policies. It is also encouraging that they believe the new system can accommodate market trends in the exchange rate and that it will be allowed to do so.

My authorities are concerned, however, that widespread controls on foreign exchange and capital flows continue to limit the role of market forces in exchange rate determination, by distorting both supply and demand in the exchange market. Notwithstanding the temporary current account adjustment, they hope that the Korean authorities will develop a timetable for easing these controls expeditiously.

This chair appreciates the often-stated commitment of the Korean authorities to liberalize the domestic financial system. Deregulation of lending rates, raising of bank ceilings on the issuance of certificates of deposit, and opening of the trust business to foreign banks are among the important liberalization steps that have been announced in past years. Thus, it is a cause for deep concern that the authorities appear to be backing away from many of these earlier commitments. In the area of interest rate deregulation, for example, banks continue to be subject to window guidance limiting their discretion in determining their own lending and deposit rates, notwithstanding the reforms of December 1988. There have also been delays in the scheduled opening of the specified money trust market, discrimination in the interbank call market, and reports of regulatory harassment of foreign banks in Korea.

This chair agrees wholeheartedly with the staff that the role of market forces in Korea's financial and foreign exchange markets should be enhanced through further substantial liberalization, but it is also critical for the authorities to follow through fully on liberalization measures that have already been announced. Moreover, we agree with Mr. Wright's comments on the desirability of enhancing the stability of the Korean stock market by increasing the access of foreign investors, rather than through government guidance and intervention.

In the area of trade policy, Korea deserves credit for the market-opening measures that it has undertaken in recent years. These liberalization measures have contributed substantially to adjustment, have actually improved Korea's export competitiveness, and have expanded consumption opportunities for Korean consumers. It is particularly gratifying to see that Korea has disinvoked its use of Article XVIII:B exemption for trade restrictions under the GATT and has committed itself to phase out all remaining trade restrictions, including those related to agriculture, by mid-1977.

In light of this record of trade liberalization, the recent campaign against "luxury" goods consumption in Korea, which often appears to be targeted at imported consumer products in particular, is cause for considerable concern. Although the Korean Government has disavowed this campaign, it is expected that the authorities will play a more active role in stopping the anti-import drive and in educating the public on the benefits of free trade. It is imperative that Korea maintain and, where possible, accelerate its trade liberalization program.

The Deputy Director of the Asian Department recalled that on the occasion of the 1989 Article IV consultation with Korea, the key issue with respect to financial policies was the extent of the stimulus to the economy, because at that time the signs of recovery were not obvious. Currently, the issue was the extent of restraint needed. In their discussions with the authorities, the staff had leaned very much in the direction that Mr. Wright had indicated--namely, that a somewhat tighter stance of financial policies would be desirable in the second half of 1990. Indeed, the discussion of the medium term had been thoroughly couched in alternative scenarios showing the effect of immediate tightening versus tightening later. Although both of the scenarios included in the staff paper eventually converged to a broadly satisfactory path, in the interim period, 1991-92, the situation in the first scenario--which assumed an immediate tightening--would be substantially more desirable: there would be a lower rate of inflation, a faster recovery of export growth, and a somewhat higher GNP growth.

That view was further strengthened by recent developments, particularly the expectation that monetary expansion would reach or exceed the higher end of the authorities' target range, the Deputy Director continued. While there had been some decline in real velocity, it was neither overwhelming nor a sufficiently strong counterforce to monetary expansion. The staff, however, recognized the constraints on the authorities with respect to financial tightening, including the great demand for social expenditures and the concern not to disrupt the recovery in the manufacturing sector, which was undergoing a period of reorientation and restructuring.

The temporary stabilization of the Korean border price of crude oil at the pre-Middle East crisis level had been achieved through tariff reductions and the rundown of surpluses of the Oil Stabilization Fund, the Deputy Director commented. The stabilization measure did not represent a net drain on the budget because the subsidy of $10 per barrel of crude was offset by tax and tariff revenues on crude oil, which yielded almost twice that amount per barrel. More specifically, Korean retail prices of oil products were significantly above the world market levels, and they were heavily taxed: there was a 10 percent value-added tax, a 2.5 percent defense tax, and an 85 percent special excise tax; consideration was also being given to an increase in excise tax to 130 percent as of January 1, 1991. Thus, the revenue impact of those taxes was greater than the hypothetical revenue forgone by stabilizing the border price of crude oil. Moreover, the stabilization measure was not considered permanent, and the authorities would review oil pricing in early 1991. If oil prices remained high, the current pricing policies would, in the end, contribute to inflationary pressures.

Under the new exchange system, the authorities no longer controlled the direction of movement of the exchange rate, but they did limit the speed with which it could move, the Deputy Director explained. It was therefore possible that, for a while at least, the nominal rate would move in an undesirable direction. If, however, Korea was successful in restructuring its manufacturing sector--by shifting to higher technology and more capital-intensive products--the large gap in productivity increase vis-à-vis the average of its trading partners might be maintained, and in that event, the equilibrium real exchange rate would tend to rise.

As to whether the 1987 labor market reforms had had any perceptible effect on the sustainable rate of growth, the Deputy Director commented that in theory, the introduction of rigidities--even though benevolent--in the labor market in the form, for example, of a minimum wage and other labor legislation, might well have implications for the natural rate of unemployment and thus for the sustainability of a high growth rate. The impact was, however, difficult to predict because in the past two to three years, developments in the Korean labor market were atypical compared with the experience of other Asian countries. The mission had discussed those issues as well as trends in labor markets with union representatives and enterprise representatives in Seoul. The tentative conclusion was that after the initial major disturbance, labor markets would normalize. For example, following a 10-15 percent increase of labor earnings in 1990, unions had made it clear that in determining their wage demands for 1991, they would mainly look at price developments and other related issues, such as job and workplace safety. In that connection, it should again be stressed that monetary restraint at the current juncture would greatly influence wage demands in the coming year, because they would no longer be mainly motivated by the backlog of accumulated wage demands or purely political considerations.

In response to Mr. Al-Jasser, the Deputy Director of the Asian Department confirmed that the Stabilization Fund had been created to absorb fluctuations in oil prices over a long period of time. The funds currently on hand had been collected at a time when international prices were declining, and the purpose of the fund was not just stabilization but also over time to create a surplus to finance investment in energy-saving activities as well as to accumulate oil stocks. The oil fund had thus also built oil stocks equivalent to about 33 days' consumption in Korea. In fact, only a fraction of the Stabilization Fund was in liquid financial assets. The major part was invested in other activities. Even then, more than $2 billion of its total assets--some $5-6 billion--were available to stabilize prices.

Mr. de Groote observed that the Korean case illustrated an important point that he, among others, had raised on the occasion of the world economic outlook discussion regarding the transmission of oil price changes to the consumer. At that time, he had defended the notion that some asymmetry was indeed needed and that it was fully justified to transfer to the consumer increases in oil prices but that one should take advantage of the periods of decline in oil prices to constitute some reserves. While he had been unaware of the Korean case at the time, he was certain that it would have a central place in the next discussion of the world economic outlook.

The Acting Chairman recalled that there had been a general consensus at the Annual Meetings that oil price increases should be passed through to consumers. Subsequently, there had been extensive discussions--and a range of views--within the staff on what that meant operationally. The Korean case gave some interesting dimensions to that discussion. In the future, there would probably be other examples of countries taking a different approach to the problem.

Mr. Al-Jasser said that he hoped that in the future, the Board could examine all the asymmetries in the treatment of the various commodities. While it was fair to call for a pass-through of any price changes, the Korean case showed that the pass-through only operated in one direction and for one commodity--namely, where there was an increase in the price of oil. In the event of a decline, however, there was a tendency to take advantage of the windfall to support a myriad of purposes. In his view, there was some asymmetry in the treatment of oil, and he hoped that the Fund would one day examine whether it was appropriate to discriminate against a particular commodity, because, in the case of oil, overtaxation was unnecessary. Moreover, if taxation was to act as a stabilizer in the economy, when oil prices increased, taxes should absorb part of that increase, especially in countries where the prices were already above the international price. There was a need to address that issue in a more reasonable way, because there had been calls for overtaxation and asymmetric treatment of oil to the detriment of the world economy and the economies of member countries.

Mr. de Groote observed that the notion of a symmetrical pass-through rested on the assumption that competition was perfect on the market. In a market with imperfect competition, intervention was needed in principle and in general to regularize the market and to allow competition to play. It would be a strong proposition to pretend that the oil market was one where perfect competition existed.

Mr. Grosche observed that the main challenge that the Korean authorities were currently facing was the increase in the inflation rate. The sensitivity of the Korean economy to different rates of inflation was illustrated by the staff's medium-term scenarios. He was afraid that the authorities' aim to contain M2 growth to around the upper limit of the target range for 1990 might not be ambitious enough. The upper limit already provided ample room for the anticipated rate of real growth and inflation; and the formulation of a wide target cast doubt on the very function of a monetary target, namely, serving as a "credible precommitment" for price stability.

To support the declining stock market, substantial amounts of liquidity had been injected into the economy at the end of 1989 and in early 1990, and stock market conditions continued to be of concern to monetary policymakers, Mr. Grosche noted. Leaving aside the question whether stock market developments should be a major factor in the formulation of a monetary target--which he doubted--the staff's analysis indicated that the volatile downward trend of the stock market reflected to some extent the downturn in economic prospects as well as a correction to the market's earlier rapid rise.

In that connection, he would be interested to learn from the staff the extent to which the rapid increase in house and land prices as well as rents had contributed to the development of the inflation rate, Mr. Grosche remarked. Also, he wondered whether the tax measures aimed at improving the supply of residential land and at fighting speculation were considered to be sufficient to rein in price developments.

On fiscal policy, he fully endorsed the staff's call for a restrictive stance, Mr. Grosche said. To reduce social and economic disparities, the Government should rely not so much on higher expenditure but more on the adjustment of the budget structure and a reform of the tax system. He wondered whether the failure to introduce the so-called real name financial transaction system could be seen as a drawback from the objective to improve on income distribution. In that connection, he also wondered whether the recent campaign against the import of foreign luxury items could be considered to be part of a policy that aimed at reducing differences in living standards. While the objective was appropriate, such steps to achieve it seemed to be less so.

The newly introduced market-average exchange rate system was welcome because it increased the role of market forces in the determination of the exchange rate, Mr. Grosche commented. He endorsed the staff's recommendation for a widening of the daily margins. In view of the considerable interest rate differential between the U.S. dollar and the won, the widening of the margin would raise the price of the currently riskless speculation.

The staff was to be congratulated for the excellent material in the background paper, which focused on two topics of central interest to the Korean economy at the current juncture rather than repeating in text what could be discerned from the tables, Mr. Grosche remarked. He invited the staff to treat background material in a similar fashion in the future. He would be pleased if in the future, the title "Recent Economic Developments" would appear less frequently on background papers.

Mr. Ismael said that he commended the Korean authorities for the successful implementation of their adjustment policies in response to the large external surpluses recorded by the economy during the period 1986-88. The economic adjustment, however, had resulted in a fall in output growth in 1989, prompting the authorities to gear policy efforts toward promoting growth. So far in 1990, growth had been favorable.

It was cause for concern, however, that the economic recovery had been accompanied by capacity constraints and rising inflation, Mr. Ismael continued. The difficult task faced by policymakers was therefore to adopt policies that were compatible with both reducing inflation and supporting the continuation of the recovery. That was undoubtedly an impossible task. He shared the staff's view that inflation was a greater threat to the recovery than was a weakening of the underlying forces of the economic expansion. Monetary policy must, therefore, continue on the path of restraint, with the maintenance of M2 growth within the target band. As to fiscal policy, the two supplementary budgets would result in an overall fiscal deficit of 1.5 percent of GNP for 1990 compared with a zero balance in 1989, Mr. Ismael observed. As that outcome would no doubt contribute to inflationary pressures, he saw merit in the staff's recommendation that nonpriority expenditures be postponed to offset the stimulus of the supplementary budgets. That would also help to reduce the burden placed by the authorities on monetary and credit policies to mitigate the adverse effect of the fiscal position on domestic prices.

As regards the external front, he shared the view that a depreciation of the won to improve external competitiveness was not appropriate, Mr. Ismael commented. Certainly, the authorities' emphasis on wage restraint, technological improvements, and productivity increases would result in more durable improvements in external competitiveness. In addition, he welcomed the progress made by the authorities in the liberalization of trade. He urged that the remaining quantitative restrictions be phased out as quickly as possible and that the five-year tariff reduction program be adhered to. A more liberal trade policy was certainly in line with Korea's increasing role in the world economy.

Mr. Meron remarked that Korea had been exemplary in its implementation of a wide range of economic reforms during the 1980s. Such reforms had often been undertaken in the face of enormous odds, and the authorities had shown a great deal of courage in their enforcement. The pursuit of anticyclical economic policies was, however, cause for concern, as was borne out by the staff report: the key development in 1990 had been a rapid recovery of economic activity, which had taken place before the adjustment performance in 1989 had cooled the economy down. Hence, a worrisome increase in the rate of inflation had occurred.

Not only the acceleration of inflation but also the nature of economic recovery was cause for concern, Mr. Meron continued. Economic recovery in 1990 had marked a departure from Korea's growth pattern in the 1980s. Whereas, until 1988, growth had been export led, the recovery in 1990 had been the consequence of a sharp rise in domestic demand. Furthermore, demand had been driven mainly by construction and private consumption rather than by investment in plant. Not surprisingly, employment growth in 1989 and 1990 had been concentrated in the services and construction sectors. Such an economic recovery, induced by the nontradable sector, might turn out to be ephemeral, particularly as the economy was losing competitiveness in the meantime.

The almost 10 percent inflation rate in 1990 reflected soaring labor costs, Mr. Meron observed. Real wages had risen at a rate of 12 percent and 18 percent in 1988 and 1989, respectively. The staff report seemed to suggest that overgenerous wage settlements had been granted in order to restore industrial peace. Monetary policy had accommodated the higher inflation rate. It appeared that in a fast-growing economy, a sudden slowdown was of greater concern to the authorities than was rising inflation. Anxious to restore economic growth to its previous pace, the authorities had permitted inflation to spread. The second medium-term scenario outlined in the staff report illustrated the risks of a policy without a clear anti-inflationary commitment: wage price spirals and weakening investments would stall recovery in exports as competitiveness deteriorated. Stabilization measures introduced at that stage would lower the rate of growth, so that the original short-run policy in support of growth would prove to have been self-defeating as a consequence of accelerated inflation.

Despite the progress that had been made in liberalizing the financial sector, Korea was still only at the halfway point, Mr. Menda considered. It was not enough to tighten financial policy only gradually through some direct measures to restrict domestic demand. Partial administrative measures could only have partial effects. Such ambiguity could also be found in fiscal policy. It was surprising to note, for instance, that the authorities had chosen to solve the housing shortage by involving themselves directly in the construction industry rather than creating the appropriate conditions for the private sector so that market forces could prevail.

It was interesting to note that exchange rate policy was currently more market based, although daily movements were outlined to narrow limits, Mr. Menda commented. Exchange movements currently reflected domestic financial policies. That was a most positive development, since it indicated that the authorities felt confident in that challenge. The staff seemed to expect some appreciation of the won as a result of the recommended tightening. If depreciation was indicative of too lax a policy stance, it was indeed inappropriate, and the floating, parity rate should not be used to accommodate inflation. Hence, he understood the staff's exchange rate recommendations essentially as recommendations on financial policy. The exchange rate discussion was different from that in the past, where exchange rate movements, rather than reflecting the policy stance, had been used as an instrument to influence competitiveness and deflate the economy. Those two properties of exchange rates--as the outcome of relative financial policies and as instruments in their own right--were never ending.

Mr. Bossone made the following statement:

The economic events characterizing Korea in the past two years have given ample evidence of the remarkable resilience of the economy and of the authorities' prompt, effective policy response to the problems facing the country. I wish to join previous speakers in congratulating the Korean authorities for the successful and rapid completion of the economic adjustment program undertaken in times of fundamental change toward a more democratic society, and for their ability to minimize the costs of adjustment by allowing the economy to rapidly resettle on a sustained path of growth. I also wish to commend the authorities for their continued commitment to open markets--a commitment they have recently reinforced by disinvoking Article XVIII:B of the GATT and by undertaking to phase out, or bring into GATT conformity, all remaining import restrictions by mid-1997.

At a time when in any country the government is put under increasing pressure to undertake vast programs of social expenditures and to play a large redistributive role, as is now the case in Korea, it is all the more necessary to keep the economy growing as steadily and fast as possible. This allows the system to satisfy social demands while containing the potential for conflicts among social groups and classes, which necessarily becomes more pressing the lower the growth of the overall pool of national resources. Besides, keeping the economy growing rapidly while adding to the country's stock of social infrastructure has the long-run beneficial effect of affording society a balanced path to economic development.

From this point of view, the authorities' preoccupation with the need to maintain a high growth profile is not only understandable but also desirable. The inherent risk, of course, is that of overaccelerating the pace of economic activity and of magnifying expectations to untenable levels. If this risk materializes, inflation is the necessary outcome, and I believe that Korea is today very much exposed to such risk.

Inflation has increased during 1990 owing to intense resource use and the impact of large wage settlements. Cost and price pressures are bound to accelerate in 1991 if economic activity proceeds at the same speed and if wage claims continue to be wholly accommodated.

Liquidity is clearly in excess in the economy, and I entirely concur with the staff's view that tighter financial policies are necessary to avert the risk of a wage-price spiral. Unfortunately, the authorities, although recognizing the need for restrictive policies, do not seem to be sufficiently committed to react accordingly; in fact, they fear that tight policies would affect investment and undermine growth.

The experience of many other countries, however, should remind Korean policymakers that unchecked high inflation undermines investment and growth, and that the cost of disinflation is larger the higher the initial level of inflation and the longer the high price growth has been tolerated in the past. The lessons of experience should give the Korean authorities enough cause to reconsider their policy objectives and to face the current situation appropriately.

In the circumstances, this chair recommends that the authorities take the following measures:

(i) Contain M2 growth to around the lower limit of the target for 1990 rather than the limit indicated by the Government during consultations with the staff;

(ii) Postpone nonpriority budget expenditures, as suggested by the staff, in order to offset the additional stimulus of the supplementary budget. In this respect, it should be noted that compensating adjustments in other budget outlays and taxes would not eliminate the budget's overall expansionary effect on aggregate nominal income;

(iii) Peg the exchange rate to a nominal target, possibly established in terms of a basket of currencies. In fact, the present exchange rate system still allows for accommodating inflation if necessary. In this regard, the Government's intention to forsake the use of the exchange rate as a direct policy instrument is cause for some concern, particularly at a time when inflation indicators would suggest an opposite course. In any event, allowing the exchange rate to reflect economic fundamentals requires from the Government a commitment to fight inflation if macroeconomic equilibrium is to be pursued. Should inflation persist and result in balance of payments deterioration, the exchange rate would be subject to periodic depreciations, which would contribute to perpetuating the problem.

In the context of the restrictive financial policies advocated above, attention should be paid to the efficient and nondistorting transmission of monetary impulses throughout the economy. To this end, the leverage of interest rates and open market operations should be increased by further strengthening the competitiveness of the banking sector and deregulating the primary bond market. Additionally, the authorities should consider diversifying and extending the maturities of the government bond issues.

Failure to undertake these measures would put in serious jeopardy the credibility of the Government with respect to the price stability objective; it would induce wage earners to assume that their claims would always be validated; and, it would worsen inflationary expectations. In contrast, the adoption of such measures would help contain price pressures, and most important, would send the economy an unequivocal anti-inflationary policy signal. Furthermore, over the medium term, the resulting higher real interest rates and the nonaccommodating exchange rate would prompt firms in the export sector to seek greater competitive margins through improved combinations of factors and the introduction of more advanced technologies. In this way, the pressure from higher financial costs would eventually contribute to accelerating the transition of Korea from a labor-intensive to a technology-intensive industrial economy.

In conclusion, Korea's medium-term prospects remain bright, if current inflationary tendencies can be reduced. In view of the authorities' impressive policy track record, this chair is confident that the attainment of noninflationary growth in Korea will not encounter major obstacles. To this end, however, it is crucial that the authorities fully acknowledge the risks inherent in the current circumstances and the need for timely action to avert them.

Mr. de Groote made the following statement:

As the staff paper aptly notes, other countries have come to look at the Korean experience over the past decade as an example of successful outward-looking development. Now, at the start of the 1990s, Korea is faced with the challenge of reorienting its economy more toward domestic demand forces while keeping on a track of sustained, noninflationary growth.

Whereas last year the prominence of domestic demand could still be regarded more as a side effect of the rapid external adjustment of the economy that almost halved the real GNP growth rate, the growth in real domestic demand is now projected to outpace overall growth for at least another two years, although by a declining margin. The Korean authorities should therefore focus on controlling internal demand developments in order to ensure that the economy achieves balanced growth across all sectors.

Such a strategy entails the adoption of a number of policy stances that are not unfamiliar to the Korean authorities. I would like to address them under the following four headings: according a prime role to market forces; adhering to sound macroeconomic policies; establishing a social consensus; and setting a credible medium-term framework for structural policies.

As to according a primary role to market forces, there is little doubt that the authorities have embraced this objective. Indeed, as observed by Mr. Yamazaki, Mr. Wright and others, it is commendable that despite the economic difficulties of the past year the authorities have taken further steps toward market liberalization in such areas as trade, taxation, the exchange market, and financial sector reform. I am confident therefore that they realize the importance of enhancing further the role of market forces, especially in the domestic financial market, through continued substantial liberalization. This means phasing out the administrative measures that were introduced to alleviate the difficulties associated with the economic slowdown last year. It also implies doing away with part of the remaining compartmentalization within the domestic financial system, allowing interest rates fully to reflect market forces, and increasing the role of international market forces. As a result, the transmission mechanism of monetary policy will become more effective, yielding more rewarding results in the containment of inflation. For example, less caution with respect to capital market liberalization would probably lead to short-term capital outflows, pushing up interest rates, but this would be in line with the needed restrictive monetary policy stance. At the same time, the negative impact of this increase on stock prices could be cushioned by foreign investors responding to increased market access. On the issue of stock prices, I was particularly interested by the remarks made by Mr. Wright on the dimension of the market.

As to the need for adherence to sound macroeconomic policies, the staff's view that inflation poses the greater risk to the Korean economy is now unfortunately corroborated by the effects of the crisis in the Middle East as well as by the recent flood. It is therefore of the utmost importance for the authorities to take a restrained stance in financial policies. I have already stressed the need for higher interest rates to slow down monetary growth in order to return to a medium-term path of low inflation along the lines of the first scenario in the staff paper. Monetary policy, however, should not bear the burden alone. In this respect, I would urge the authorities not to impart additional fiscal stimulus to the economy in 1991. Moreover, a neutral fiscal balance would refrain from exerting supplementary upward interest rate pressures and could thus soften somewhat the contractionary impact of a tight monetary policy. In any event, upward interest rate pressures should not be resisted. Indeed, higher rates will most likely affect consumption and construction spending--two sectors that have been feeding onto price and wage pressures. In addition, higher rates will help counteract imported inflation to the extent that they induce an appreciation of the won.

The staff points to the wage negotiations in early 1991 as being of crucial importance for price and wage developments and, therefore, for the inflation outlook in Korea. Interpreting this in a more policy-oriented way, it would seem that the need for the establishment of a social consensus is clearly visible. Indeed, with such a consensus, all parties concerned--labor, management, and the Government--will be able to preserve the external competitiveness of the Korean economy and try to distribute the welfare gains obtained as a result in a socially acceptable manner. Since the labor market is still in a period of transition in which the formal framework and practice of labor-management relations as well as the role of government policy are still evolving, there is ample scope for reaching such a consensus, especially now that labor-management relations have calmed down. Consensus-building could be centered around such elements as the share of labor in GDP, the distribution between wage and nonwage benefits, and the provision of basic social services by the Government. Considerations of this type would typically have to be assessed in a medium-term framework.

This emphasis on the medium term also underlies my final remarks concerning the need for setting structural policies in a credible medium-term framework. Let me first encourage the Korean authorities to continue with their financial market liberalization and internationalization efforts according to preannounced schedules. Aside from that, I would invite them to put increasing emphasis on the liberalization of agricultural imports. The strength of trade liberalization in Korea so far, which was concentrated on nonagricultural goods and services, resided in the fact that it was carried out gradually through preannounced programs that were adhered to strictly. I would suggest to proceed in the same way for agriculture. While recognizing the substantial efforts required to mitigate the adjustment difficulties involved in restructuring the agricultural sector, I would like to submit, first, that Korea is in a much better starting position now to absorb these adjustment costs and, second, that the country will benefit significantly in the longer run. Indeed, the surplus labor released from the agricultural sector can be redirected to the manufacturing sector, where it will help to ease the labor market bottlenecks that will undoubtedly come to the fore again once external demand picks up.

I wish to congratulate the staff on having replaced the traditional background paper by a study centered on topics of central importance for the policy decisions to be made by the Korean authorities. I recommend that this initiative should be followed in other areas. As I have observed in the past, traditional background papers unavoidably duplicate the staff report.

Mr. Ghasimi said that since the beginning of their adjustment strategy, the Korean authorities had made commendable efforts to reduce large external imbalances and defuse the momentum of inflationary pressures owing to exceptionally high economic growth in recent years. Indeed, while the current account surplus, which had shrunk sharply from 8.2 percent of GNP in 1988 to 2.4 percent in 1989, was expected to return to a balanced situation in the current year, output growth had fallen sharply. Moreover, inflationary pressures had continued to heighten owing to some constraints facing the economy. In the circumstances, some modifications in the envisaged policies, including the introduction of a number of new compensatory macroeconomic and structural measures, had been considered essential to maintain an overall environment conducive to a sustainable economic growth. Although the response of the economy to the changing policy stance had been rapid--with the real GNP growth rate currently expected to recover to about 10 percent in 1990, the fundamental economic conditions needed to guarantee a sustainable economic expansion through continuous and adequate investment in plants and equipment had yet to be realized.

Despite the uncertainties surrounding the continuation of Korea's exemplary economic performance of the past several years, he was confident that the policy measures and structural reforms sought by the authorities within the context of their medium-term program would enable them to overcome the difficulties facing the country in the period ahead, Mr. Ghasimi remarked. He agreed with the thrust of the staff's appraisal, and therefore had only a few brief comments to offer.

In the external sector, he welcomed the introduction of a new exchange rate system to allow exchange rate changes to further reflect economic realities as well as the behavior of market forces, Mr. Ghasimi commented. Furthermore, he was encouraged by the authorities' view that a sustainable competitiveness in the external sector must be achieved through the further enhancement of productivity and technological advancement, which were complementary to the use of the exchange rate instrument. Indeed, the adoption of such a mixed policy, which had so far proved its effectiveness in several leading exporting countries, would enhance the authorities' adjustment efforts and strengthen the export sector against unfavorable movements in the country's exchange rate.

The authorities had progressively continued their import liberalization policy through their decision to dismantle the remaining restrictions on imports of goods by mid-1997 and through the implementation of the third five-year program of tariff reductions for 1989-93, Mr. Ghasimi observed. Furthermore, the initiation of a new three-year program in 1989 to remove restrictions on the importation of nearly one half of all agriculture, forestry, and fishery products was a commendable step, which should be emulated by the developed countries. In that connection, and in view of the vulnerability of the rural population to liberalization of the agricultural sector, the new measures that had been taken in April 1989 to enhance agricultural efficiency, restructure production, and diversify the income sources of the rural population were most welcome.

The authorities must also be commended for addressing the social aspects of adjustment, Mr. Ghasimi stated. In that regard, the expansion of the pension and medical insurance services, so as to bring the whole country under their coverage, and the implementation of certain tax reforms as well as the adoption of a program for constructing two million new housing units to meet the increasing demand for low-income housing were all steps in the right direction.

Mr. Thorláksson said that the Korean authorities were to be commended for the remarkable adjustment achieved since 1988 as a result of their economic policies, following a period of exceptionally high growth and a substantial current account surplus. However, not all the problems had been overcome, and the authorities faced fundamental policy issues relating to the possibility of overheating of the economy.

He agreed with the main thrust of the staff report and, as the main issues had been addressed by other Directors, he would comment on only one point, Mr. Thorláksson remarked. As the recovery of growth after the slowdown in 1989 had been driven by domestic consumption at a time of high capacity utilization and tight labor markets, and in light of the recent monetary expansion and wage increases, a tighter fiscal stance to restrain the emerging inflationary pressure would have been more appropriate. Consequently, he questioned the desirability of introducing fiscal stimulus through the supplementary budget in the current year. He did not doubt the necessity of increasing expenditures for social programs and infrastructure, but expenditures directed toward social goals should be within the limits of a fiscal strategy aimed at maintaining an economic balance and supporting monetary policy while containing inflation. Such a strategy would entail postponing nonpriority expenditures, as had been suggested by the staff, or increasing revenues, which were at a comparatively low level and had been declining relative to GNP. In that context, he urged the authorities not to postpone passing through the increase in international oil prices to domestic prices.

Mrs. Hepp said that the economic performance of the Korean economy during the second half of the 1980s had been impressive, and she joined previous speakers in commending the Korean authorities for their exceptional achievements, particularly in terms of economic growth. The study of their policy strategy was a good lesson--particularly for developing countries--in how to achieve significant results in terms of growth and stability through the adoption of sound economic policies and a broad range of structural reforms. It was especially remarkable that the authorities had succeeded in balancing progress in the liberalization and internationalization of the economy with attention to social disparities and the needs of the population.

A sharp adjustment of the economy had been achieved during 1989, following the exceptionally high growth of recent years, through the implementation of a mix of timely fiscal, monetary, and exchange rate measures, Mrs. Hepp continued. Of particular interest was the introduction of the new market-average exchange rate system, which had recently led to a depreciation of the won against the U.S. dollar, reflecting the market perception of the economic fundamentals of Korea.

Those adjustment measures were showing results, and signs of recovery were again evident, Mrs. Hepp commented. However, in view of the high utilization of capacity and the tight labor market conditions, a risk of growing inflation persisted. As Mr. Kwon and the staff had clearly emphasized, the key issue was how to reach the appropriate equilibrium in policies, so as to reduce inflationary pressures without disrupting the ongoing recovery. In that regard, she fully shared the staff's appraisal and recommendations.

It should be stressed that two exogenous developments--namely, the impact of the Middle East crisis, in view of Korea's total dependence on oil imports, and the effects of the recent flood--were making the authorities' task more difficult, Mrs. Hepp remarked. On the first point, the use of resources of the Petroleum Business Fund appeared to be the most appropriate short-term policy response. In view of the uncertainties surrounding the crisis in the Middle East, a further adjustment of domestic oil prices could exacerbate inflationary pressures, a process that would not necessarily be easy to reverse if and when international oil prices declined to normal levels in the future. That situation underlined the concern expressed by Mr. de Groote, among others, regarding asymmetry. Furthermore, Mr. Kwon's comment that the authorities were prepared to review their energy pricing policy if conditions in the Middle East persist, was certainly the most prudent approach in the circumstances.

She had also noted that the Government's proposal of a second Supplementary Budget for FY 1990, which was mainly associated with the effects of the Gulf crisis, and in particular, to compensate for the flood damages, would result in a higher deficit for 1990, Mrs. Hepp commented. The substantial reduction of the deficit proposed in the budget for 1991 clearly showed the temporary character of those difficulties, and she could support the authorities' approach. On another point, she welcomed the Government's announcement that Korea would join the international community in providing financial assistance to the Middle East countries most affected by the Gulf crisis.

Mr. Ahmed made the following statement:

> My authorities are in broad agreement with the staff's analysis. The key policy issue facing the Korean authorities is how to manage the transition from rapid demand expansion and increasing price pressures to a more sustainable pace while supporting a continuation of the recovery. With resource use at relatively high levels and domestic demand showing signs of considerable strength, an adjustment in monetary policies is clearly needed. This chair believes that early action would reduce the need for sharper adjustments later, with adverse consequences for growth.
>
> The authorities' concern that a tightening of financial policies could disrupt the recovery is understandable. But this concern has to be balanced against the adverse effects of continued high inflation, which would eventually stall the recovery and require more drastic action at a later date. The task is indeed a challenging one: how to combat accelerating inflation without weakening the underlying forces of expansion.

As to the policy options confronting the authorities, in view of the considerable risks of a wage-price spiral leading to accelerating inflation and the slightly more expansionary stance of fiscal policies--as embodied in the second Supplementary Budget for FY 1990--my authorities agree that it would be better to tighten financial policies now rather than later. Even if one were to accept the authorities' preference to tighten policies gradually, it would seem that prompt and sustained action will be needed to prevent any overshooting of the targeted growth in monetary expansion.

With regard to the appropriateness of the exchange rate, this chair agrees that exchange rate depreciation would be inappropriate. However, an appreciation of the exchange rate, consistent with the anti-inflationary posture of domestic policies, would, in our view, be the best instrument for strengthening cost-competitiveness discipline. Indeed, it could be argued that the recent weakness of the exchange rate has tended to undermine efforts to reduce inflation by validating wage and cost increases at rates above those consistent with low inflation. A higher exchange rate would therefore be an essential ingredient in the strategy to lower inflation--even if it entails some immediate loss of competitiveness. This setback would be temporary, as exchange rate strength would serve as a most important force to contain wage and price increases.

I would like to ask for a clarification on the staff's first medium-term scenario. This scenario is based on the assumption that the authorities promptly tighten financial policies with a view to reducing inflationary pressures. If, however, monetary policy bears the main burden of the restraint, a more contractionary stance will mean accepting some increase in short-term interest rates. As a consequence, the interest-sensitive components of spending would be negatively affected and domestic demand and output growth would slow. A break in the inflationary trend is achieved through the easing of domestic demand pressures and a moderation of wage increases.

It is not clear how the exchange rate is expected to respond to such a tightening of policies. One could, of course, think of arguments where a tightening of credit and an increase in interest rates would not result in significant upward pressure on the exchange rate. For example, it can be said that an increase in interest rates would largely follow recent movements in world financial markets; or that financial markets in Korea are not fully integrated with those abroad.

But if we accept for the moment that the exchange rate would tend to appreciate somewhat, how can we reconcile such an outcome with the very sharp recovery in export volume that is being postulated for 1991, particularly considering that the staff's own econometric work suggests that price elasticities of demand for exports are fairly high and that external demand for Korea's exports is also projected to weaken?

Moreover, one important condition in the success of the anti-inflationary strategy being proposed is that it permits the opening of a significant gap in the labor market and thereby alters wage-setting behavior. I wonder whether the staff has a rough idea of how much unemployment would rise as a consequence of this policy of financial restraint. It is important to know this in view of the priority that the Government attaches to reducing social and economic disparities and improving the quality of life of its people.

The Korean authorities have pursued a commendable path in the liberalization of the financial sector. However, continued action remains to be taken for both increasing the integration of the domestic market into the global financial market and improving the efficiency of the domestic financial market. In this respect, I agree with the staff that the authorities should expedite the process of liberalization in order to reduce the occasional reliance on direct controls. Furthermore, it is important to stress that the unification of the regulatory environment of banks and nonbank financial institutions is an important step toward enhancing transactions between these two subsectors.

Mr. Noonan said that the Korean authorities were to be congratulated on their remarkable achievements over recent years. Nonetheless, he agreed with other speakers that the authorities were currently faced with a difficult challenge in adjusting to a sustainable and noninflationary level of growth. He also agreed with other speakers that domestic demand must be constrained so as to moderate inflationary pressures. The authorities' response should be to ensure, through restrained fiscal and monetary policies, that they did not further contribute to inflationary pressures while supporting sustainable growth. The impact of the crisis in the Middle East increased the need for such policy restraint.

On other points, the pursuit of a housing program as ambitious as two million new units over a four-year period, when combined with large pay increases, must contribute to excessive domestic demand pressures, Mr. Noonan observed. That was equivalent to building a new city for some 8 million people. In view of the other demands on the building and construction sector, particularly for infrastructural development as set out in the staff's report, it might be prudent for the authorities to allow higher interest rates to play a role in postponing some of the private sector's demand for housing construction. The authorities might also focus on measures to achieve a more efficient use of the existing housing stock. In view of the authorities' concern that high interest rates could restrict investment in the manufacturing and export sectors, he wondered whether the staff had any suggestions regarding how those concerns could be allayed.

As to fiscal policy, it appeared that a substantial source of recent inflationary pressures had been the fiscal stimulus introduced during the past two years, which, in turn, was related to the increased provision of social services by the public sector, Mr. Noonan commented. In his view, the increase in the social wage represented by the increase in services should go hand in hand with some moderation in pay increases and not, as had happened in the recent past, be accompanied by large pay increases. The possibility that those programs might have significant future financing requirements must also give rise to some concern. He invited the staff to comment on the extent to which those programs were funded, and their likely impact on future outlays.

Mr. Raza made the following statement:

> Despite problems associated with rapid adjustment and a severe flood, the Korean economy has continued to perform well. The sharp deceleration notwithstanding, real output increased by close to 7 percent in 1989, and growth during the first half of 1990--estimated at 10 percent on an annual basis--has been even more robust. Although significantly below the rate of growth recorded during the past few years, this is no mean achievement even under normal circumstances; in fact, it compares well with the country's record of the past ten years or so. The sustained high growth during the immediate past is attributable to the pursuit of a fine blend of monetary, fiscal, and exchange rate policies, for which the authorities are to be commended.
>
> I am in broad agreement with the staff's assessment of the short- and medium-term outlook as well as its policy prescriptions. I would, however, like to underline a few developments having a bearing on future growth and offer some comments.
>
> The spurt in economic activity noticed during the past year has been supported by private consumption and a boom in construction, both residential and nonresidential. There has been little investment in machinery and equipment, and therefore the creation of additional capacity has been limited. Development thus has, in the words of Mr. Kwon, been "unbalanced." Private investment is apparently hampered by the decline in the national savings rate. In fact, after many years, a savings-investment imbalance has emerged in the private sector. The surge in private consumption has given rise to capacity constraints and has also generated inflationary pressures, which have also been fueled by excess liquidity generated by earlier current account surpluses. These developments taken together point to a difficult period ahead.
>
> The slowdown of economic activity in 1989 was caused by the decline in exports. This, in turn, was attributable to Korea's weakened competitive position in the overseas markets, mainly as a result of the large increase in unit labor costs, and the adverse effects of the appreciation of the won. These were the direct

result of rapid adjustment to the large external surpluses experienced during 1986-88. The economy is, in a way, thus being required to readjust--this time to the situation created by rapid adjustment in the earlier period. The Korean experience clearly illustrates the danger of too rapid an adjustment.

On the export front, Korea has relied heavily on the U.S., Japanese, and European Community (EC) markets. Of these three, it generally had an unfavorable trade balance with Japan. Its trade balance with the EC has also started to move into a deficit position. On present indications, the same may happen vis-à-vis the United States. The time has come for the authorities to seriously consider diversifying their export market.

In Korea, a large segment of society still depends on agriculture. However, GDP generated in the agricultural sector has remained practically flat during the past four years; it grew, on an average, by just about 1 percent per year. With special emphasis being placed on equity and social justice, the authorities may like to examine in depth the reasons for the stagnation in the agricultural sector. In view of the special place of agriculture in the Korean economy, I fully agree with the go-slow policy of the authorities in removing all restrictions on agricultural imports.

I share the staff's view that, under the present circumstances, inflation poses a serious danger to the sustainability of the recovery. Great restraint in financial policies is therefore of paramount importance. The staff's medium-term scenario makes this point clear.

Excess liquidity in the system notwithstanding, a target range of 15 percent to 19 percent for monetary growth during 1990 seems consistent with the projected growth of nominal GNP and an acceptable level of price increase. However, in view of the fact that M2 is currently expanding at a significantly higher rate, there is urgent need for restraint.

I also agree with the staff that monetary policy will have to play a key role in curbing inflation without endangering recovery. This will, however, entail further liberalization of the interest rate structure and the development of new instruments of monetary control to enable the Bank of Korea to undertake more active open market operations. Of course, monetary policy will have to be backed by a supportive fiscal policy.

As the staff suggests, there is urgent need to postpone all nonpriority expenditure and thus provide some scope for credit expansion to the private sector. However, in view of the equally urgent need to reduce regional and sectoral disparities, I would not suggest any cut in social and welfare programs as implied in the staff's recommendation.

As regards exchange rate policy, I fully agree that depreciation of the currency to gain competitiveness would not be an appropriate policy--at least not under current circumstances. I also welcome the new MAR system which allows markets to play a relatively more positive role in determining the exchange rate. I am also one with the authorities in assessing exchange rate movement in relation to developments in competitiveness, the balance of payments, and domestic financial conditions. However, the continued emphasis laid by the staff and the authorities on stabilizing the nominal effective exchange rate rather than the real effective exchange rate is still somewhat puzzling. With the inflation rate running higher than in main trading partner countries, stabilizing the exchange rate in nominal terms would in no way improve the competitiveness of Korean exports; it may, in fact, worsen it. Authorities may like to re-examine the whole issue afresh.

I am happy to note that immediate, short-term problems and difficulties notwithstanding, the authorities have continued to pursue structural reforms. I am also glad to note that these reforms are aimed at, inter alia, reducing social and economic disparities and improving the quality of life. The authorities have also taken important steps in reforming the tax structure, liberalizing financial markets, and opening up trade and exchange rate regimes. It is encouraging to note that they intend to continue with these policies. I would, however, recommend a gradual approach. In fact, as regards further exchange market reforms, I support the authorities' view that these must await the further liberalization of financial and capital markets.

The Korean economy is already on the way to recovery, and the authorities are trying to move it toward a sustainable, though not necessarily rapid, growth path.

Mr. Obame said that he endorsed most of the comments made by previous speakers as well as the staff appraisal. The Korean economy had responded favorably to the adjustment measures implemented by the authorities in the course of 1989 to reverse the deteriorating trend in external competitiveness and the sharp economic slowdown. Thus, real GDP was expected to rebound substantially in 1990 owing to strong activity in the construction sector and a continued strength in private consumption. Meanwhile, export volume was expected to increase, and despite the high level of imports, gross official reserves would remain at a comfortable level.

One of the main challenges confronting the Korean authorities--which they themselves had recognized--was how to move the economy to a sustainable, low-inflation growth path, Mr. Obame considered. There did not seem to be a substantive difference of views between the staff and the authorities on how to achieve that objective. The staff was advocating a restrained stance in financial policies to reverse the inflationary trend in view of the tight supply-demand balance in Korea. While the authorities did not disagree with that approach, they were concerned about the implications of tighter financial policies for the current fragile economic recovery.

Indeed, the issue appeared to be the pace of implementation of a restrictive policy stance, Mr. Obame continued. In that connection, the medium-term scenarios suggested two different approaches to the conduct of macroeconomic policies. Although he saw merit in the authorities' strategy, which combined gradual tightening with some direct measures to restrain demand and contain price increases for specific products, he would encourage them to consider also the benefits of Scenario I, which envisaged immediate tightening, especially in the light of the inflationary impact of high oil prices.

Like the staff, he believed that the performance of the Korean economy over the past years was commendable, and he could endorse the observation that viewed from different angles--including high foreign investment, resource mobilization and utilization, as well as high productivity--the Korean experience was an example of successful development, Mr. Obame commented. Moreover, the authorities' trade liberalization efforts as well as their commitment to bring all remaining restrictions on imports into conformity with the GATT were also commendable.

Miss Montiel made the following statement:

> Having been the model for developing economies during the 1980s, Korea is now facing all the typical problems of an overheated economy. The rapid correction of current account disequilibria through the nominal appreciation of the exchange rate and the increase in real wages as the economy moved onto a more sustainable growth path has induced an acceleration of inflation, a decrease in the growth of productivity in the manufacturing sector, a deficit in both the external current account and the operations of the consolidated Central Government for 1990, and a deceleration in the rate of growth.
>
> The challenge faced by the authorities is a difficult one, namely, to control inflation through the tightening of financial policies and, at the same time, to maintain the recovery of economic activity. In that regard, the maintenance of a favorable growth rate of 7 percent a year by a country with a population growth rate of 1 percent a year is not a cause for great concern, although it represents a substantial deceleration in growth when compared with the previous year. However, to evaluate the slowdown of the economy, it is helpful to compare the 1989-90 growth rates with the trend, particularly taking into account the fact that the economy is already facing capacity constraints.

The implications of the change in the orientation of the economy for the sustainability of growth is, however, cause for some concern. These structural changes, which are the result of policies implemented to correct short-term disequilibria on the external front, have increased the production of nontradable goods, thereby channeling a substantial amount of scarce resources to that sector while partly crowding out the private investment in equipment that is needed to continue the expansion and growth in productivity of the export sector.

In the fiscal sphere, I welcome the authorities' emphasis on social security and welfare programs, which have helped, together with other income measures, to increase the equitability of the distribution of the fruits of growth. Although this chair assigns a paramount importance to the Government's social objectives, which have helped to develop a more peaceful social environment, the financial stability of the economy requires that the increase in social program expenditures for 1990 be compensated by a reduction in other expenditures in view of the projected shortfall in nontax revenues.

Monetary astringency and interest rate policy will play a fundamental role in achieving the price stability required for sustainable growth and in assuring an efficient allocation of resources. In that respect, I have some difficulties with the imposition of controls on the allocation of bank credit. In this connection, the duality present in the financial sector, whereby interest rates are somewhat liberalized and yet controlled, might be posing some difficulties for the management of monetary policy to the extent that it hampers the transmission mechanism.

From the staff report, it is not possible to evaluate the adequacy of interest rates. I would appreciate some elaboration, particularly with respect to two points:

(i) the rationale for setting the interest rate of the main instrument of monetary policy--namely, stabilization bonds--below the free market rate; its impact on liberalized interest rates; and its relation to the Bank of Korea rediscount rate; and

(ii) the term structure of interest rates, particularly with respect to loans. Indeed, the empirical data included in the staff documents suggest that commercial bank rates do not reflect expected inflation and the risks embodied in different kinds of loans with different characteristics and different maturities. For example, the discount on bills, loans for exports, term loans with maturities from one year to three years and those from eight years to ten years have the same range of interest rates.

As to monetary and interest rate policies and the development of the stock market, this chair concurs with Mr. Wright that the authorities should broaden the structural reform program so as to deepen the stock market and allow gradually the correction needed in that market.

In closing, this chair would like to join previous speakers in commending the Korean authorities for their remarkable achievements and for the progress made in the liberalization of the economy.

The Deputy Director of the Asian Department said that land prices had contributed to inflation to the extent that they had been an important factor in pushing up wage demands. The recently announced measures to dampen the increase in land prices had had some effect. According to unofficial figures, land prices, which had risen by over 30 percent in 1989, had increased between 8-10 percent in each of the first two quarters of 1990. Nevertheless, it would be premature to make a firm statement on recent trends in land prices.

More generally, the staff had not yet systematically studied land prices with respect to their institutional framework or their influence on economic policy, but it might do so for the coming consultation, the Deputy Director continued. Certainly, land prices had become a politically important issue, because it impinged on income distribution and, although income distribution in Korea was relatively equal, the population was highly sensitive to changes in the distribution. That sensitivity had also influenced economic policies; in particular, the authorities had indicated that the sharp increase in land prices and the high returns from land speculation were hampering further steps in financial liberalization.

That situation was, of course, deplorable, the Deputy Director commented. As Mrs. Hansen and other speakers had observed, the central bank still could not effectively fully use its open market instruments. One reason was that interest rates had not yet been fully liberalized. Moreover, the real names issue also affected income distribution, and a final decision had not yet been made in that regard.

The staff had been assured that the earlier campaign against the importation of luxury goods was not government policy nor was it government inspired, the Deputy Director explained. Instead, it was a popular movement reflecting, again, the sensitivity of the income-distribution issue.

It was important to clarify that the Government's direct involvement in the housing program was relatively low, the Deputy Director remarked. The total program provided for the construction of 2 million apartments over a period of five years. Out of that 2 million, 250,000 were low-rent apartments in which the Government was directly involved. The rest were financed by public financial institutions, which would have to obtain their funds through the issuance of bonds. Prospective buyers also were obliged to buy bonds.

The question of whether there should be a nominal peg for the exchange rate was an issue that would remain for some time, the Deputy Director considered. Clearly, a nominal pegging without the corresponding financial policies would not be helpful. The staff had therefore emphasized the tightening of financial policies rather than an exchange rate peg. In fact, the direction of the staff's recommendation was to increase participation in foreign exchange markets and to widen the participation of banks. As to Mr. Ahmed's question about the exchange rate assumption in Scenario 1, the implicit assumption was that any nominal appreciation would be offset by a reduction in inflation. Therefore, competitiveness would not change and exports would not be adversely affected.

As to the funding of the large social programs, apart from the pension program, which in the initial period would run surpluses, the resource claims of other social programs would tend to raise interest rates, the Deputy Director observed. Therefore, the longer-term fiscal stance must be to broaden and increase the tax base. The tax/GNP ratio in Korea, at 17 percent, was in the lower range of ratios for countries with a similar per capita income level. Therefore, there was scope for increased taxation in line with the increased social demands that were being made on the Government.

The effect of a more restrictive monetary policy on unemployment should not be a serious problem, because there was currently an acute labor shortage in manufacturing, the Deputy Director commented. Moreover, manufacturing enterprises strove through various means--for example, the provision of education, housing, and fringe benefits--to attract workers from other sectors of the economy.

On other issues, the staff would provide a detailed explanation on the structure of interest rates on a bilateral basis, the Deputy Director of the Asian Department remarked. In that connection, the authorities were indeed concerned that investment in manufacturing was interest-rate sensitive, but they already had in place various schemes to mitigate that effect. In particular, export-oriented manufacturing enterprises received various advantages, including certain loans at lower interest rates. While there was some dilemma, the restructuring of Korean industry as well as its potentially high productivity continued to offer good prospects and should, in the end, offset the dampening effect of high interest rates. It was true that the role of the stock market in the economy was still limited, but it should be noted that, according to the International Finance Corporation, since 1985 the value of shares had risen from $7.5 billion to $141 billion--a nineteenfold increase. The Korean stock market was, in fact, currently the third largest market in Asia.

Mr. Kwon said that he was grateful to Executive Directors for their constructive comments, suggestions, and policy recommendations, which he would convey to his authorities. As the staff had answered most Directors' questions, he would limit his comments to only a few key issues.

The first issue was the authorities' energy pricing policy and the role of the Petroleum Business Fund, Mr. Kwon continued. As the staff had explained, the fund had been established in the early 1980s for a variety of purposes. The first was to achieve stable domestic energy prices in the wake of fluctuations in international world oil prices. Moreover, it was to be used to promote adequate conservation and energy exploitation, among other purposes. The fund had, however, retained some financial assets to shield the domestic market, as necessary. As he had indicated earlier, in view of uncertainties regarding the duration of the crisis in the Middle East as well as the future movement of oil prices, the authorities had decided to maintain a current level of domestic prices for the time being by using the resources available in the fund because, as the staff had clearly pointed out, their imminent task was to ease domestic inflationary pressures.

That did not, however, mean that the Government would protect consumers through its fiscal policy, Mr. Kwon observed. To do so would imply an increase in subsidies, which would exacerbate the fiscal position. If the authorities judged that higher oil prices would continue for a long time, they would review their energy pricing policies with a view to bringing domestic prices more in line with international prices.

As to trade liberalization, especially with respect to agricultural products, it should be noted that for most countries, structural reform in the agricultural sector was difficult to achieve in a short period of time, Mr. Kwon commented. In view of the traditional perception of the farmer and land in Korea, it would be extremely difficult for the Government to explain its agricultural policies only in terms of economic rationale or the theory of comparative advantage. Traditionally, farmers were considered to be the foundation of the nation. Nevertheless, the Government had decided to disinvoke Article VIII:B of GATT, and agricultural reform would proceed on that basis. Although there had been strong resistance from farmers since the disinvokation of Article VIII:B, which had created tremendous political problems and pressures on the Government to reconsider its agricultural policies, the authorities were determined to pursue the agricultural liberalization policies as promised in the GATT agreement.

The Government was also determined to proceed as scheduled to internationalize the financial and capital markets, Mr. Kwon commented. There was some controversy as to whether the authorities should move more vigorously at the current stage to liberalize the domestic financial market. In their view, more time was needed to comply entirely with the market forces in determining interest rates, particularly at a time when the domestic economy was in a transition after facing rapid wage increases in recent years. The authorities therefore intended to pursue the liberalization of the domestic financial market on a step-by-step basis.

The campaign against the importation of luxury goods aimed at reducing excessive consumption was a part of private sector response to the Government's initiative to increase private sector savings, Mr. Kwon explained. The Government was not involved in any way in curtailing the importation of luxury goods and would not intervene in the importation of such goods by the private sector.

The Acting Chairman made the following summing up:

Executive Directors observed that rapid external adjustment in the Korean economy had taken place and commended the instrumental role of the authorities' policies of nominal exchange rate appreciation and market opening. The external adjustment process had also been accompanied by sharp increases in labor costs and domestic demand pressures. In 1989 export volume had declined and, consequently, output growth had slowed abruptly. In 1990, the authorities had cautiously redirected policies toward supporting a recovery.

Directors noted, however, that the recovery was already facing capacity constraints, particularly a tightening labor market, and inflationary pressures had intensified. The key policy issue, therefore, was the need to break the momentum of inflation. While recognizing the desire of the authorities to avoid disrupting the recovery as well as the delicate task of economic policy under these circumstances, Directors emphasized the need for a restrained policy stance. This had become even more appropriate in the wake of recent developments and uncertainties in the world oil markets, and the greater emphasis given by the authorities to social welfare objectives.

It was important to maintain a firm anti-inflationary stance of monetary policy and, in the view of most Directors, a further tightening of credit and some increase in interest rates would be required to bring inflation under effective control. To alleviate the impact of such a tightening of monetary policy on the private sector, fiscal restraint was necessary. In this regard, Directors noted the strong pressures for greater government expenditures for social improvement and disaster relief, but cautioned against a general premature relaxation of fiscal policy. They therefore welcomed the tighter stance of the proposed 1991 budget. Greater attention to social concerns in the budget should be achieved through reforms of the budget structure as well as tax reforms in order to contain the budget deficit. Inasmuch as there were practical limits in present circumstances on the scope for additional fiscal restraint, it was important now to pursue further market-opening measures and related structural reforms.

Directors commended the authorities on the introduction of the new system of exchange rate determination and welcomed the greater role it provided for market forces. They shared the authorities' view that an exchange rate depreciation to improve external competitiveness would not be appropriate in the present circumstances and welcomed the authorities' emphasis on wage restraint, technological improvement, and productivity increases to achieve lasting competitive strength in Korea's exports.

Directors recognized that recent events in the Middle East had put a substantive burden on Korea's balance of payments, but there was general agreement that Korea's underlying external position was sufficiently strong to absorb the shock. While noting the authorities' desire to smooth the economy's adjustment to higher international oil prices, several speakers cautioned against a long delay of a full pass-through.

Directors commended Korea's considerable efforts over the past decade to liberalize its economy, and particularly the steps taken in recent years to reform trade, taxation, financial markets and the system of exchange rate determination. Directors encouraged the authorities to move ahead to fully implement announced reforms and to adopt further complementary actions in these and related areas. For instance, noting the high degree of sensitivity of the Korean authorities to sharp fluctuations in the stock market, several speakers urged more rapid structural reforms to broaden the capital markets and to liberalize access to them, including access by foreign investors. Some Directors also expressed concern over several administrative measures, particularly the guidelines for financial institutions that had been introduced since the last consultation; they urged that these measures be phased out soon.

Korea's undertaking to phase out, or bring into conformity with the GATT, all remaining restrictions on imports, which are largely on agricultural products, by mid-1997, was welcomed by Directors. The removal of these restrictions would require considerable adjustment in Korea's rural areas, and Directors emphasized the need to press ahead with measures to facilitate this process.

In conclusion, there was a broad consensus among Executive Directors that the Korean economy remained poised for rapid further growth, and there was general commendation for the enhancement by the authorities of the role of market forces in the economy, for the central importance that the authorities attached to sound macroeconomic policies, and for the increased attention to social issues. Directors hoped that these policy priorities would continue to go hand in hand with further external liberalization and structural reforms. In that context, Directors noted the strong determination of Korea to collaborate with the international community.

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

4. GUINEA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Guinea (SM/90/142, 7/17/90; and Sup. 1, 9/17/90). They also had before them a background paper containing a statistical annex (SM/90/178, 8/13/90).

The staff representative from the African Department remarked that during discussions held in Washington on the occasion of the 1990 Annual Meetings, the Guinean authorities had informed the staff that domestic retail prices of petroleum products had been raised by a weighted average of about 43 percent as of September 19, 1990. That action constituted an important move in the right direction for the fiscal outlook in 1990, as well as for the process of structural reform in the petroleum sector.

Mr. Santos made the following statement:

> The Guinean authorities are grateful to the staff for the preparation of the supplement to its report, which provides the Executive Board with updated information on the various policy measures implemented after the circulation of the staff report on the 1990 Article IV consultation with Guinea. Indeed, since the issuance of this report, a number of positive developments have taken place that could alter significantly the prospects of the Guinean economy both in the short and the medium term. My authorities are in broad agreement with the revised staff appraisal contained in the supplement and have no major difficulty with the staff's policy recommendations. I will therefore limit my statement to highlighting the recent measures taken and their impact on the macroeconomic framework.
>
> Over the past several years, the authorities have been implementing an ambitious rehabilitation program with support from the Fund, the World Bank, bilateral donors, and official creditors. As Directors will recall, the Executive Board approved a three-year arrangement under the structural adjustment facility together with the first annual arrangement thereunder on July 29, 1987, and subsequently approved the second annual arrangement on March 27, 1989. The third annual arrangement should have been put in place before July 28, 1990--the end of the three-year commitment period. Unfortunately, due to a divergence of views on the sequencing and timing of the policy measures to be implemented, understandings could not be reached in time on the financial program for 1990, and the authorities did not avail themselves of the third annual arrangement. Nevertheless, they proceeded with the implementation of virtually all the measures discussed with the staffs of the Fund and the World Bank during the negotiations for the third annual arrangement. Moreover, the authorities took a series of additional measures that are detailed in their letter to the Managing Director attached to the supplement to the staff report.

The bulk of the measures taken was concentrated on the petroleum sector in view of its critical importance to the success of the adjustment process. In this respect, the authorities have signed and ratified a protocol of agreement establishing a semi-public company in charge of the supply and distribution of petroleum products and appointed a new liquidation team at the National Hydrocarbons office (ONAH) to ensure transparency in the liquidation process of that company. As a result, the management of the oil sector has improved considerably as has the collection of the specific tax on petroleum products. With the complete overhaul of the sector, the conditions for an adjustment in the prices of petrol products were realized. It is in this context that the authorities enacted on September 18, 1990 substantial increases in the retail prices of petroleum products, which in the case of gasoline reached 47 percent. The magnitude of the increases takes into account the recent surge in oil prices in world markets following the onset of the Gulf crisis and also makes it possible to generate higher oil tax revenues than estimated in the revised budget law adopted in July 1990.

The authorities also decided to accelerate the adoption of other structural measures in order to expedite the liquidation of ONAH and the privatization of the petroleum sector. It is expected that the adjustment in the domestic prices of petroleum products will facilitate the negotiations with the new partners scheduled to begin in October 1990. The purpose of these negotiations is to establish a new mechanism for setting the prices of petroleum products so as to reflect world price developments. In addition, the authorities intend to privatize the transportation of petroleum products and turn over service stations to private management. They expect to complete this exercise by early 1991.

With regard to the electric power company (ENELGUI), its management has been dismissed and the board of directors dissolved. Full management authority for a one-year interim period was given to a technical assistance team, which was directed to design a new organizational structure with a view to improving billing and collection procedures as well as streamlining procurement. This team will also evaluate the enterprise's managerial staff and prepare a rehabilitation program for the electricity distribution grid.

The other measures taken recently include the adoption of a new customs code, the establishment of a roster of taxable enterprises, and a 1 percent increase in the Central Bank's preferred refinancing rate. Moreover, the monetary authorities pursued a flexible exchange policy throughout 1990, which contributed to the stabilization of the real effective exchange rate and enabled the authorities to hold the spread between the official and parallel market exchange rates to under 5 percent.

The resolute implementation of the authorities' adjustment program should make it possible to achieve a viable macroeconomic framework in 1990. Already, a tangible improvement in the Government's financial operations has taken place, enabling the Treasury to reduce its indebtedness to the Central Bank. Also on the inflation front, there are positive developments that indicate that the Government's inflation rate target for 1990 is within reach.

All in all, the Guinean authorities are of the view that they have taken the necessary important steps that would enable them to maintain a viable macroeconomic framework over the medium term. They are also of the view that the measures taken have laid the groundwork for a successful negotiation on a program to be supported by an enhanced structural adjustment arrangement in 1991. But in the meantime, the importance of a timely release of the anticipated external financial assistance to support their efforts cannot be overemphasized. It is the authorities' hope that the recent impetus given to the adjustment process will demonstrate to the multilateral institutions and bilateral donors their determination to build upon the progress achieved over the past several years and make further progress in the reduction of the internal and external financial imbalances.

Mr. Serre made the following statement:

I welcome the set of measures described in the supplement to the staff report, which are designed to stabilize the Guinean economy at the present critical juncture. The measures already taken as well as those to be implemented until the end of 1990 aim not only at reversing the policy slippages seen in 1989-90 and at reducing the resulting domestic and external imbalances, but also at resuming a confident relationship with the international financial community. Such a confident relationship is essential to mobilize the external assistance needed to support the adjustment process, according to the revised budgetary and balance of payments targets. However, I share the staff's concern that, although these targets appear attainable, strong commitment on the part of the authorities is indispensable to maintain the momentum of the adjustment.

The performance of the Guinean economy in 1989-90 was disappointing in many respects despite the pursuit of sustained growth supported by the mining sector. Slippages were registered in both fiscal and monetary policy, and the overexpansionary macroeconomic stance had direct consequences on the external sector. As a result, the current account deficit surpassed the program targets by almost 2 percentage points of GDP. In addition, inflationary pressures remained high, contributing to sustained negative real interest rates. Finally, little progress was made with respect to structural policies, placing additional pressures on the budget.

Since the basic finding emerging from the staff report is that the present situation might become inextricable if rigorous actions are not taken in the short run, I shall focus my comments on a few specific points in that respect.

As to macroeconomic policies, much remains to be done in spite of recently achieved progress. Fiscal discipline is still central to the success of the authorities' strategy. Under the revised budget, the strengthening of revenue will essentially depend on the mining sector and, to a lesser extent, on income, profits, and exchange-based taxes. This breakdown has to be radically improved in the future, with less reliance on the mining sector. In this regard, it should be stressed that there is no more room for complacency with respect to increasing the special tax on petroleum products. On the expenditure side, I agree with the staff that total expenditures have to be contained at about 20 percent of GDP. Within this context, the reform of the civil service as well as the streamlining of the relations between the Government and the parastatal sector will be of the utmost importance. Finally, I urge the authorities to avoid further movements in Government accounts at the Central Bank outside the control of the Treasury.

As regards monetary and credit policies, the authorities should rely on a prudent demand-management stance that would allow enough room to foster domestic savings and to divert financing to the real sector. Restructuring the legal and institutional framework on a durable basis will be critical in the short run as will be setting up more indirect mechanisms to control credit expansion. In this respect, the authorities should pay close attention to money supply development in order to attain the objective of reducing inflation.

Concerning structural policies, there is little to add to the staff's assessment. I would only stress the need to strengthen the current stance and to give priority to the already identified key reforms. I urge the authorities to pursue the ongoing discussions on disbursements for structural and sectoral operations supported by the World Bank and other donors. Rigorous implementation of the actions agreed upon under the education and private sector loans as well as under the structural adjustment credit will attest to the authorities' commitment to move ahead. Finally, every effort should also be made to take advantage of the country's natural resource base and of the potential to diversify the productive base, especially in agriculture.

As to the external sector, the improvement of the external position could be the result of measures taken to curb inflation and of higher tax payments by the mining companies. This policy stance should, however, be further reinforced to pave the way for durable progress in this area, and to seize the opportunity of better than expected revenues performance in the mining sector.

With respect to exchange rate policy, I agree with the staff that it will be important "to maintain a stable exchange rate that ensures external competitiveness," in view of the specific nature of the present Guinean export base. Moreover, it is clear that the exchange rate has been one of the channels through which inflation introduced itself into domestic costs and prices, in particular since the economy suffered from structural rigidities. Any slippage would then feed inflationary expectations, thus leading to further pressures for depreciation. Therefore, the authorities should increase budgetary and monetary discipline rather than rely on further depreciation.

The accumulation of external arrears also needs to be closely monitored. The authorities should promptly make every effort to reduce arrears in an adequate manner so as to normalize relations fully with all external creditors.

In sum, this chair is confident that Guinea can regain the significant track record that has been established over the past several years. The recent acceleration of the adjustment process will pave the way to maintain a viable macroeconomic framework over the medium term. The pursuit of an adequate track record and the implementation of additional measures, if necessary, will, it is hoped, facilitate the conclusion of a program supported by Fund resources. I support the proposed decision.

Mr. Yoshikuni made the following statement:

The performance under the first and second annual structural adjustment arrangements was not satisfactory. While there was a resumption of economic growth and some reduction of inflationary pressures, fiscal deficits and external imbalances remained high and structural adjustment was delayed. At the previous Board discussions on Guinea, this chair expressed concern about the fiscal slippages and the delay in structural reforms. Regrettably, the authorities failed to address these concerns, and the structural adjustment arrangement has lapsed, leaving significant internal and external imbalances unadjusted.

I am in broad agreement with the staff's appraisal and support most of the policy recommendations. Furthermore, I welcome the authorities' commitment to, and recent implementation of, corrective measures, as described in the supplementary paper. This being said, in order to resume progress toward the original adjustment objectives, the authorities should further commit themselves to strengthening the momentum of adjustment.

As regards fiscal policy, the reduction of the overall deficit should be accelerated. To ensure and expand an appropriate revenue basis, the measures designed to improve customs and tax administration should be implemented. Although the 1990 budget had benefited from a substantial increase in revenue from the mining sector, the increase can be expected only until 1991, followed by a reduction thereafter. In this regard, I fully agree with the staff that the higher revenues in 1990 should be reflected in higher government savings and not be used for an expansion of expenditures. At the same time, the authorities should make an effort to raise nonmining revenue in order to ensure the future revenue base. In this connection, I welcome the reform of the petroleum sector, including the substantial increases in retail prices of petroleum products, which will have a beneficial effect on the collection of the special tax on petroleum products. In this connection, I would appreciate the staff's comments on whether the range of price increases was sufficient in view of world price developments.

Meanwhile, it is essential to continue the containment of public expenditure. In particular, measures to control the wage bill and streamline the civil service should be accelerated. While we appreciate the intention to introduce a civil service roster and a computerized system for civil service payroll disbursements, appropriate monitoring and follow-up of the measures should be undertaken so that they have a sufficient effect.

As regards monetary policy, although there has been a reduction in inflation, the data for the first seven months of 1990 indicate an annual rate of inflation of 18 percent, compared with a targeted 16 percent for the year. It is thus important that the necessary restraint over total domestic credit and the upward adjustment in interest rates to achieve positive real interest rates are realized. In this regard, I wonder whether the corrective measures noted in the supplementary paper are sufficient to pursue the monetary policies just mentioned.

As to structural adjustment, there is a need for further reform in order to remove the inefficiencies that originated in the highly centralized economy and create a new, effective institutional and legal framework. In the public enterprise sector, I welcome the acceleration of privatization, liquidation, or restructuring. It is, of course, important to obtain adequate results, including a reduction of the burden on the government budget.

I agree with the staff that it will be critically important to maintain a stable exchange rate under a flexible exchange rate policy, accompanied by a tight financial policy. Although the authorities expect the external position to improve, I share the staff's concern that after 1990 substantial gaps are likely to arise, and there is a serious risk of accumulating net external arrears. Since financial assistance from bilateral and multilateral donors is essential for future economic development, the authorities should obtain and sustain the confidence of the international financial community by pursuing cautious external policies so as to avoid generating new arrears.

As regards a future arrangement with the Fund, the authorities' letter refers to an enhanced structural adjustment program. In view of the disappointing performance record under the structural adjustment arrangement, I am somewhat cautious at this stage about the authorities' ability to pursue the vigorous adjustment objectives of an enhanced structural adjustment arrangement in a sustainable manner. In addition, I am concerned about the still fragile macroeconomic situation, owing to the delay and shortcomings of policy adjustment. The authorities need to implement the requisite corrective measures and significantly strengthen the macroeconomic framework of the program, as prior actions, if an enhanced structural adjustment arrangement is to be approved. In this regard, while I welcome the recent policy initiatives noted in the supplementary paper, I would emphasize the importance of sustaining these efforts and establishing a good track record prior to the request for a new arrangement. With these remarks, I can go along with the proposed decision.

Mr. Monyake made the following statement:

The Guinean economy has registered some progress in recent years, which will have a significant impact both in the medium and the long term. Indeed, growth has accelerated, even exceeding the program target if performance in 1989 is taken into account. The rate of inflation has been continually dropping, although it fell short of the projected level for 1989. Actual data for the first seven months of 1990 indicate that the rate of increase of consumer prices on an end-period basis decelerated from 26.3 percent in 1989 to 18 percent. Guinea has succeeded in achieving a foreign trade and payments regime that is largely free of restrictions, except for limits on travel allowances and on certain outward transfers. Tangible progress was made in several crucial areas, including civil service reform, improvements in the organizational structure of various departments and employee selection procedures, and budgetary accounting, monitoring, and control mechanisms. The recent measures taken to improve performance in the energy sector are commendable. I welcome the authorities' renewed commitment to proceed with the implementation of virtually all measures discussed with the staff of the Fund and the World Bank during the negotiations of the third annual arrangement under the structural adjustment facility.

Unfortunately, there have been slippages in program implementation. In 1989, the authorities could not embark on the agreed program of tax reforms; current expenditures exceeded the program target; savings and investment as well as external current account targets were not met; and a certain number of public enterprises could not be restructured, privatized, or liquidated as scheduled by end-1989.

Perhaps these slippages should not be seen totally as a sign of weakness on the part of the authorities, or lack of perseverance in their adjustment effort. For a country like Guinea, managing a transition from a situation where a highly centralized, state-controlled economy was predominant for almost three decades, to one wherein a market-oriented, outward-looking economy emerges and flourishes is difficult. Certainly, a reasonable length of time is required to produce the necessary results. What is important in this regard is the authorities' continued commitment to the reform effort, which they have shown so far and intend to intensify in the future. I commend the authorities for their intentions and urge them to redouble their efforts, in view of the momentum lost in certain crucial areas of reform.

The recent adjustment of interest rates will help the process of promoting gradual financial deepening. I understand and appreciate the staff's concern regarding the establishment of an interest rate structure that is positive in real terms. In fact, the development of the Guinean economy over the medium term will depend largely on increased private sector activity, which will have to rely heavily on bank credits. In order for the private sector to respond adequately, the cost of borrowing has to be reasonable and attractive. At present, the rate of inflation is relatively high, and the desired objective of enhancing private sector investment can be achieved by bringing down the rate of inflation to a sustainable level.

In Guinea, there has been a heavy reliance on exchange rate policy to bring about viability in the external sector, as witnessed by frequent nominal exchange rate adjustments. The fact that there had been an appreciation of the currency in real effective terms in the latter part of 1989, despite the afore-mentioned exchange rate adjustments, perhaps suggests that priority should be given to further reducing inflationary pressures through appropriate macroeconomic and structural policies. In this connection, I share the view of both the authorities and the staff that, before any further depreciation of the exchange rate, a careful assessment of external competitiveness has to be made, and that emphasis has to be put on tight fiscal and monetary policies to avoid domestic inflationary pressures and frequent adjustments in the exchange rate.

I am concerned that the authorities and the staff were not able to reach understandings on a comprehensive economic and financial program, resulting in failure to proceed with the third annual structural adjustment arrangement. This unfortunate situation will, no doubt, have adverse implications for the authorities' adjustment effort, as the lack of desired concessional financing and debt relief will make the implementation of the needed reform measures even more difficult. I would urge the authorities to proceed with their renewed effort to keep the ongoing reform programs on track and to stand ready to deepen these reforms during the remainder of the program period. Similarly, I would urge the Fund to show more flexibility and to give due consideration to the difficulties confronting the authorities. I share Mr. Santos's view on the importance of the timely release of the anticipated financial assistance until the understandings are reached. I wish the authorities well in their effort to overcome the current difficulties and support the proposed decision.

Miss Creane said that she welcomed the additional measures recently put forward by the Guinean authorities and believed that they would have a positive impact on the adjustment of the fiscal and current accounts. More than ever, Guinea should use the brief breathing space provided by higher mining revenues to take the structural reform measures necessary for future and lasting economic stability.

She supported the staff's recommendation for firm control of financial policies, Miss Creane continued. Despite temporarily healthy revenue growth from the mining sector, revenue as a percent of GDP still remained low. The increase in petroleum product prices and taxes would be an important step toward correcting that ratio, but strong overall tax and customs reform were also needed. At the same time, restraint and strict prioritization of government expenditures remained particularly important. Appropriate expenditure choices should be made easier with the rise in petroleum prices. She also firmly supported the staff's emphasis on the importance of the elimination of fraud.

On monetary policy, the recently announced increase in the Central Bank's refinancing rate was welcome, but in view of the still negative interest rates, the high rate of money supply growth, and the outlook for continued inflation, there remained room for considerably tighter monetary policy, without concern for cutting credit for development investment and with the added benefit of encouraging savings, Miss Creane commented.

The announced package of reforms, as described by Mr. Santos, were a good start to recoup some of the lapses in public enterprise reform over the course of the structural adjustment arrangements, particularly those recent steps taken or planned for reform of the petroleum price structure and the electrical company, Miss Creane considered. She hoped that the reorganization and budgetary procedure reform measures enacted over the past year would correct the deficiencies in monitoring programmed policy implementation. However, further movement on structural reform was still needed across all sectors of the economy. For example, all government accounts should be brought under the control of the Treasury, and the financial market would benefit from considerable further development and reform. Necessary foreign and domestic private investment would be attracted by the stable, more market-oriented economy that should result from those structural reforms.

Excessive reliance on the performance of one sector indicated a clear need for export diversification, Miss Creane remarked. While agreeing with the staff that the backwardness of infrastructure and institutional rigidities were the major factors inhibiting development of a nonmining export sector, she thought that diversification was also not likely if the Guinean franc continued to appreciate in real terms, although she also agreed that the relative stability of the exchange rate was an important goal.

The case of Guinea had been particularly disappointing in view of the advances made in the mid-1980s, Miss Creane commented. Therefore, she was pleased with the recent measures that had been taken and urged the authorities to fully implement all supplemental steps with the hope of turning Guinea closer toward lasting economic adjustment and prospects for renewed access to Fund resources.

Mr. Goos said that it was disappointing and a matter for serious concern that after two structural adjustment arrangements and substantial external financial support, most of the domestic and external imbalances were higher than in 1986, while at the same time the gross national savings ratio had significantly declined, and critical structural reforms remained to be implemented. Notwithstanding the difficulties resulting from the transformation of the previously heavily centralized economy into a market-oriented economy as mentioned by Mr. Monyake, recent experience raised substantial doubts about the authorities' commitment to their adjustment targets. Those doubts were reinforced by their failure to strengthen the reform effort, even under the very favorable external conditions of the past year.

The staff and Mr. Serre were correct in cautioning against the possible negative impact of a continued unsatisfactory track record on future external financial assistance, Mr. Goos considered. That concern, of course, had already been borne out by the inability to secure a third structural adjustment arrangement, and certainly would weigh even more heavily when Guinea requested an enhanced structural adjustment arrangement for 1991. In that context, he noted from the supplementary paper that the World Bank was expected to disburse a structural adjustment credit tranche in 1990. He found that expectation surprising in the absence of a Fund arrangement, and would welcome the staff's comment.

The recent policy package described in the supplementary paper represented an important step in the right direction, Mr. Goos commented. In that context, he joined other speakers in especially welcoming the already implemented increase in domestic petroleum prices. However, he agreed with the staff that the further strengthening of the adjustment effort was urgently needed to contain the negative effects of the recent oil price increase on the external accounts, including a full pass-through of developments in world energy prices to the domestic price level. The urgency of additional corrective action was further reinforced by the uncertainty surrounding the feasibility of the financial targets for 1990 and the worrisome fact that the balancing of the current budget as revised by the authorities would rely to a considerable extent on a much lower reduction in payments arrears than originally contemplated. Still another reason for forceful and timely action was the modest decline in the external account deficit envisaged under the medium-term scenario, which was difficult to reconcile with the substantial external financing gaps envisaged until the end of the projection period.

On specific policy issues, while fully agreeing with the staff's recommendations, he would underline the importance of positive real interest rates at a time when the oil price surge had made an increase in national savings all the more important, Mr. Goos stated. He also endorsed the staff's advice on exchange rate policy, including in particular the emphasis placed both on external competitiveness as a yardstick for assessing the possible need and adequacy of exchange rate action, and on the desirability of stable exchange rate developments. Finally, he was concerned about repeated references in the staff report to fraud and seemingly widespread violations of the existing law, which he understood, occurred also in the public sector. He strongly hoped that that worrisome situation would be rectified before long, and at any rate, before the request for a possible enhanced structural adjustment arrangement. With those observations, he endorsed the staff appraisal and supported the proposed decision.

Mr. Hogeweg said that he generally agreed with Mr. Goos's observations. In addition, he was concerned about the extreme weakness of the macroeconomic database in Guinea. It appeared that most data were based on estimates and might be subject to a substantial margin of error. Thus, the analysis and conclusions based on those data should be taken with appropriate caution. Historical data on transactions with the U.S.S.R were not even included in the report. Finally there was no page on Guinea in the Fund's International Financial Statistics (IFS).

Statistics were vital to economic policy, Mr. Hogeweg observed. If policymakers had no reliable knowledge on past and current developments in the economy it was difficult to formulate appropriate policies. In the circumstances, it was also difficult for the Fund to be confident that its recommendations were correct. Once figures were set in type and circulated in the form of neat tables, they tended to look deceivingly real, even if their consistency was by design only. He firmly believed that a workable minimum of sufficiently accurate statistical information was needed for Fund support to be responsibly possible.

He noted the desire of the authorities for an enhanced structural adjustment arrangement after losing the third tranche of the structural adjustment arrangement and their clear elaboration of new measures that had been taken and those that were contemplated, Mr. Hogeweg commented. Guinea needed both a sound macroeconomic framework and a deepening of structural adjustment, particularly in the petroleum sector in view of its budgetary consequences and, more generally, to make the economy less dependent on mining. The commendable list of measures set out in the supplementary paper should all be implemented before a new program which adequately addressed the fundamental issues at hand could be brought to the Board. He sincerely hoped that that would prove to be no obstacle.

He fully agreed with the importance that the staff attached to maintaining a stable exchange rate that ensured external competitiveness together with tight financial policies, including positive real interest rates, Mr. Hogeweg remarked. However, the maintenance of a flexible exchange rate appeared among the list of measures taken in the supplementary paper. He wondered how the two could be reconciled.

Mr. Zhang said that he joined previous speakers in support of the proposed decisions. Since he was in broad agreement with the staff's appraisal of Guinea's economy and its recommendations, he would make only a few brief comments.

In recent years, Guinea had undertaken a series of major economic reform measures to improve its economic development, Mr. Zhang observed. Although the overall macroeconomic environment had improved somewhat during the three years through the end of 1988, economic performance in 1989 had fallen short of the program's objectives owing to political and social constraints as well as slippages in implementing some of the restructuring measures. However, it was encouraging to note from the supplementary paper that the authorities had demonstrated their strong determination to continue their economic recovery efforts and had recently implemented a number of key measures. Structural reform was indeed of great importance to the success of the overall economic reform. It was widely acknowledged that a reasonable length of time was needed to bring about necessary changes. The fundamental goal was to promote efficiency in the enterprises, particularly in the key public ones, and to develop the economy in general. In that context, he was pleased to learn from Mr. Santos that since July, the authorities had taken a number of effective measures, particularly in the oil sector.

Fiscal policy remained the most crucial area in the adjustment program, Mr. Zhang emphasized. He encouraged the authorities to take appropriate measures in securing nonmining revenue, especially revenue from the excise tax on petroleum products. The latter certainly required greater attention owing to the recent surge in world oil prices. As for the satisfactory results in revenue from the mining sector owing to favorable prices for alumina and continued bauxite production at maximum capacity levels, he shared the staff's view that such revenue should be reflected in higher government savings and not be used to generate an unsustainable expansion in expenditure. It was equally crucial that the authorities should strictly adhere to established budgetary procedures and strengthen expenditure control.

With the necessary important reform steps already taken, the authorities had not only shown their determination in their adjustment efforts, but also had laid a viable macroeconomic framework for the current year and over the medium term, Mr. Zhang considered. The financial assistance from the international financial institutions was indispensable.

The staff representative from the African Department recalled that Mr. Hogeweg and Mr. Goos had raised broad issues relating to both the database and the speed of structural reform. As Guinea had had a totally planned economy for some 20 years, the price mechanism had not existed until about 1984-85. In the past five years the authorities had made a considerable effort to open the economy up, introduce a market mechanism, and start developing institutional and administrative structures to support a market economy. That was not an easy task. Moreover, that process took time. While the staff considered that there were moments when diverse elements of the process must proceed at the same time in order to be mutually supportive, it was also recognized that in certain areas, progress would be perhaps considerably slower than was desired.

Like Mr. Hogeweg, the staff was concerned about the state of macroeconomic statistics, the staff representative continued. Neither the staff nor the authorities were satisfied with the quality of the statistics. Nevertheless, there had been significant improvement in the past five years, which had to be viewed in the context of the preceding 20 years, when even the most elementary and basic data did not exist. In the staff's view, the authorities should be encouraged through technical assistance, both from the Fund and other institutions, to develop the statistical base as fast as possible. In its own interpretation of the statistics, the staff sought to be as cautious and prudent as possible.

On the specific issue of a page on Guinea in International Financial Statistics, he was pleased to note that over the past 12-18 months, there had been several discussions between the Fund's Bureau of Statistics and the Guinean authorities, including discussions during the recent Annual Meetings on that question, the staff representative commented. It was hoped that there would be an IFS page for Guinea before the report on the 1991 Article IV consultations with Guinea was brought to the Board.

As to data relating to transactions with the U.S.S.R, while such data were available, the staff was not confident about its reliability, the staff representative remarked. There, too, the staff was working with the Guinean authorities to make sure that that data were incorporated both in the balance of payments and the budget. Current data on transactions with the U.S.S.R had not been included, but it was expected that reliable data would be available for the 1991 Article IV consultation.

With regard to petroleum prices, following the recent adjustment, the domestic retail price of gasoline was about $3.18 per gallon, which was almost exactly the average for all West African countries, excluding Nigeria, the staff representative noted.

As to whether the measures currently in place or foreseen for the rest of the year were likely to ensure an appropriate monetary policy stance for 1990, two separate factors had to be taken into consideration, the staff representative explained. The first was the fact that Guinea was a gold-producing country, and the central bank purchased a great deal of gold. In earlier years, gold was purchased with foreign exchange. As confidence in the exchange rates and in the exchange system developed, the central bank had increasingly purchased gold in domestic currency, which helped to explain why monetary expansion in 1990 had been considerably higher than in previous years. The authorities had recently taken some measures on the interest rate side, and the staff was waiting to see if inflation did, in fact, come down to targeted level of about 17 percent for the rest of the year. The latest information suggested that monetary policy would need to be kept very tight during the remainder of the year if that inflation objective was to be achieved. It would also depend to a great deal on the fiscal stance, because it was assumed that the central bank would receive large net repayments from the budget. For the moment, the staff considered that the measures in place with regard to monetary policy should be sufficient, but, it was, of course, expected that the authorities would closely monitor developments and take additional action if necessary.

As to disbursements from the World Bank and other bilateral and multilateral donors, one of the assumptions in the scenarios with regard to the budget and the balance of payments was that the envisaged external assistance for 1990 from sources other than the Fund would broadly arrive as scheduled, the staff representative commented. The disbursements foreseen from the World Bank did not, however, include the second tranche of the structural adjustment credit, but rather included an education sector loan, with a first tranche of $5-7 million, and a sector adjustment loan for the development of the private sector. with a first tranche of about $25 million. The staff considered those two operations to be very important. The educational sector loan in particular was linked to the school year, which started in October. Thus, the disbursement of that loan was already delayed, which was going to cause some difficulties. Moreover, he understood that the Bank had not made any decisions with regard to the disbursements of the two loans and that some conditions still needed to be satisfied for disbursement of the second tranche of the structural adjustment loan. While it was difficult at the current stage to make a judgment regarding the timing, it was not unlikely that the second tranche of the structural adjustment loan would be released in early 1991. To the extent that the envisaged external assistance was not realized, there would be a further accumulation of both external and domestic arrears.

On the exchange rate, Mr. Hogeweg had referred to an apparent inconsistency in policies, the staff representative from the African Department recalled. In fact, there was no inconsistency. The staff was not proposing a nominal anchor in the case of Guinea, but rather a stable real effective exchange rate. The authorities clearly understood that that implied lowering the inflation rate as fast as possible, as well as tight monetary and fiscal policies, which, in turn, implied nominal adjustments in the rate. The flexibility referred to in the letter addressed to the Managing Director was flexibility with regard to nominal adjustments, which was consistent with the staff's position.

Mr. Goos said that if he understood the staff correctly, footnote 1 on page 2 of the supplementary paper needed correction, because it explicitly referred to the second tranche of the second structural adjustment credit, which, according to the text, was needed to close the financing gap projected for 1990. On another point, he wondered whether, among the conditions attached to the disbursement of the next tranche under the structural adjustment credit of the World Bank, there was the condition that an arrangement with the Fund should be in place.

The staff representative from the African Department remarked that he was referring to the specific conditions that would allow the Bank to disburse its loan. Those conditions were, in fact, to a large extent covered by some of the measures that the authorities had listed in the attachment to their letter.

The staff representative from the Exchange and Trade Relations Department observed with respect to whether a Fund arrangement must be in place before such Bank lending occurred, that the guidelines on Bank-Fund collaboration offered scope for flexibility. For example, in the case of Guinea, although a Fund arrangement was not yet in place, a first group of measures that were in the right direction had been put in place in the course of negotiations on Bank credits. That positive element should be taken into account in forming a view as to whether, in fact, Bank disbursements could proceed. In the interim, the staff would renew its efforts to complement those measures along the lines that Directors had advised. If during that period, a proposal for a loan was under consideration by the Bank, in the staff's view, there was flexibility in the current guidelines on Bank-Fund collaboration to allow the Bank to proceed with a disbursement even if an arrangement with the Fund was not in place. It was important, however, to stress in that regard that while the financing issues remained to be resolved, the staff had been able to work together with the authorities to get them to introduce or agree upon a first series of measures that went in the right direction.

Mr. Yoshikuni said that he understood that the Fund had to be satisfied with the economic framework of the authorities before the World Bank would proceed with the disbursement of a structural adjustment credit. In the event that the World Bank made such a disbursement, he wondered whether the Fund would be pressed to agree on an arrangement for Guinea.

The staff representative from the Exchange and Trade Relations Department remarked that the Bank staff had clearly indicated to the Executive Directors of the Bank that any decisions regarding disbursements would be taken in close coordination with the staff and management of the Fund. At the same time, it had been recognized that for operations such as an education sector project or private sector project, there was a long lead-time for the presentation of the loan request in the Bank, and that some flexibility might be needed in those instances where it would be costly to hold up a Bank operation for a few months until a Fund arrangement was in place. While it was not possible to judge whether the Bank would proceed with a disbursement in the case of Guinea, the staff had felt that some flexibility on both sides was reasonable under the circumstances.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/146 (10/5/90) and EBM/90/147 (10/10/90).

5. BURUNDI - TECHNICAL ASSISTANCE

In response to a request from the Burundi authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/317 (10/2/90).

Adopted October 5, 1990

6. MOROCCO - TECHNICAL ASSISTANCE

In response to a request from the Moroccan authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/318 (10/2/90).

Adopted October 5, 1990

7. VIET NAM - TECHNICAL ASSISTANCE

In response to a request from the Vietnamese authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/321 (10/4/90).

Adopted October 5, 1990

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/254 (10/4/90) and EBAP/90/255 (10/5/90) and by an Advisor to Executive Director as set forth in EBAP/90/255 (10/5/90) is approved.

9. TRAVEL BY ACTING MANAGING DIRECTOR

Travel by the Acting Managing Director as set forth in EBAP/90/256 (10/5/90) is approved.

APPROVED: August 27, 1991

LEO VAN HOUTVEN
Secretary