0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/50

10:00 a.m., May 3, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
F. Cassell	C. Enoch
Dai Q.	
	C. S. Warner
	A. Rieffel, Temporary
J. de Groote	J. Prader
E. T. El Kogali	
E. A. Evans	C.-Y. Lim
	R. J. Lombardo
	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	
M. R. Ghasimi	O. Kabbaj
	B. Goos
J. E. Ismael	E. Kiriwat
B. Jalan	L. E. N. Fernando
	J. R. N. Almeida, Temporary
M. Massé	C. L. Haynes, Temporary
Mawakani Samba	K. Kpetigo, Temporary
	I. A. Al-Assaf
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: J. A. Holsen, Policy, Planning and Research Staff. Administration Department: H. Wiesner. African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director. Asian Department: P. R. Narvekar, Director; K. A. Al-Eyd, P. Gotur, L. Nielsen, W. M. Tilakaratna. European Department: H. O. Schmitt. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; P. A. Acquah, E. Brau, S. B. Brown, B. Christensen, H. Hino, L. W. Pauly, C. Puckahtikom, J. P. Pujol, K. P. Regling, R. L. Sheehy, J. V. Valderrama, L. M. Valdivieso. External Relations Department: A. F. Mohammed, Director; R. J. Bhatia, Special Representative to the United Nations. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; T. M. C. Asser. Research Department: J. A. Frenkel, Economic Counsellor and Director; R. D. Haas, Y. Harada. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: F. G. Laske, Treasurer; S. I. Fawzi. Western Hemisphere Department: S. T. Beza, Director. Personal Assistant to the Managing Director: H. G. O. Simpson. Special Advisor to the Deputy Managing Director: W. A. Beveridge. Advisors to Executive Directors: M. Al-Jasser, F. E. R. Alfiler, J. Basiuk, M. B. Chatah, W. N. Engert, J.-L. Menda, M. Pétursson, S. P. Shrestha, A. Vasudevan, R. Wenzel. Assistants to Executive Directors: H. S. Binay, G. Bindley-Taylor, B. A. Christiansen, H. Codrington, E. C. Demaestri, A. Y. El Mahdi, M. E. Hansen, M. A. Hammoudi, A. Iljas, C. J. Jarvis, M. E. F. Jones, C. Y. Legg, V. K. Malhotra, N. Morshed, W. K. Parmena, C. Schioppa, J.-P. Schoder, C. C. A. van den Berg, Yang J.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Evans, Executive Director, to the Executive Board.

2. INDONESIA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Indonesia (SM/89/64, 4/6/89). They also had before them a background paper on recent economic developments in Indonesia (SM/89/73, 4/21/89).

Mr. Ismael made the following statement:

Since 1985, when the slump in world prices of oil began, Indonesia experienced a sharp drop in government revenues, thereby curtailing its past high rate of economic growth. During this time, a drop in the value of the U.S. dollar, to which the Indonesian currency is closely tied, sharply increased Indonesia's expenditures for foreign loan repayments, of which a substantial portion is denominated in Japanese yen.

To meet these dual external pressures, budgets were kept tight. At the same time, the economy was restructured through a program of far-reaching economic reforms. Over three years, successive reform measures swept aside regulations and practices that insulated the domestic economy from competition, contributed to high costs and inefficiency, and generally inhibited the growth of the private sector and of its non-oil exports.

Five trade deregulation packages were introduced, in May 1986, October 1986, January 1987, December 1987, and November 1988. These trade reform packages together have dismantled almost half of the existing 1,200 nontariff barriers, affecting virtually every sector of the economy. Besides easing trade restrictions, the November 1988 package completely deregulated interisland shipping as well, thereby opening the industry to greater competition.

In addition, four financial deregulation packages were introduced, in June 1983, October 1988, December 1988, and March 1989. The first financial reform package abolished all credit ceilings, permitted banks to set their own interest rates on most loans and deposits, and reduced the use of subsidized credit from the central bank. The recent reform packages were designed to enhance competition within the financial sector, encourage new channels for financial intermediation, and reduce the cost of intermediation. The ultimate objective is that these financial reforms would support the trade reforms by

increasing savings and channeling them toward the newly profitable export industries and other productive sectors.

Steadfast pursuance of an effective monetary policy, in addition to these fiscal restraint and structural adjustment measures, has made it possible for Indonesia's economy to record further gains in 1988/89. Output growth has been solid--4.6 percent compared with 3.6 percent in the previous fiscal year--particularly in the non-oil manufacturing sector; inflation has moderated--7.6 percent compared with 9.2 percent in the previous fiscal year; 1/ the external current account deficit has been contained at $1.9 billion, or about 2.5 percent of GDP, despite the weakness in world oil prices; net official reserves have been roughly sustained as well at about five months of non-oil/gas imports, or $6.1 billion compared with $7.4 billion in the previous fiscal year; and the overall budget deficit has remained moderate at 2.6 percent of GDP compared with 2.0 percent in the previous fiscal year. However, the most striking development was again the substantial increase recorded by non-oil/gas exports, causing its share in total exports to rise to 61 percent compared with 52 percent in the previous fiscal year.

The success of the policies pursued is again made evident by the new 1989/90 budget, which launches Indonesia on the first year of its fifth five-year development plan starting April 1, 1989. Although the new budget is growth oriented, the overall fiscal deficit will be contained at 2.7 percent of GDP. The budget provides for a 26 percent increase in government spending--including a 15 percent pay raise for government employees, their first in four years--to Rp 36.6 trillion, or $21.3 billion, with non-oil revenues contributing 68.7 percent of total revenues. As recently as 1983/84, the contribution of non-oil revenues to total revenues was as little as 22 percent; their share increased to slightly more than 50 percent of the total for the first time in 1987/88. The ratio of oil to non-oil revenues in the new budget is based on the conservative estimate that oil prices will average $14 a barrel, down from the $16 a barrel projected in the 1988/89 budget.

The new budget projects non-oil/gas exports to reach $13 billion in 1989/90, up from $11.8 billion estimated for the previous fiscal year and only $5.91 billion five years ago. To achieve this target, exporters will have to make further improvements in the price, service, and quality of their products, whereas the Government will have to continue its efforts

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1/ Calculated on an annual average basis; if the inflation rate is calculated on a point-to-point basis, which is the common practice in Indonesia, a lower inflation rate of 6.6 percent in 1988/89 and 8.3 percent in 1987/88 is obtained.

to abolish remaining structural constraints to improve the business climate and infrastructure, and bring about a reduction in the prevailing high interest rates. As to the latter, off-shore borrowing ceilings were lifted in March 1989 and replaced with a new provision stipulating that banks must maintain daily foreign exchange net positions not exceeding 25 percent of their capital. Preliminary results show that the deposit rate has gone down 1 percent to 17.5 percent, and the lending rate has gone down from 24 percent to 21.6 percent in April 1989. Total exports are projected to reach $20.27 billion for 1989/90, up from $19.3 billion in the previous fiscal year. Based on projections of a continued slump in world oil prices, the value of Indonesia's oil and gas exports is estimated at $7.25 billion in the new budget, down from $7.5 billion in 1988/89 and $14.9 billion in 1984/85.

Though continuing to decline, oil revenues will remain the single largest source of government funds, projected to contribute Rp 7.9 trillion--$4.6 billion--down from Rp 8.86 trillion in the previous fiscal year and Rp 10 trillion in fiscal year 1987/88. To stimulate oil exploration to increase the volume of proven oil reserves, new terms and conditions for production-sharing contracts were introduced in August 1988 and further improved in February 1989. Specifically, incentives were extended: first, to contractors working in remote and deep-sea areas and in smaller, marginal fields; second, to promote tertiary recovery operations; third, for the price of oil that contractors are required to sell on the domestic market; fourth, for the extension of exploration periods; and fifth, for the fixation price of gas.

Non-oil tax revenues in the new budget are estimated at Rp 14.9 trillion, an increase of Rp 3.2 trillion--27.6 percent--from the 1988/89 tax receipts of Rp 11.7 trillion. The sharp increases in tax revenues will be made possible through more efficient collection, an extension of the value-added tax to goods at the wholesale level and to include most services, and an increase in the sales tax rate levied on luxury consumer items as introduced in January and April 1989.

On the expenditure side, the largest item in the new budget--Rp 12.24 trillion, 51.6 percent of total routine expenditures of Rp 23.45 trillion--will be payments honoring Indonesia's foreign debt obligations. The previous budget earmarked Rp 10.65 trillion--$6.19 billion or 52.9 percent of 1988/89 routine expenditures--for debt repayment. Indonesia's 1989/90 total debt service ratio will remain at about 39 percent; however, it is projected to decline gradually to 27 percent by the end of the fifth five-year development plan in 1994.

Development spending is projected to increase by 47 percent in 1989/90, to Rp 13.1 trillion--$7.61 billion--up from Rp 8.9 trillion--$5.35 billion. The budget anticipates Rp 11.33 trillion--6.59 billion--will be raised from foreign sources, chiefly the 14-member Inter-Governmental Group on Indonesia, in the form of grants and concessionary loans, up from Rp 7.16 trillion--$4.34 billion--provided during the previous fiscal year.

In presenting both the new budget and the fifth five-year development plan to the House of Representatives in January 1989, President Suharto projected an economic growth rate of 5 percent in the new fiscal year, up from 4.6 percent; an inflation rate of 5 percent, down from 7.6 percent; and a per capita income growth rate of 3.1 percent. The above-mentioned targets, together with the new budget's non-oil/gas export growth target of 15 percent, will pose real challenges to the authorities.

To achieve such a strong and sustained growth rate over the medium term, the authorities are committed to continue the assault on the high-cost economy through further deregulations to relax remaining constraints over time. Monetary policy will continue to be directed to promoting economic activity by taking into account the maintenance of monetary stability as well as a sustainable balance of payments position. Likewise, the exchange rate policy will continue to be directed to setting the exchange rate in a way that safeguards the competitiveness of Indonesia's tradable goods and maintains public confidence in the rupiah. Mindful of the heavy debt service burden, the authorities will continue to pursue a prudent borrowing policy and to direct its usage in line with the development plan.

Mr. de Groote made the following statement:

At the end of his statement, Mr. Ismael identified the main objective of his authorities as continuing the attack on the high cost of the economy through further deregulation, and he again illustrated the delicate balance required in the conduct of Indonesia's monetary and exchange rate policies, which are the main instruments for safeguarding the results of deregulation in the short term. To these remarks, I will add just a few observations.

The adjustment of the Indonesian economy since oil prices began their decline has been remarkable. The share of non-oil/liquefied natural gas (LNG) exports in total exports increased from 34 percent to 61 percent, with a corresponding dramatic change in the structure of the tax revenues. Although at the cost of sacrificing the ambitious growth rates of the

years before 1985, inflation has been successfully contained through the effect on investments and the supply of external borrowings. A 39 percent increase in outstanding debt stock over four short years has thus made an important contribution to the fight against inflation, illustrating the decisive role external borrowing can play in the adjustment process when it is combined with the objectives of monetary stabilization.

In a period marked by accelerating polarization of suppliers' markets through regional integration of economies resulting from industrial shifts within regions, Indonesia's challenge is to make its economy compatible with those already established in the region as the ongoing drive toward integration continues. The response so far to the limited liberalization of Indonesia's investment code should serve as a guide in the formulation of the future policies already called for by the need to service external debt.

With respect to the current structure of the manufacturing industry, the staff indicates a problem of inadequate information on the public sector enterprises. At this stage, with higher priority given to the enhancement of capital markets and plans for further deregulation, there is a great need to increase both the transparency of the accounts and the performance of the public sector enterprises so as to reap the full benefits of the developing capital markets by divestiture of parastatals, and of the efficiency engendered by competition.

In an open exchange system like that of Indonesia, fiscal policy has a special importance in encouraging capital inflows, the urgent need for which was recently demonstrated by the pressure exerted on the foreign exchange reserves of the central bank by an expected further decline in oil prices. The planned reductions in subsidy payments and the efforts to enlarge the tax base and improve tax administration are therefore welcome steps.

With regard to monetary policy and the merits of financial reforms, I would like to focus on a few points. The prevailing high rates of interest on deposits and on borrowing are understandable given Indonesia's open exchange system. However, the maturity structure of time deposits, almost 90 percent of which will fall due in a year or less, is cause for concern. Differentiation in the rates of the recently introduced withholding tax on interest payments may offer a means of promoting time deposits with longer maturities.

Excessive support has been given to the export sector in the form of low-cost liquidity credits, at the expense of the central bank's other borrowers. Although Indonesia still maintains a complex system of export licensing and marketing

restrictions to control the prices of its export commodities, the extension to all exporters of preferential credits totaling up to 29 percent of total lending constitutes a major distortion in the efficient allocation of resources. A review of the liquidity credit system with a view to eliminating unnecessary support to certain export sectors will help to alleviate the burden on Bank Indonesia and its other borrowers.

Financial sector reforms are aimed mainly at easing restrictions on the opening of new branch offices and the establishment of new banks. The question here is the likely effect of the overhead costs of the new branch offices on lending rates, which are already high. In view of the expansion of the banking network, which it is hoped will accelerate the mobilization of domestic resources and encourage domestic savings, are any parallel measures being planned for strengthening the auditing and monitoring procedures in order to handle the increased volume of banking transactions, especially the loan recovery performance of the financial institutions?

The timing is favorable for Indonesia to benefit from regional externalities; it is also a moment when accelerating the deregulation process while tackling existing distortions will be well received by the international business community.

Mr. Lim made the following statement:

I fully agree with the staff that the Indonesian authorities have undertaken an impressive adjustment effort in recent years. The implementation of adjustment measures to offset the adverse impact on the economy of the decline in oil prices in 1986-87 has resulted in a broader and stronger economic base for sustained growth.

I also fully concur with the view of the staff and Mr. Ismael that attributes Indonesia's outstanding performance to the maintenance of prudent macroeconomic policies and wide-ranging structural reform. The mutually reinforcing measures of budgetary restraint, financial deregulation, and exchange rate flexibility, coupled with trade liberalization and the fostering of a more competitive and efficient economy, appear to have encouraged the private sector to participate more actively in the pursuit of sustained economic growth. In particular, the measures adopted have resulted in a relatively rapid increase in the share of non-oil commodities in the country's export basket. Table 7 in the staff report shows that non-oil exports grew from $6.2 billion in 1985/86 to $11.8 billion in 1988/89--nearly doubled in the span of three years.

As the staff has reminded us, however, there are still difficult challenges to be addressed. Indonesia's labor force is growing at a high rate, and its large external debt continues to pre-empt domestic resources for more productive undertakings. As the staff has illustrated, the medium-term outlook is sensitive to adverse external shocks and to the relaxation of prudent domestic policies. It is therefore encouraging to note from Mr. Ismael's statement that his authorities remain committed to their adjustment strategy, which has worked remarkably well in the past three years. In this regard, I welcome the authorities' fiscal moves to improve tax administration, expand the value-added tax base, and increase the sales tax.

On monetary policy, I am pleased to see that the authorities are increasingly relying on a market-based approach to liquidity control, and I welcome the intention to eventually eliminate the remaining interest rate subsidy mechanism by April 1990.

With respect to external debt management, the debt service ratio has risen sharply from 24.3 percent in 1985/86 to 39.6 percent in 1988/89 and is projected to be around this level by 1989/90. This increase indicates the need for more prudence in the country's external debt management, which should aim for less reliance on foreign borrowings.

In this regard, I agree with the staff that there is a pressing need to substantially increase domestic resource mobilization if the investment momentum is to be maintained. It is therefore important that fiscal and monetary policies encourage positive real yields on domestic savings. These actions can only lead to more efficient economic management and the strengthening of the economic base, which should in turn reinforce the confidence of the authorities to face greater challenges ahead.

Mr. Hogeweg remarked that the staff report indicated that the Indonesian authorities had followed wise and wide-ranging adjustment policies, enabling them to retain orderly external relations while real growth had averaged 4 percent a year in the 1980s and could climb to 5 percent in the 1990s. As his chair had commented at the time of the previous consultation (EBM/88/73, 5/11/88), that example clearly showed that, in the medium term, there was no trade-off between adjustment and growth. Of course, Indonesia had been able to count on strong support from the Inter-Governmental Group on Indonesia, but that support was as much a condition as a result of Indonesia's successful economic management. Indonesia remained vulnerable and would have to continue its efforts, which he was confident it would do.

According to the staff report and Mr. Ismael's statement, two general lessons could be drawn from Indonesia's exemplary adjustment policies, Mr. Hogeweg observed. First, Indonesia had combined the substantial devaluation of the rupiah, in September 1986, with a policy of positive real interest rates. Present rates were high in real terms, but they did not seem to prohibit sound growth; perhaps they even promoted growth because they encouraged savings and called for an efficient allocation of resources. In that connection, he welcomed the information that subsidized credits would be phased out. Positive interest rates seemed essential when a highly indebted country tried to adjust. Some other countries with a much higher per capita GDP than Indonesia's that had found it difficult to achieve even nonnegative interest rates should learn from Indonesia's example. Second, wide-ranging deregulation, when implemented in a stable macroeconomic environment, could have timely results. For example, foreign direct investment at present covered 30 percent of the current account deficit against only 12 percent three years previously; and non-oil exports currently accounted for half of total exports, against only 30 percent three years previously. Those trends indicated the importance of a stable macroeconomic environment and the fact that structural measures were not necessarily equivalent to long-term measures.

He agreed with the staff recommendations concerning continued vigilance in the fiscal and deregulation areas, and he understood that the Indonesian authorities concurred, Mr. Hogeweg noted. The staff view on exchange rate and monetary policies was somewhat more balanced than it had been last year, when the staff had stated that an essential component of policy toward "the maintenance of adequate external competitiveness is an appropriate management of the exchange rate, and the authorities [were] to be commended for having safeguarded the gains from the September 1986 devaluation." His chair had commented that the staff's view gave insufficient emphasis to the importance of domestic policies aimed at controlling wages and prices with a supportive monetary policy. In the present report, the staff stated that "exchange rate and monetary policies have successfully combined to maintain external competitiveness since the 1986 devaluation while containing domestic inflation and promoting financial savings." He preferred that formulation to last year's.

Mr. Marcel made the following statement:

> In the face of adverse external conditions, the Indonesian authorities reacted promptly at the end of 1986 by adopting a comprehensive set of measures. This policy package, which included significant structural reforms, succeeded in diminishing the economy's dependence on the oil sector, stimulating private investment, and opening the economy to international competition. Despite the adverse evolution of oil prices, Indonesia performed well in 1988: growth accelerated, led by the non-oil sector, while inflation remained under control; and the external current account was successfully contained owing to a significant increase in non-oil exports.

The Indonesian situation is exemplary in many respects and demonstrates that, despite strong external constraints, sound macroeconomic policies can prove efficient and that countries that do their best in implementing them can count on financial support from their creditors. My authorities are impressed by these remarkable achievements, for which the Indonesian authorities deserve to be praised. As this chair shares most of the staff's views, I will elaborate on fiscal policy, structural reforms, and external prospects only.

The necessity of generating domestic savings in order to have less recourse to external financing implies continued vigilance in the fiscal area. It is clear that the results in this field are most fragile and that the consolidation process is far from complete. My authorities agree with the staff that the overall fiscal deficit should be reduced promptly. Indeed, the fiscal deficit financed every year by adding to the external debt burden could rapidly threaten the continuing expansion of the economy. Interest payments are already restricting the room for maneuver, as outstanding debt increased from 40 percent of GDP in 1983 to about 70 percent of GDP in 1988. This is all the more worrying as development expenditures have suffered from recent adjustment. Despite the 1989 budget framework, the authorities will be increasingly confronted with some difficulties in reversing the shift from capital to current spending, since for the first time in four years the budget includes a 15 percent pay raise for government employees.

Another of the authorities' commitments is questionable: the intended sharp reduction in subsidy payments. Last year this chair considered unrealistic a 60 percent decrease in subsidies paid on agriculture input and oil prices. Indeed, the result was a 16 percent increase instead. I would like Mr. Ismael or the staff to comment on the feasibility of the 90 percent decrease envisaged in the 1989/90 budget.

While the expenditure side must be kept under firm control, the authorities should act more resolutely on measures to enhance revenue. It is noteworthy that the share of non-oil revenue in non-oil GDP has not increased during the last three years. We encourage the authorities to broaden the tax base, including the value-added tax, to be able to maintain moderate rates, and to increase the property tax rates. We welcome the measures taken with respect to the tax administration reform.

The structural aspects of Indonesia's adjustment strategy are of the utmost importance, given the constraints placed upon macroeconomic policy. Increasing the growth rate of per capita income and diminishing poverty and unemployment--absolute necessities--rely mainly on structural reforms. The results in that field are impressive. Indisputable progress has been

recorded in trade liberalization, which, together with an active exchange rate policy, proved to be a determining factor in stimulating non-oil exports. We welcome the recent deregulation package adopted in November 1988 affecting foreign investment, and we encourage the authorities to take further initiatives in that field. We agree with the staff that additional steps in the financial sector are of the greatest importance in improving financial services and developing the capital market. I would appreciate comments from Mr. Ismael or the staff on the status of the bond market and the possibility of financing part of the budget deficit via this market.

Despite real efforts to stimulate non-oil exports, the external position remains vulnerable. The debt service burden is a major cause of uncertainty. According to the staff's base scenario for the next five years, the debt service ratio could decline from 39 percent to 28 percent, but this scenario includes significant speculation concerning domestic savings and investment efficiency. Alternative scenarios show clearly the sensitivity of the results to external shocks, but they also underscore the fact that, if structural reforms were less effective, GDP growth would be reduced and unemployment would increase.

Mr. Goos observed that, like previous speakers, he continued to be impressed by the Indonesian authorities' persistent implementation of adjustment policies and the further progress and stabilization they had achieved, which was evidenced on many fronts, including the further decline of the consumer price index. Moreover, he welcomed their intention to continue their adjustment effort in the framework of the new five-year economic program. That was warranted given the fact that the situation remained vulnerable, not least because of the impact of the high debt burden.

Against that background, he fully agreed with the staff's policy recommendations, notably its advice to pursue further efforts to increase domestic savings and to improve the efficiency of the economy, Mr. Goos continued. That advice seemed to be all the more relevant in view of the disappointing decline in the savings performance of the public sector in the past year and the lack of further tangible progress in the reduction of the current account deficit. More needed to be done on those fronts; specifically, he agreed with the staff that those efforts had to be directed toward both revenues and expenditures.

At the same time, care should be taken that excessive reliance on further revenue measures did not undermine production incentives and thereby the objective of generating employment opportunities, Mr. Goos commented. While recognizing that the tax/GDP ratio was still comparatively low, the tax burden had increased substantially over recent years and was expected to increase further in the non-oil sector by a startling

rate of almost 28 percent during the current year. Mr. Marcel had apparently differed in that assessment, and it would be helpful to have the staff's comments.

The situation underlined the need to proceed with vigor in containing current expenditures, Mr. Goos noted. In that context, despite the strong improvement in revenue performance, fiscal savings were projected to remain largely unchanged in terms of real GDP under the new budget, at least as presented in the staff report. The staff had pointed to several areas where further savings in current expenditures could occur, notably subsidies, where further reductions would also be beneficial for overall economic efficiency. The large increase in development spending envisaged under the budget was noteworthy. Even considering that the implementation rate might eventually be lower than 100 percent, flexible implementation of the spending plans would appear advisable with a view to avoiding undue strains on the domestic supply capacity, which could jeopardize the inflation target. The different assessments of the authorities and the staff of prospects for inflation that year presented a warning signal.

With respect to inflation, appropriate monetary and credit restraint would remain critically important. While recognizing the welcome decline in the inflation rate, he remained concerned about the strong expansion in monetary aggregates, a point he had touched upon during the previous discussion on Indonesia (EBM/88/73). However, he commended the authorities for the flexible management of interest rate policy, which appeared exemplary in that it was no doubt instrumental in containing inflationary pressures and, more important, in stabilizing the exchange rate. He wondered whether the pronounced downward trend in the exchange rate since the early 1980s, through its influence on expectations, might not be a major factor behind the still very high level of real interest rates.

As regards structural policies, he could endorse the detailed analysis and recommendations contained in the staff report, Mr. Goos said. While he continued to be impressed by the steps taken in that area, he wished to reiterate his suggestion of the previous year that the authorities should aim at formulating a more comprehensive and systematic approach to structural reforms, which could be announced to the public, so as to provide a reliable framework for the decisions of economic agents.

Overall, economic policies and performance were exemplary in many respects as Indonesia had been more successful than many other countries in a comparable situation in coping with serious external shocks, Mr. Goos stated. But that success was no reason for complacency, and he hoped that the authorities would consider the recent improvement in oil prices an opportunity to strengthen their stabilization efforts, rather than to relax adjustment.

Mr. Haynes made the following statement:

We commend the authorities for their commitment to reform and for the progress they have made in their efforts to restructure the Indonesian economy. In recent years, macroeconomic and structural policies have successfully redirected resources to the nontraditional sectors while improvements in competitiveness and in the investment climate have allowed a sharp reduction in the dependence on the oil sector and reduced the economic imbalances that emerged during the early 1980s.

During 1988, these factors led to a further strengthening of economic activity, moderation of inflation, and stabilization of the external current account imbalance at about the same level as in 1987. However, despite these gains, the challenges facing Indonesia over the medium term are still considerable.

In particular, it is necessary to sustain growth of at least 5 percent a year. Per capita incomes are still low, and given the rapidly expanding labor force there could be pressure on the authorities to take measures to reduce poverty and stimulate the economy. Such demands could undermine the progress made so far in reducing external and budgetary imbalances. Moreover, debt payments already absorb a significant share of resources and, with the risks associated with the current level of exposure, there is little room for policy slippages. This is particularly important if the economy is to remain on a sustainable growth path and achieve an outcome at least comparable to that in the staff's illustrative medium-term scenarios.

We note from the background paper that under Repelita V almost 2 1/2 million jobs a year will be needed to meet the demands of a rapidly growing labor force. This underscores the need for sustained policies to encourage direct investment and build on the favorable cost advantages that Indonesia possesses at present. In particular, this major effort would seem to require continuing emphasis on labor-intensive industries. Perhaps the staff or Mr. Ismael could comment on investment prospects in this area.

In the baseline medium-term scenario, public savings are expected to remain roughly unchanged during 1989/90 and to expand moderately by 1993/94. The authorities have had some success in raising non-oil revenues, but Indonesia's low per capita income and inability to secure effective tax compliance have kept the revenue/GDP ratio low. We therefore welcome efforts to strengthen tax administration to help mobilize domestic resources. However, the results of this exercise, especially in the short run, are uncertain, and while stronger oil prices than those forecast in the budget would compensate for any shortfall, we are concerned that such gains may be

offset by faster than anticipated growth of current outlays. If such overruns are as significant as suggested in the staff report, the authorities may need to introduce additional expenditure measures, particularly on the expenditure side, before the end of the financial year.

Over the medium term, fiscal consolidation will require that the authorities pursue vigorously their intention to limit the impact of subsidies on the budget. The planned reduction for 1989/90 is welcome, and we encourage the authorities to continue to give priority to this matter, thus providing additional flexibility to budgetary policy. In addition, as the review of state enterprises is completed, efforts to improve the operational autonomy and pricing policies of public enterprises are welcome. Over the long run, this should allow better mobilization and improved utilization of domestic resources. In this connection, we note with concern that in recent years, operational and maintenance expenditures associated with past public investment have borne the brunt of fiscal restraint. Prudent rationalization and divestiture of public enterprises should ease these problems.

In contrast to public savings, the staff projects a strong pickup in private savings, equivalent to almost 2 1/2 percentage points during 1989/90, or more than half the increase projected over the five-year period ending 1993/94. While we agree on the need for Indonesia to mobilize more resources, the increase planned for this year appears optimistic. We recognize nonetheless that the authorities are continuing to implement important structural reforms, particularly in the financial sector, which might help to mobilize savings over the medium term. Perhaps the staff can comment on whether these measures are projected to have any significant impact during 1989/90.

The Indonesian authorities have maintained high real interest rates in an effort to prevent large-scale capital flows associated with uncertainty about the path of the exchange rate. These rates have been stabilizing and, as yet, appear to have had little effect on credit, but ultimately a gradual reduction over time would seem highly desirable. The concern about the effect of declining oil prices on the exchange rate underscores the need for the balanced approach to growth being pursued by the authorities.

In the external sector, the strong expansion of exports of manufactured goods has already compensated for the continued weakness of the oil sector. The competitiveness achieved by earlier devaluations has evidently enabled Indonesia to expand existing markets and penetrate new ones. With further investment, Indonesia's potential to increase its market share for manufactures will be greatly enhanced, but the authorities

should continue to pay close attention to maintaining its competitive edge. This emphasis is particularly important in view of Indonesia's current debt service burden, which continues to deflect resources away from other growth-oriented activity. While Indonesia's performance and good payment record have enabled it to retain access to capital markets, the risks associated with its current exposure suggest that the authorities need to exercise caution in undertaking any new liabilities. I would be interested in knowing whether Indonesia has considered market-based hedging techniques as part of its overall debt management strategy.

Mr. Finaish made the following statement:

Since the early 1980s, the Indonesian authorities have achieved commendable progress in adjusting the economy to lower oil receipts, both prior to and following the sharp drop of oil prices in 1986, through maintenance of macroeconomic stability and implementation of far-reaching structural reforms. And although Indonesia's economic situation remains difficult, the authorities' determined adjustment and reform efforts have laid a strong foundation for transition from oil dependency to a more diversified and industrialized economy. With a supportive external environment, the continuation of adjustment measures should enable the economy to achieve rates of growth sufficient to absorb the growing labor force, while keeping inflation moderate and gradually easing the external debt burden.

As I am in general agreement with the thrust of the staff appraisal, I will comment only on a few policy issues. First, in the area of public finance, additional revenue and expenditure measures may be needed in 1989/90 to ensure that the overall fiscal deficit can be financed from available net external financing. However, every effort should be made to avoid undue compression in development expenditures, especially as these expenditures have recorded significant declines over the past two years.

Second, as noted by the staff, Indonesia's present debt service burden weighs heavily on the country's future growth prospects and increases the vulnerability of its balance of payments to adverse international exchange rate and interest rate changes. The authorities' debt management strategy--which seeks to supplement their efforts to strengthen domestic resource mobilization and promote non-debt-creating capital inflows by diversifying the currency composition of new borrowing and improving the average terms of public sector borrowing through minimizing recourse to commercial borrowing--is appropriate. It would perhaps be feasible, particularly in light of Indonesia's well-developed debt management system, to strengthen

that strategy further by broadening the scope for minimizing the exchange rate and interest rate risks through the utilization of some of the hedging instruments available on the market.

Third, the structural reform effort in Indonesia has been bold and far reaching. As noted by Mr. Ismael at Meeting 89/2 (3/10/89) of the Committee of the Whole for the Development Committee on problems and issues in structural adjustment, Indonesia's experience in this regard could provide useful lessons for the design and implementation of structural reform packages in other countries. In the period ahead, there would seem to be scope for further trade and tariff reform, as well as for simplifying the regulatory environment for investment. Indeed, measures to increase efficiency in investment and thus to reduce the incremental capital/output ratio will be crucial for the attainment of the medium-term growth objective.

Regarding the staff's medium-term analysis, it is clear that the medium-term outlook is sensitive to a number of exogenous variables, including the price of oil. The staff has simulated the impact of alternative oil price assumptions, but it would have been useful to include some analysis of the policy adjustments that would be called for in the event of major deviations in either direction from the oil price assumption. Perhaps the staff could comment on this issue.

The staff simulations show the impact on growth and on the external position of larger public consumption or lower efficiency gains from structural reform. In both cases, the simulations indicate lower growth rates than in the baseline scenario, but they also seem to show a lower external current account deficit and a decline in the volume of external debt. This result probably stems from the particular formulation of the model being simulated, where changes in domestic policies have an impact basically on the supply side, which then acts as a constraint on imports and capital inflows. However, it seems doubtful that the impact on the external position of increased public consumption will actually be as indicated by the staff. If demand effects are taken into account, increased public consumption or lower efficiency gains are likely to make the external position more, instead of less, difficult.

To conclude, the Indonesian authorities' adjustment and reform effort over the past few years has been commendable. Their task in the period ahead is to build on their hard-won adjustment gains in their drive to attain a rate of economic growth commensurate with the need to raise per capita income, alleviate poverty, and increase employment while ensuring internal and external financial stability.

Mr. Fernández Ordóñez made the following statement:

The performance of the Indonesian economy during the last few years, compared with that of countries facing similar problems, is highly remarkable. The case of Indonesia is a good example of the success of the formula that combines strong adjustment programs with the support of multilateral institutions and the generosity of donor countries.

Deserving of commendation are, first, the Indonesian Government, which has shown the capability and the courage to adopt the right economic policies at a time that has been very difficult for any oil exporting country; second, the support of multilateral institutions, especially the World Bank which this fiscal year provided Indonesia the largest share of its resources; and finally, the crucial work of the Inter-Governmental Group on Indonesia, which gathered significant amounts of aid, of which the contribution of Japan is praiseworthy.

In this context, the key word in our recommendations for this Article IV consultation is continuity: in the collaboration between Indonesia, the multilateral institutions, and the donor countries; in keeping sound financial policies; in reducing fiscal deficits; in implementing the successful mix of exchange rate and monetary policies; and, above all, in implementing structural measures.

I share the staff's assessments and recommendations, but I would like to comment on what should be an important factor in the development of the Indonesian economy during the next few years: foreign direct investment. In the past, capital inflows to this economy have been biased toward official sources. The balance of payments summary illustrates the consequences of this policy: annual amortization payments of more than $4 billion are expected during the next five years. The baseline medium-term scenario incorporates the changes in the composition of capital inflows and projects an annual figure of $1.2 billion for foreign direct investment. Even though this figure is double that registered last year, it continues to be rather low if the size of the Indonesian economy is taken into account. We therefore welcome the measures introduced in 1987 and 1988 to simplify foreign investment legislation as well as the sharp rise in the number of approvals of foreign investment projects in 1988 as shown in the background paper. We strongly support this policy adopted by the Indonesian authorities and encourage them to continue on this path as we are convinced that foreign direct investment can make an important contribution to the development of the economy.

Mr. Fernando made the following statement:

There is much in the Indonesian experience that deserves high commendation, above all, the authorities' credibility and their commitment to and steadfast implementation of an internally consistent set of policies. We welcome the fact that despite continuing high indebtedness, adjustment fatigue is not evident. It is illuminating to consider the key elements of this commendable performance. First, the authorities attached the highest priority to macroeconomic stabilization, and their reliance on fiscal restraint in promoting this objective is striking. Successive budgets stimulated domestic savings and provided confidence for external sources of finance to strongly underpin the public investment effort.

Second, the sharp increase in external resources in the wake of the oil price developments of the last decade has been maintained, and would note the buildup of government deposits with the banking system that are being drawn down to finance the capital budget. More generally, the oil-based wealth has been associated with a strengthening of the productive potential of the economy.

Third, the authorities provided for diversification of the economy through an ongoing program of structural reform. The results--in terms of the sectoral contribution to GDP growth, the commodity composition of exports, and the revenue base--are striking.

The Indonesian authorities are looking to the private sector to provide the dynamism and impetus to growth. Reliance on fiscal stimulus has been sharply tempered by the claims of external creditors, by external financing constraints, as well as by the low returns on past investment. While a number of incentives and a liberalization of policies have improved the climate for private sector participation, an important issue relates to the high cost of credit, which is the product both of high positive rates of interest and of intermediation costs. The interest rate instrument serves several objectives. It should provide an incentive to save; it should also attract business investment; and it should promote the conservation of external assets. To deter speculative transactions, short-term rates may have to move up substantially. Despite the high lending rates--over 20 percent in deposit banks; 12 percent for Bank Indonesia liquidity support is included--private sector demand for credit is reported to be strong. Yet, term finance--which is the type of instrument more relevant to investment in manufacturing--is costly and in short supply. This situation could worsen as Bank Indonesia phases out its liquidity credits.

Under these circumstances of interest rates tending to remain high, private investment may have to be stimulated through a wider array of policies. Increased emphasis on broadening and deepening the capital market is one channel. The challenge is to entice small savers to the equity net. The disparity in returns between bank deposits and equities may have been reduced through the removal of both tax exemption of deposit interest as well as the withholding tax more recently; this trend is welcome. Also, foreign direct investment in priority areas could be another cost-effective channel. The authorities may wish to strengthen the promotional role of the investment agencies in this connection.

Another issue is the role of external capital in Indonesia's adjustment strategy. The debt situation has pre-empted much of the gains from adjustment. Creditors' claims have been secured through floating rates, with the Indonesian authorities bearing the exchange risk. Nearly 30 percent of current expenditures in the budget are devoted to interest on external debt obligations. Together with scheduled repayments of principal, these large claims have caused the burden of fiscal adjustment to fall heavily on capital expenditure and on outlays for maintenance of capital stock. In this context, the authorities have rightly placed emphasis on a higher rate of per capita growth in order to sustain the momentum of structural reform. The medium-term scenario assigns a clear role for external finance to promote growth while maintaining Indonesia's record of voluntary access to financial markets.

A related aspect, especially in the current state of evolution of the debt strategy, is the recognition that should be given to Indonesia's good behavior in its relations with creditors, which has undoubtedly been facilitated by appropriate domestic policies. Although country circumstances differed, the debt overhang of heavily indebted countries, including Indonesia, can be traced to a commonality of circumstances in the private financial markets that facilitated foreign borrowing. Indonesia's debt stock--two thirds of which is nonconcessional--exceeds 250 percent of export earnings. Debt service, at 39 percent of exports, is high. The share of total debt subject to variable rates has risen further recently. International efforts are intensifying in the light of recent initiatives to distribute the debt burden more equitably between debtors and creditors. No doubt, this is envisaged in the context of arrangements that include multilateral institutional financial support. We hope that the financial community will give due weight to Indonesia's interests in this area.

Mr. Ghasimi made the following statement:

The staff analysis of the Indonesian economy presents a comprehensive overview of developments since the early 1980s. Despite the difficulties associated with the instability in the petroleum market and fluctuations in international oil prices during the past decade, the performance of the economy has been remarkable. The authorities are to be commended for the implementation of a comprehensive structural adjustment program, which had positive results, and for their commitment in continuing to pursue further reform measures so as to maintain growth as well as to achieve financial stability and a sustainable balance of payments position.

The comprehensive structural adjustment program, along with effective monetary and fiscal policies, improved the efficiency of the economy and augmented the non-oil/liquefied natural gas activities, as mentioned by Mr. Ismael. In the framework of this program, the authorities have undertaken appropriate exchange rate measures, contained the fiscal deficit, introduced reforms in the tax system, and promoted suitable deregulation packages in the trade and financial sectors.

Indeed, as indicated in the staff report, the results, especially in the export sector, were impressive. The economic dependency on the oil and gas sector has been reduced substantially. This sector's share of GDP was 14 percent in 1986-88, compared with 21 percent in 1981-85, and the share of oil and gas exports in total exports was 48 percent in 1986-88, compared with 75 percent in 1981-85.

The authorities have been successful in dealing with the crisis that all oil exporting countries are experiencing. They have implemented courageous adjustment measures which have been difficult for the country, given the social impact of the adjustments on the economy.

While we welcome the continuous moderate overall budget deficit, we believe that the burden of fiscal adjustment should not be felt in a decline in development expenditures, which was experienced during 1988/89. In this regard, the Government's decision to increase development outlays by 47 percent in 1989/90 is a step in the right direction. However, to contain and to further narrow the fiscal deficit, it is important to maintain current expenditures while broadening the tax base and improving the administration of tax collection so as to increase government revenues.

In this context, we welcome the authorities' decision to continue strengthening the financial situation of public enterprises with the aim of improving their autonomy and pricing

policies. This could be an incentive for efficient management and better financial discipline for these enterprises. However, financing the fiscal deficit through external resources, as mentioned in the staff report, is a matter that needs careful and further analysis, given the existing substantial external debt in Indonesia. Staff comments on this issue would be appreciated.

In regard to monetary policy, although the authorities are to be commended for the wide range of measures undertaken in this area, especially maintaining positive interest rates in real terms, the negative impact of a high interest rate on investment should not be underestimated. Indeed, this could discourage private investors, especially the small and medium-sized enterprises, from further reliance on the financial institutions.

There is no doubt that deregulations in the monetary sector have produced positive results. In fact, monetary management has improved substantially, and resource allocation has become more efficient in providing the correct incentives to the private sector. However, the effects of these deregulations need to be properly assessed by the central bank to avoid any disruption in the smooth functioning of the monetary system. In this connection, the supervisory capacity of the central bank needs to be reinforced so as to monitor closely the working of the financial institutions.

Although we commend the Indonesian authorities' management of their external obligations, the vulnerability of the balance of payments to external shocks continues to give cause for concern. We welcome the authorities' intention to use corrective measures in promoting the mobilization of domestic savings and foreign nondebt capital inflows and in implementing a prudent debt strategy, so as to mitigate any possible disturbances in this area.

In view of the country's vulnerability to external shocks, we agree with the authorities' decision to build up adequate reserves, equivalent to five months of non-oil/gas imports, so as to withstand any possible adverse event.

On social development, given the fast growing labor force and the present standard of living, we welcome the cooperation of the World Bank in financing projects in Indonesia aimed at further development and improvement of the infrastructure and other sectors of the economy. However, additional measures need to be undertaken to enhance private and public investments. The resulting impact on developments in both urban and rural areas would offer additional employment opportunities and a better standard of living.

Finally, with respect to the medium-term outlook, while we recognize the sensitivity of different scenarios to domestic policy and adverse external shocks, we believe that the prospects outlined in the baseline scenario are the most appropriate in the case of Indonesia. The chances for success of this scenario are high, given the good performance of the economy during this decade and the authorities' determination to pursue adjustment reforms.

Mr. Lombardo made the following statement:

The adjustment effort made by Indonesia in the last few years has been impressive. Like other oil exporting countries, Indonesia had to adapt its economy to a strong decline in oil prices, and the reaction of non-oil/gas exports to structural adjustment is outstanding; from 27 percent of total exports in 1983-84, estimates for 1988-89 set this share at 61 percent. This reaction more than compensated for the decline by about one half in oil and liquefied natural gas exports.

In fact, non-oil exports responded strongly to the exchange rate and deregulation measures, averaging growth of 15 percent a year in volume terms from 1982/83 onward. Furthermore, growth in manufactured exports averaged over 30 percent during the same period. Undoubtedly, the successful combination of exchange rate and monetary policies was a key point in maintaining external competitiveness while containing domestic inflation and promoting financial savings. As the staff points out, given the continued difficult external position and the need to raise savings further, continuing these policies is essential.

In addition, the staff states that "domestic resource mobilization policies should permit Indonesia to reduce its recourse to foreign savings over the medium term." Moreover, the staff encourages improvement in the foreign investment climate, points out that in the next few years enhanced donor assistance will be needed to support macroeconomic policies, and notes that new commercial borrowing should be limited to levels that demonstrate continued voluntary market access.

Indonesia is on the verge of a new stage of development, but it is clear that the process of adjustment has to continue, in particular promoting the development of the capital market and reducing distortions in the financial system. This is necessary because it is difficult to envisage how an indebted country like Indonesia can maintain or even accelerate the pace of adjustment and growth if foreign investment and financing is not timely and adequate.

The staff remark that "further substantial policy efforts will be required to raise economic growth and maintain domestic and external financial stability" is noteworthy. Nevertheless, after the strong adjustment already achieved, the implementation of sound policies, the diversification of exports, and the control of domestic inflation, Indonesia merits the continuation of strong support. The international community should assist Indonesia in achieving sustained growth, without jeopardizing the successful process of adjustment already started.

Mr. Enoch made the following statement:

Once again this chair commends the Indonesian authorities for their continued efforts to maintain sound economic management, in particular to adjust in the face of adverse external developments. The authorities clearly understand the relationships between firm macroeconomic policies, concerted structural adjustment, and economic growth. This was demonstrated in Mr. Ismael's statement on problems and issues in structural adjustment at Meeting 89/2 of the Committee of the Whole for the Development Committee (3/10/89) and in his statement today.

But Indonesia faces a continuing challenge. Owing to good economic management, there now seems to be no immediate stabilization problem, but there remains the urgent need to grow out of debt and poverty. As the staff appraisal shows, growth is particularly important in relation to the rapid expansion of the population and even faster growth in the labor force. The baseline scenario for the medium-term outlook, endorsed recently by the President of Indonesia, envisages real output growth of 5 percent a year.

To achieve this level of growth, while reducing vulnerability to exogenous shocks on the oil account and not adding to the debt overhang, requires rapid diversification, increased levels and efficiency of investment, and greater domestic resource mobilization. The medium-term scenario in the staff report, designed to achieve the projected level of growth, rests on a number of assumptions regarding these factors, which are undoubtedly challenging. It is interesting that, in many of the key variables, a large part of the improvement is assumed to occur in the current year. For example, the incremental capital/output ratio is projected to fall from 6 percent to 5.2 percent this year and to worsen somewhat in subsequent years; and both private sector saving and investment are expected to leap by almost 2 1/2 percentage points of GDP. Foreign direct investment is projected to nearly double, and government non-energy revenues show a sharp increase.

As the staff report makes clear, the risks to these projections are many. It is thus necessary at the outset to ask whether the measures appropriate to the envisaged jump to the projected higher growth path are in place. Looking first at the central government accounts, revenue enhancement and expenditure containment seem called for to maintain financial stability. I concur with the staff that the authorities' planned 35 percent increase in non-oil revenues looks optimistic, especially as the bulk is expected from improved tax administration, and I support the staff's call for a widening of the tax base. On the expenditure side, I welcome the intention to reduce subsidies further, not only because of the fiscal deficit but also because of the improved resource allocation that will result; the need to translate the intent into action is heightened by the staff's assessment that expenditure is exceeding the budgeted level this year.

I urge the Indonesian authorities to take forward their evaluation of public enterprises, with a view to possible divestiture. The potential benefits may be large. For the Central Government, there would be revenue gains, directly and through widening the tax base; for the economy, greater efficiency would contribute to improving the aggregate incremental capital/output ratio; and for the capital markets there would be a welcome addition of depth.

Structural policies are urgently needed to raise both the scale and efficiency of investment, and I commend the authorities for the steps already taken to reduce subsidies and liberalize trade. Nevertheless, I endorse the staff's view that significant additional trade and tariff reforms should be urgently considered.

Efficient resource utilization will support the success already achieved in promoting export diversification through an appropriate exchange rate policy. The remarkable increase in non-energy exports in the years since 1986 is one of the clearest examples of the benefits of a country improving and then maintaining its competitiveness through exchange rate action backed by fiscal and monetary control. I also welcome the considerable progress made in liberalizing the financial sector and improving the management of monetary policy. In this context, the state banks seem obvious candidates for privatization. I also join the staff and other Directors in reminding the authorities that a freer banking system requires higher standards of banking supervision.

The situation in respect of the constraints on investment remains unsatisfactory, particularly for foreign investors, and the Indonesian authorities risk driving foreign investment elsewhere, thus preventing Indonesia from benefiting fully from

the upsurge in manufacturing output and exports that is transforming many of the economies of the region. As a supplement to liberalizing the investment regime, further deepening of the capital market is desirable; I have already mentioned the role that privatization might play. In addition, I join Mr. Marcel and others in suggesting that some other long-term domestic borrowing might be helpful, not only in reducing the external burden but also in contributing to capital market development.

Despite all the admirable adjustments already made by the Indonesian authorities, and the significant further improvements set out in the medium-term projections, the overseas debt stock will continue to rise. The financing of this debt will remain dependent on concessional special assistance. I trust that this will continue to be forthcoming, given the hard evidence of the continuing commitment of the Indonesian authorities to sound economic management.

Mr. Fogelholm made the following statement:

Mr. Ismael's description of an "assault" to be continued by the authorities on the high-cost economy through further deregulation is most appropriate as it vividly depicts the dynamism of the comprehensive policy approach adopted by the authorities in the face of adverse external developments. The impressive results are clear evidence that consistent adjustment efforts, including the implementation of a wide range of structural reforms--within a sound macroeconomic framework-- make an important difference in terms of economic developments. The diversification of the industrial base with its subsequent lessening of the previously high dependency of the economy on oil and gas production and exports is particularly impressive.

I am in general agreement with the staff appraisal and can subscribe to most of the comments by previous speakers. I will therefore comment only on the medium-term outlook, for which the medium-term scenarios are an excellent base, and on foreign investment policy.

The prospects for fairly balanced, high-growth development seem good, provided that domestic policies remain sound and that the external environment does not worsen drastically. The staff's sensitivity analysis shows, however, that the margins are not large. On the domestic side, the authorities would be well advised to aim at a smaller than projected fiscal deficit. At least in the current year, there appear to be good opportunities to achieve additional savings as oil prices have been and are still well above the forecast level. This additional income should not be spent; I would welcome comments from Mr. Ismael regarding the Government's plans in this regard.

Like Mr. Fernández Ordóñez, I would like to support warmly the staff's proposal regarding the simplification of procedures for both domestic and foreign investment. The present application system--as described in the background paper--appears unnecessarily complicated. The potential benefits to be derived from simpler procedures are substantial, as evidenced by the enormous increase in dollar terms of project approvals in 1988. It is obvious that there is a huge and probably growing foreign interest in the well-performing and buoyant Indonesian economy. As an alternative to much-needed domestic savings and as a provider of new productive capacity in the non-oil sectors of the economy, foreign investment should be an attractive target for policymaking. In this connection, I would like to verify that my understanding of the foreign investment policy is correct in that, with some exceptions, all investors are expected to divest after 10-20 years of operation. If I am correct, could the staff or Mr. Ismael provide the reason for this policy? Also, can it be assumed that the domestic companies will have the interest and capacity to take over these foreign-owned firms?

Mr. Yoshikuni made the following statement:

Faced with large economic distortions caused by the decline in oil prices in the mid-1980s, the Indonesian authorities made timely responses that brought about a favorable economic recovery. Economic developments in 1988 continued to be broadly satisfactory. Particularly noteworthy is the introduction of a flexible exchange rate policy. Although this measure resulted in a sharp increase in expenditures for foreign loan repayments, the economy became dynamic and the non-oil sector grew remarkably. Indeed, the excessive reliance of the economy on the oil/liquefied natural gas (LNG) sector had been a major concern, and the need to change the structure of the economy had been underscored for some time. However, the timely exchange rate devaluation, coupled with trade liberalization and financial deregulation measures, provided adequate international competitiveness to the non-oil industry. As a result, non-oil/LNG exports surpassed those of oil/LNG for the first time in 1987, and this encouraging development continued in 1988.

This year is the first of the five-year development program, Repelita V, whose policy objectives and framework I generally support. Repelita V emphasizes economic growth and development to raise per capita income. However, the economy is still vulnerable to external shocks, as evidenced by the large amount of international debt outstanding. Therefore, frequent changes of the policy stance between growth and adjustment would not be desirable.

The 1989/90 budget appears to be in line with Repelita V. On the revenue side, however, a conservative estimate would be appropriate on non-oil/LNG tax revenues, as it is often the case that a revenue-raising plan, through strengthening tax administration, will take longer than expected to bear fruit. The increase in development expenditures seems to count on this increase in non-oil/LNG revenues. Too rapid an expansion of development projects would be dangerous, and the public financial position of the project process should be closely monitored from the viewpoint of the overall public financial position. Assigning priorities to projects is highly desirable, and projects with low returns or long gestation periods should be closely reviewed. While recognizing the importance of the development plan for the Indonesian economy, we believe that emphasis should be placed on overall macroeconomic stability at this stage.

Monetary policy has been conducted in a broadly satisfactory manner during the past several years, and it is particularly commendable that the authorities succeeded in subduing inflationary pressure despite a large exchange rate devaluation. The structural reform of the financial sector continues to be important to raise further the private savings ratio, which is already high compared with other developing countries. As regards interest rates, the lending rate seems to be high in view of the current inflation rate, and the spread between lending and deposit rates could be further reduced through structural measures.

As regards exchange rate policy, significant movements of the rupiah were experienced in the 1980s owing to the economy's vulnerability stemming from its trade structure. Credit should be given to the authorities for their success in maintaining a restriction-free exchange rate system, despite significant balance of payments disequilibrium. As I noted earlier, this flexible exchange rate policy contributed to the rapid growth of the non-oil industry; on the other hand, it might have been harmful in attracting foreign direct investment because of the exchange rate risk. The stability of the exchange rate is important in this context. In light of the still fragile fiscal position and large external debt, non-debt-creating foreign direct investment should be pursued further. From this viewpoint, recent measures to ease the restrictions on foreign direct investment are welcome.

It is also important to continue efforts to diversify the export base. The authorities have succeeded in shifting from an import-substitution policy to an export-oriented strategy, and this effort should be further strengthened. The flexible exchange rate policy has played a large role. However, the current exchange rate seems adequately competitive, and the

First, with regard to fiscal policy, subsidies were five times the budgeted amount in fiscal year 1987/88, and were three times the budgeted amount in fiscal year 1988/89--20 percent above the previous year's level. The amount of subsidies budgeted for the next fiscal year is modest, and we hope the pattern of the past two years will not be repeated.

We also noted the 15 percent increase in civil service salaries this year following a four-year freeze. Our impression is that civil service salaries will remain low after this increase. If it were possible to offset further increases with reductions in nonsalary expenditures, the entire economy might benefit from a reduction in administrative bottlenecks. We also urge the authorities to make greater efforts to mobilize non-oil revenues.

Second, we are struck by the high real interest rates prevailing in Indonesia, and we share the concerns of the authorities that these rates could deter investment. Perhaps it would be useful for the staff in conducting the 1990 Article IV consultation to focus attention on this area in an effort to identify policies that could help bring these rates down without adverse repercussions. We would also be interested in having the views of the staff on the statutory prohibition of domestic borrowing. Is it possible that a relaxation of this prohibition would serve to deepen the domestic capital market and thereby contribute to financial stability, assuming that fiscal policy continues to be restrained and monetary policy continues to be prudent?

Third, we do not regard the baseline scenario developed to assess the medium-term outlook to be an optimum one. We urge the authorities to aim for somewhat faster external adjustment. Otherwise, any adverse change in the external environment is likely to jeopardize the objective of Repelita VI--the next five-year plan--to achieve a takeoff into self-sustaining growth. This implies less reliance on external financing from official sources and more foreign direct investment. With regard to the latter, as noted by Mr. Fernández Ordóñez, the amounts of investment shown in the baseline scenario seem modest and smaller than the levels suggested by the value of foreign investments approved during the past year.

Fourth, our major concerns about the prospects for the Indonesian economy relate to the pace of structural adjustment. In particular, we are deeply concerned by the slow pace of reform in the public enterprise sector. Compared with the efforts of other countries that invested heavily in this sector in the 1960s and 1970s, Indonesia's efforts to rationalize the public enterprise sector appear to be below average. In addition to substantially increasing the contribution of this sector

to the budget, that an active rationalization program could lead to a measurable increase in productivity in the economy. We are also disappointed that the efforts of the World Bank have not had a greater impact on this sector.

Another area of concern is the trade regime. We welcome the trade liberalization packages introduced over the past two and one-half years, and note that nontariff barriers have been eliminated on all but 15 percent of import categories. We have learned, however, that this small group of categories accounts for a much larger share of Indonesia's imports by value. We fully agree with the staff on the need for a comprehensive review of the tariff structure. In addition, we join Mr. de Groote in urging the authorities to be more active in removing barriers to exports and unnecessary export incentives.

Mr. Al-Assaf said that, like previous speakers, he was pleased to learn from the staff report and Mr. Ismael about the continued impressive performance of the Indonesian economy since the previous consultation discussion. The authorities should be congratulated for their achievements, in particular in two areas: the strengthening of the tax system and the substantial progress in the external sector.

Those achievements were remarkable, but it was clear that in order for them to remain durable, a broad and gradual transformation of the economy was required, Mr. Al-Assaf continued. That long-term process was essential to remove the many inefficiencies that were continuing to prevent the economy from achieving its full potential. The measures already taken in such areas as trade, the opening up of restricted business activities to foreign capital and competition, and the development of financial intermediation were commendable. He was encouraged by the continued commitment of the authorities to further deregulate and relax constraints on the operation of market mechanisms, as indicated by Mr. Ismael. That was indeed essential if the private sector was to continue to enhance its contribution to growth and total exports.

However, from a short-term perspective, and in spite of the progress so far, it appeared that the authorities would be facing a number of difficult challenges in the months ahead, Mr. Al-Assaf noted. One would be to contain the 1989/90 budget within its limits without compromising other important macroeconomic objectives, particularly growth. The staff report made the case for additional revenue and expenditure measures, based in part on cautious projections of the effects of various tax reforms on the current year's revenues, and the possibility of some expenditure overruns. The approach taken by the staff was sound, but it was also worth noting that routine expenditures, such as payments related to debt servicing, represented the bulk of total expenditures while other expenditures, especially subsidies, had already been drastically cut under the present budget.

While he agreed with the staff that some room for maneuver existed in the generation of extra revenues, he preferred a wait-and-see approach for two reasons, Mr. Al-Assaf remarked. One was that oil/liquefied natural gas revenues could be higher than projected. Another reason was that the Indonesian tax system had been undergoing rapid changes, and some time might be required for the system to fully absorb those changes before new ones were introduced. However, the authorities should stand ready to take all actions necessary.

Mr. Kpetigo made the following statement:

After a long period of relative economic prosperity characterized by high growth of real per capita GDP, Indonesia has experienced, since 1985, a succession of adverse external developments such as the slump in world oil prices and the depreciation of the U.S. dollar. These have created a temporary setback to Indonesia's otherwise impressive economic performance. We are pleased that the swift and sustained implementation of appropriate macroeconomic and structural policies to counter these developments has resulted in a marked improvement in the key economic and financial indicators and a reallocation of resources in the economy. Noteworthy is the increasing importance that the non-oil sector is gaining as evidenced by its ready contribution to total fiscal revenues and GDP expansion.

Despite these important achievements, the Indonesian economy still faces serious challenges, as reflected in its continuing vulnerability to oil price declines and the heavy burden the external debt is exerting on scarce resources. In this context, we commend the Indonesian authorities' new five-year development plan that seeks to address these challenges. Its main objectives appear appropriate, especially with regard to sustaining economic growth at 5 percent a year in real terms, creating more job opportunities to absorb the growing labor force, and above all, alleviating poverty while reducing the external debt service burden.

Since I am in broad agreement with the staff appraisal and most of its policy recommendations, I will comment only on fiscal and structural adjustment policies. In view of the large increase in development spending contemplated for the first year of the plan and the uncertainties surrounding world oil markets, we share the staff's view that fiscal policy should continue to emphasize greater mobilization of domestic resources, in particular non-oil revenues. We welcome the tax measures enacted recently and the initiatives taken by the Government to strengthen tax compliance and administration and to impose more stringent penalties for tax evasion, and we note the increase in electricity tariffs implemented recently. The measures being formulated by the authorities to improve the operational

autonomy and pricing policies of the public enterprises, to rationalize inefficient activities, and to strengthen the financial performance of the public enterprise sector should be given due consideration as they could enhance the contribution of this sector to the domestic resource mobilization effort.

While revenue enhancement has an important role to play in the authorities' domestic resource mobilization effort, it is appropriate that expenditure restraint complement the revenue-raising measures. In this connection, the authorities' intention to build on the progress already made in phasing out subsidies through further substantial reduction of these subsidies under Repelita V is encouraging.

Indonesia has implemented an impressive program of structural reforms in trade, industry, and finance with some success. As a result, Indonesian business has been opened to foreign investors, the economy is increasingly outward oriented, and resource allocation in the economy has improved. Undoubtedly, the economy as a whole has benefited substantially from these reforms. I concur with the staff's view that notwithstanding their remarkable achievements, for which the Indonesian authorities are to be commended, further actions appear necessary to consolidate the progress already achieved, increase investment efficiency, and improve the business climate and infrastructure by removing bureaucratic impediments and strengthening monitoring capability. We encourage the Indonesian authorities to maintain their assault on the high-cost economy through adequate structural reforms. As indicated in the baseline scenario, because of the economy's vulnerability to external shocks, vigorous structural adjustment and the pursuit of macroeconomic policies supported by financial sector reforms will be required to attain the objectives of Repelita V.

Given the Indonesian authorities' commitment to implementing the appropriate policies, I echo the staff's call for enhanced donor assistance to Indonesia in order to buttress the authorities' adjustment efforts.

The staff representative from the Asian Department observed that the rate of return on investment in public enterprises had declined sharply, from about 4 percent in the late 1970s to about 1 percent in the 1980s, owing to several problems, including overstaffing, lack of direction, and bureaucratic interference by the ministries. The Government was in the process of reforming the public enterprises, aiming at the divestiture of those making profits or with potential; for the other enterprises, the authorities were considering closure, or sale of part of the operations. The authorities hoped to make the enterprises more efficient in a deregulated environment where they would face increased competition. They also hoped to reduce the size of the public sector to the point where only

strategically important enterprises would remain. The emphasis on efficiency would contribute to domestic resource mobilization.

The subsidized liquidity credits extended by the central bank had initially been designed to reach priority sectors, the staff representative noted. Since the 1983 financial system reform, the Government had attempted to reduce liquidity credits available while adjusting interest rates upward on several occasions, most recently two days previously when rates for most liquidity credits for exports had been raised to 14-15 percent. As to whether the expansion of branches would add to banks' operating costs and thus to interest rate costs, the banks that would benefit from the reform package would be mainly the stronger, larger institutions that could satisfy the Government's capital requirements. The deregulation would tend to promote mergers among smaller banks, although many such banks were in rural areas where operating costs were low. The staff therefore did not envisage that the expansion in the branch network would lead to a rise in interest rates.

In an open economy with no exchange rate restrictions, monetary policy could not maintain an interest rate that was not related to interest rates abroad or to exchange rate expectations, the staff representative added. At present, the structure of interest rates in Indonesia reflected a premium above exchange rate expectations, but only in the short term. In the early 1980s, as the authorities had begun to restructure the economy away from dependency on oil, there had been an evident need to undertake large devaluations; subsequently, whenever oil prices had declined, expectations had arisen concerning a devaluation by the Government, but the authorities had successfully resisted those pressures and thus had contributed to an increase in confidence. The Government had no interest in maintaining high interest rates, which, in fact, had come down in recent weeks. Deposit rates had been reduced by 1 percent, and Bank Indonesia had reduced its discount rate by 2 percentage points, while other measures taken in March had also contributed to the availability of liquidity, as commercial banks had been required to maintain a limit on their net foreign asset positions, leading to the repatriation of some of their foreign assets. In the long run, however, interest rates and expectations would be served by sound macroeconomic policies.

The increase in non-oil revenues and other measures should help to achieve the fiscal objectives and increase domestic resource mobilization, the staff representative commented. The extension of the value-added tax to services and the good revenue performance of property taxes, which in recent years had grown by about 35 percent, should also contribute. Nevertheless, the authorities realized that tax compliance was very low, and there was scope for significant improvement. While a higher tax burden could have an adverse impact on incentives in the short term, given the low tax/GDP ratio in the economy--less than 10 percent, compared with the average of the region of over 14 percent--there should not be a long-term impact on investment. Another source of domestic resource mobilization would be the rationalization of expenditures, particularly the reduction of subsidies, notably on petroleum and fertilizer. The

petroleum subsidy depended on the price of oil, which, as it rose, increased the cost to the oil company. The staff did not believe that the subsidy would be reduced that year given the current level of oil prices, unless price adjustments for domestic oil production were raised. The fertilizer subsidy had always been above the budgeted amount because of an accounting procedure whereby the Government allowed for small-scale subsidies in the budget but actually financed a higher level, according to the availability of resources over the course of the year; if sufficient resources were not available, the cost would be carried over to the next fiscal year. The staff had made it clear that, especially in the context of Repelita V, subsidies should be reduced over the course of the five-year plan.

The authorities' budget statement indicated that they expected a 5 percent annual rate of inflation for 1989/90, based on the prevailing annual rate, the staff representative explained. In recent months, however, inflation had accelerated somewhat, and the staff had stated during the consultation discussions that a 7 percent rate would be more realistic, based on the authorities' decision to extend the value-added tax and to raise some prices, as well as the increase in demand pressures associated with the rise in civil service salaries. Recent trends suggested that inflation had risen to an annual rate of about 7.2 percent. The staff expected that rate to moderate toward the end of the year, when the original extension of taxes and the results of other measures would be absorbed. The staff analysis indicated that narrow money was the monetary aggregate that had the most direct impact on prices, and it had not grown rapidly in recent years.

The decline in reserve money was explained by the reduction in banks' liquidity requirements in November 1988 and by the decline in net foreign assets of Bank Indonesia during the course of the year, the staff representative explained. The decline in reserves had occurred because of lower oil prices as well as capital movements in the early part of 1989. The authorities had, in the management of their reserves, tried to diversify and in recent years, for example, the share of the yen in external debt had risen; they had also engaged in swap operations. However, the more advanced market hedging techniques were not under consideration because they would require sizable and costly manpower. With respect to asset and liability management, the authorities had engaged in some innovative approaches, including currency options and options for repayment. One such agreement had been reached with a Japanese consortium at end-1988.

As to whether the divestiture requirement was adverse to the growth of foreign investment, recent deregulation and liberalization measures would go a long way toward removing most of the impediments to foreign investment, the staff representative remarked. The Government was committed to maintaining a favorable environment, and any problems that would arise would be tackled in a constructive manner, with the recent extension of the period for divestiture to 15 years an important example.

The ownership ratio had been raised, especially in the export sector, to about 95 percent, depending on the type of investment.

With respect to the medium-term scenarios and the policy options available to the authorities should oil prices move in either direction, in general, demand-management policies would have an impact on economic performance and growth in the short term, the staff representative noted. But the scenario focused on a longer period of time, and in that sense, the model focused only on factors that contributed to the potential rate of growth of the economy. Staff calculations indicated that a dollar movement in the price of oil would have roughly $0.5 billion impact on the current account and about 1/2 percentage point on growth, assuming present policies continued in place. If oil prices increased, the Government would raise expenditures, especially on infrastructure needed to support private sector investment. The Government would also have to consider increasing expenditures on certain current items, such as operations and maintenance, and especially those expenditures designed specifically to increase employment opportunities and eliminate poverty, major objectives of the Government. The authorities had demonstrated in the past that they were ready to adjust in the case of a decline in oil prices, focusing mainly on reducing development expenditures, and they were not expected to deviate from that stance.

The Government, in the interest of fiscal discipline, was not willing to engage in domestic borrowing, the staff representative stated. In the 1960s, the Government had borrowed heavily in the domestic market when inflation was high in Indonesia, and the Government wanted to refrain from domestic borrowing until all the government bonds had been redeemed. It remained unclear as to whether a government decision to engage in domestic borrowing would lead to any immediate alleviation of the debt structure of Indonesia. Government borrowing would perhaps lead to a crowding out of the private sector, which could then increasingly turn to external borrowing. The external financing of the fiscal deficit of 2.7 percent of GDP was considered consistent with development financing and available commercial borrowing, as outlined in the baseline scenario of the medium-term outlook. The staff, of course, would recommend further reduction in the deficit and less reliance on external financing. The amount of commercial borrowing to finance the budget was small, and financing was provided mainly by the Inter-Governmental Group on Indonesia. Several speakers had noted the high interest payments in the budget, which reflected the decline in government revenue. For the medium term, however, the staff projected a deceleration in the debt service ratio, which would alleviate the problem of interest payments in the budget.

The staff considered it feasible to reduce the incremental capital/output ratio quickly because of the deregulation measures that had been and would be taken, the staff representative from the Asian Department commented. Moreover, cyclical movements in the early 1980s, with large oil revenue and significant investment in infrastructure, had contributed to a high ratio, but current experience in the region indicated that the

ratio was declining. Nevertheless, the medium-term scenario indicated that as capital deepened, the incremental capital/output ratio would increase slightly.

The staff representative from the Research Department noted that the effect of major deviations in either direction from oil price assumptions could be determined from the staff's models by adding the policy shocks and external shocks which were given independently in Annex I (SM/89/73). With respect to the effect on the current account deficit of an increase in public consumption, the staff would categorize the results as theoretically ambiguous; they depended on the estimated parameters in the model, which in the present case were the marginal propensity to import, shares of exports, and output. In other words, the lower levels of activity were consistent with lower levels of indebtedness, as shown in the simulations. In any event, the amounts involved were relatively modest.

The staff representative from the Exchange and Trade Relations Department commented that with respect to the policy advice on exchange rates, the staff had attempted to combine a balanced use of cost-reduction and demand-management policies as well as exchange rate policy to raise competitiveness. For 1989, the staff's assessment implied some pessimistic inflation forecasts and took into consideration recent wage adjustments that would call for caution to be exercised in further wage increases. It had also taken into consideration concern for exchange rate stability, thus shifting the emphasis on the need for domestic cost containment.

Mr. Ismael said that at present, the process of deregulation in Indonesia remained incomplete. The authorities had embarked on that process because, first, growth was a central goal of government policy. Second, growth could be achieved only if exports increased enough to pay for needed imports and to service debts. Third, given the level and uncertainty of oil prices and the quantity of Indonesia's known oil reserves, the only reliable source of export growth was a wide range of non-oil/liquefied natural gas (LNG) exports. Fourth, non-oil/LNG export growth required an efficient, low-cost productive economy to enable business to compete in world markets, which in turn required a competitive domestic market. Fifth, government protection and controls, which impeded the functioning of the competitive domestic market, should thus be eliminated. And sixth, the benefits of deregulation and growth should be widely and evenly spread among the population.

From an empirical point of view, it had to be recognized that there remained important pockets of protection, import restrictions that raised costs and penalized both exporters and consumers, and a number of restrictions on exporters, Mr. Ismael continued. For that reason, the Government was committed to relaxing such constraints over time, and he could assure Directors that more action would be taken in the near future. Thus far, the authorities had concentrated on introducing competition to the manufacturing sector by lowering more tariff barriers. In future, the authorities would try to reduce distortions in pricing and further reduce

barriers to competition from imports. Deregulation, nevertheless, would have to be implemented on a stage-by-stage basis after careful consideration of both feasibility and impact.

The Government was fully aware of the problem of high interest rates, but the authorities were faced with a dilemma in trying to reduce them, Mr. Ismael observed. In the prederegulation era, the central bank could simply issue a decree that reduced deposit rates from 20 percent to 18 percent, for example, while lending rates would be reduced similarly. But since the introduction of deregulation in the banking sector in June 1983, on the one hand, the population expected the central bank to reduce interest rates, which the central bank was hesitant to do, while on the other hand, the banks considered that they should determine the interest rates and the central bank should not interfere. That dilemma had led to the time-consuming process of persuading the banks to reduce the interest rate. In March, the Government had resorted to lifting the foreign borrowing ceilings to induce a decrease of interest rates by lowering the cost to banks. He hoped that the reduction of borrowing and lending rates that had been achieved in April could be further stimulated downward.

A similar dilemma was faced with regard to subsidies, Mr. Ismael continued. The stable oil prices, at a rather high level, were, on the one hand, a benefit to the economy. But on the other, the higher the oil price the higher the subsidies that had to be paid by the Government. The authorities were searching for ways to solve the problem in order to reduce the subsidies provided through the budget.

A successful series of economic reforms had attracted $4.4 billion in foreign investment commitments during 1988, a record 300 percent higher than the previous year's commitment of $1.5 billion, Mr. Ismael stated. The 1988 total alone amounted to nearly 20 percent of the $21.5 billion in foreign investment since enactment of the foreign investment law in 1967 opened Indonesia to outside investors. It was worth noting as well that Indonesia had been the largest recipient in Southeast Asia of foreign investment, and in 1988/89 it was assured of maintaining that position as the $4.4 billion committed to Indonesia was almost four times the amount received by, for example, Thailand in 1988. To further improve the business and investment climate, it was expected that in the near future, the Government would introduce a negative list to replace the priority list used so far. That measure should further promote foreign investment.

With respect to fiscal revenue, Indonesia at present was one of the lowest taxed countries in Southeast Asia, Mr. Ismael stated. The tax ratio in 1988/89 had climbed to 10.9 percent and was projected to increase further to 12.5 percent in the new budget.

The Chairman made the following summing up:

> Executive Directors noted that, notwithstanding a weakening of world oil prices, the Indonesian economy had continued its

remarkable performance in 1988/89. Output growth was solid, owing to buoyant non-oil or gas exports and investment demand; inflation moderated; the external current account deficit was successfully contained; and the fiscal position was bolstered by a strong non-oil revenue performance and expenditure restraint.

Directors observed that this performance attested to the impressive progress achieved in diversifying production and exports through the adjustment and structural reform policies undertaken in recent years. Strong support for these policies from foreign donors and multilateral development institutions had also helped Indonesia to weather external shocks and to strengthen the basis for rapid economic expansion under the fifth five-year plan.

With a view to sustaining growth-oriented adjustment policies, Directors stressed that prudent fiscal management would be critical. They underscored the importance of reducing the overall budgetary deficit through strong efforts to mobilize additional domestic resources, and they indicated that priority should be attached to containing the high public debt burden. In this regard, Directors welcomed the revenue measures introduced in the 1989/90 budget and recent initiatives to further improve tax administration and compliance, and they encouraged the authorities to adopt revenue measures to make the tax system more elastic. Equally important, Directors stressed expenditure restraint, including the phasing out of the remaining subsidies through appropriate price adjustments. Directors welcomed the authorities' determination to implement steps to strengthen the financial performance of the public enterprise sector so as to augment its contribution to resource mobilization. In this context, divestment of public enterprises was also advocated.

Directors commended the broad scope and objectives of the structural reforms to deregulate the economy, improve efficiency, increase domestic and foreign competition, enhance financial intermediation, and encourage private sector initiative. They noted with satisfaction the recent strengthening of the momentum of reform and stressed that continuation of flexible exchange rate management and domestic demand restraint, including the continuation of a cautious monetary policy, should underpin these reforms. They emphasized that maintaining the momentum of reform was critical to meeting the difficult policy challenges in the medium term. Central among these was the creation of an environment for durable and faster economic growth adequate to provide jobs for a rapidly growing labor force and to raise living standards. Directors remarked that further structural reforms in the areas of trade, investment, and finance were essential. Reference was made, in particular, to a further reduction in trade barriers and the rationalization of the tariff structure, the simplification of investment

licensing procedures, further cost reduction and improved efficiency of financial intermediation, and the elimination of credit subsidies. The commitment of the authorities to foster the rapid development of a cost-effective and competitive economy through further deregulation was particularly welcomed.

Directors noted with satisfaction Indonesia's consistent record of orderly debt servicing. They observed, however, that the debt service burden remained onerous and that Indonesia remained vulnerable to external shocks. All this underscored the need for continued prudence in external debt management. New commercial borrowing should be limited to modest levels, and Directors highlighted the importance of policies designed to strengthen domestic resource mobilization and promote non-debt-creating capital inflows. The significant role that direct foreign investment can play in the development of Indonesia was noted by a number of speakers. In addition, continued donor support will be essential to the success of the Government's adjustment efforts.

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

3. BANK-FUND COLLABORATION IN ASSISTING MEMBER COUNTRIES

The Executive Directors considered a memorandum jointly prepared by the managements of the Bank and the Fund on Bank-Fund collaboration in assisting member countries (SM/89/54, Rev. 1, 3/31/89).

The Chairman noted that the present meeting, as suggested by several Directors, provided an opportunity to conclude the discussions on Bank-Fund collaboration. He wished to express his thanks to the President of the World Bank for the courtesy with which he had conducted the long, and sometimes difficult, discussions that had taken place and for his tireless efforts to reach a compromise. He also appreciated the strong support of Executive Directors, particularly joint Directors, which had been essential to achieve the present outcome.

The joint memorandum was a compromise, but he was pleased with the final result, the Chairman continued. Although the procedures outlined in the text could not solve every problem, he was optimistic that they provided the tools to achieve a strong and constructive collaboration with the Fund's sister institution. He recognized, nevertheless, that in the end the success of Bank-Fund collaboration depended on the staffs' goodwill, common sense, and diligence in working together on a daily basis. The experience gained every day in several areas, particularly the work on the task force in the context of the debt strategy, was most encouraging. The two Boards could also make an indispensable contribution to more effective collaboration, especially through the appropriate harmonization

of policy advice to the respective managements and through the promotion of coordination to that effect in the capitals. He was confident that efforts were being made to that end.

He would continue to keep the collaborative process under review, and at an appropriate time, if necessary, he would inform the Executive Board of his views on the experience with the improved collaborative procedures, which he regarded with optimism.

Mr. Cassell made the following statement:

I welcome this document and the agreement between the two institutions that it embodies. Over the past year, there have been serious problems in Bank-Fund collaboration. These seem to have stemmed mainly from two related causes. The first is institutional deficiencies, which perhaps have always existed but whose potential for divisiveness has been sharpened by developments in the 1980s. For example, the conditions under which the World Bank should be prepared to undertake policy lending in the absence of a Fund program have not been clearly specified. This may not have mattered much in the past but has become a source of friction and controversy as the focus of the two institutions increasingly overlapped. Also, policy discussions with member countries have sometimes been conducted in parallel by the Fund and the Bank, and the policy prescriptions of the two institutions have not always been the same. This has resulted in confusing signals being sent to member countries, which has done a great disservice to all concerned. The second cause of the problems in collaboration has been inadequate communication between the Fund and the Bank staffs.

The agreement reached between the two managements goes a long way toward resolving these problems. In particular, paragraph 12 deals with the crucial question of the procedure that should be applied in the event of a disagreement between the two institutions. This language, combined with paragraph 9, which acknowledges that the Fund has primary responsibility for aggregate aspects of macroeconomic policies, establishes the principle that the Bank should not go ahead with policy-based lending in circumstances where, in the Fund's view, the macroeconomic framework is inadequate. This is a sensible conclusion, and one that I hope we can all support.

The document--in paragraph 12--suggests that in the event of disagreements, the managements will "want to consult their respective Executive Boards." It would be useful if we established a regular procedure whereby the Board of the institution that has the primary responsibility for the policy area under discussion sends an account of its conclusions to the other Board; that Board can thus take the conclusions into account in framing its decisions. We recently had an example of

communication between the two Boards on the compensation issue, and the experience shows that much remains to be done to improve the procedures.

The other institutional point on which I would lay particular emphasis is discussed in paragraph 15, which states that it should be the responsibility of the managers of both institutions "to seek a resolution of any major differences of view between the institutions before the matter is discussed with the member, and before either staff makes proposals to the member." This is an important recommendation, and it is one that must be implemented properly.

The document rightly recognizes that the Fund and the Bank have overlapping functions and responsibilities and that the best way to approach these is through specialization and the pooling of knowledge and complementary talents. The suggestions for institutional mechanisms to bring this about seem sound, and the procedural proposals in the second half of the document are as sensible as they are overdue.

But obviously deeds, not words, will count in the end. To make these new procedures work, we also need a change in attitudes--a spirit of cooperation not of rivalry--and it will be the key test of management in both institutions to see that this is brought about.

On some of the other specific points in the paper, regular meetings of senior staff and secondments between the two institutions are a good idea, and a regular exchange of information on work plans and calendars will also be useful. I would also particularly commend the idea of having policy framework papers, or something like them, for middle-income countries. The process for policy framework papers has been extremely useful in the countries where it has been applied, and it has done much to improve coordination between the Fund and the Bank. There would seem to be no compelling reason why the process could not be applied to middle-income countries also, and it might be especially useful when countries are going to make more use of longer-term facilities like the extended Fund facility.

The joint task force on the debt strategy will clearly be an early test of coordination between the two institutions, and I am glad to hear that the signs are encouraging, as mentioned by the Chairman.

Let me conclude by commending again the agreement that has been reached, and the hard work that went into it--in particular, the personal contributions made by the Managing Director and the President of the World Bank. The test of those efforts,

of course, will be in future operations. It is essential that the terms of this agreement should be applied properly and in the right spirit.

Mr. Lim made the following statement:

Like other speakers, I welcome the document before us. As we all know, the agreement concluded between the Managing Director and the President of the World Bank is the product of a long and difficult negotiation process. This chair commends the Managing Director's efforts in reaching agreement on the contentious task of defining areas of primary responsibility for each institution; the agreed text, while less than foolproof, nevertheless provides a satisfactory operational basis on which to proceed.

It is clear, as the agreement acknowledges, that the gray area between each institution's areas of primary responsibility has widened appreciably in recent years. In this context, the various proposals set out in paragraphs 14-20 to improve the procedures for the resolution of conflicts are constructive and worthy of support. We are also attracted to the suggestion that, over the longer term, a greater exchange of staff between the two institutions should be encouraged. It may be useful for the staff to provide the Board with a paper reviewing progress on a number of these fronts and reporting on the experience with the improved collaborative procedures, perhaps in time for the Annual Meetings.

In the end, good faith in the interpretation of this agreement by management and staff on both sides of 19th Street will be needed. There is no doubt that scope remains for differing interpretations of the agreed wording in a number of sensitive areas. To give but one example, the reference in paragraph 23, on collaboration in the presence of overdue obligations, to the need for both managements to act in the full "spirit of solidarity" could nevertheless justify a multitude of sins if one institution decided that it knew better than the other institution the other's best interests. The potential for conflict remains if only because, as the agreement recognizes, each is an independent institution. It would be interesting to hear the staff's views on whether, in fact, the difficulties experienced in individual cases would have occurred if this agreement had been in place over the last year or so.

In this regard, the efforts of both institutions over the next few months to develop appropriate responses to the call for greater emphasis on debt reduction in the debt strategy will present an early and important test of the newly reaffirmed

spirit of collaboration. We will watch the operation of the recently established task force with great interest.

However, the agreement correctly acknowledges in paragraphs 24 and 25 that the ultimate responsibility lies with the common shareholders of both institutions. If collaboration is to work effectively at the operational level, it needs to reflect a consistent and clear view on the part of our authorities as to the appropriate areas of responsibility of each institution, and this view needs to be clearly enunciated by each Board.

Mr. Marcel made the following statement:

My authorities are grateful to the Managing Director and to the President of the World Bank for having been able to reach an agreement, which of course was their primary responsibility to do, although the outcome is no less valuable for that. The text represents a compromise which, as such, cannot please everyone in all of its aspects and, as stressed by the Chairman, cannot solve all of the problems. However, it is helpful and paves the way for better and closer coordination between the two institutions in the near future.

I would like to stress why we need closer Bank-Fund collaboration within a clearly defined framework. The debtor countries suffer the most from the lack of collaboration between the Fund and the Bank. Indeed, this issue should not be looked at in terms of power relationships but in terms of what is best for the member countries. Good collaboration helps in the timely design of efficient programs and is the best catalyst for the necessary complementary financing. In this respect, two types of situation must be avoided. One is the occurrence of conflicting policy recommendations during discussions with the authorities, which tends to lengthen negotiations by creating ambiguity; while conflicting policy recommendations arising in the framework of donor groups do not cause as much concern, they nevertheless damage the image of both institutions. The other situation to avoid is one where the World Bank engages in adjustment lending without a parallel Fund program.

The Fund and the Bank had different but complementary missions in the past; to a large extent, they still do. The Fund must help member countries resolve their balance of payments problems; it is the central monetary institution. The World Bank must foster the development of member countries; it is the central developmental institution. However, to cope with the debt crisis, the shareholders have broadened the scope of both institutions. In short, the Fund now has to include structural policies, social consequences, and a growth

perspective in the design of its programs; and 25 percent of the World Bank's loans are for structural and sectoral adjustment.

Incidentally, conflicts between both institutions are fruitful and should not be shied away from. Nonetheless, because of their differing objectives--namely, balance of payments equilibrium and development--it is normal that the institutions would diverge on the sustainable level of investment or on export taxation. A broad dialogue is needed, provided that areas of primary responsibility are clearly defined.

Fund conditionality is established according to specific rules which have been defined by the Board and are reviewed regularly. Bank conditionality, because of the institution's focus on development, does not and cannot rely on such precise definitions, and each loan's conditionality is the result of discussions between staff and management that do not involve the Board. Of course, the Board approves all loans, but the second and third tranches are released without consulting the Board. My authorities cannot stress enough the need to maintain the quality of Fund conditionality. Furthermore, closer Fund-Bank collaboration will enhance Bank conditionality.

With these considerations in mind, we believe that the text before us should be very helpful in avoiding administrative frictions and in facilitating the resolution of differing views. It is important that the primary responsibility of the Fund for macroeconomic policies be recognized--I will not dwell on the differences between aggregate aspects of macroeconomic policies and macroeconomic policies, since this distinction seems somewhat redundant to me. We also attach great importance to the content of paragraph 12; indeed, without such a paragraph, determining the areas of primary responsibility for each institution would be meaningless.

The suggested administrative procedures are useful; however, some flexibility might be needed on the part of each institution, especially in the organization of missions. Such collaboration may be time consuming, and we therefore urge the staffs of both institutions to avoid too much bureaucratization and to be aware that all delays penalize the countries involved.

The establishment of a policy framework paper-like document for middle-income countries, could be useful. However, this matter should be considered further and discussed by the two Boards.

Finally, it is of the utmost importance to have the closest collaboration between the two institutions as regards the implementation of the debt strategy as well as the elimination of overdue obligations.

Mr. Al-Assaf made the following statement:

At the outset, I would like to congratulate the Managing Director for persevering with his efforts to conclude a mutually satisfactory agreement with the President of the World Bank on this most important issue. It was the view of this chair that the two managements were the most qualified to resolve these disagreements. I am glad that prudence has carried the day without compromising the effectiveness or reputation of the Bretton Woods institutions, whose collaboration is crucial to the attainment and maintenance of economic stability and the development of the world economy.

I am pleased that this agreement builds on, rather than supersedes, the foundations laid down more than two decades ago. By and large, the record of collaboration has been a source of pride, and hence merits enhancement rather than dilution. Since division of labor is of the essence, areas of primary responsibility should be respected, while common grounds should be dealt with collaboratively. This is necessary not merely to reduce frictions between the two institutions but also to maximize the efficient utilization of the resources of each institution.

Since the points of disagreement have been resolved after extensive discussions by all concerned, I need not comment on paragraphs 1-12 of the memorandum except to inquire about the procedures to be used by both institutions to make the borrowing countries fully "aware of the responsibility of the institution for policy advice in the areas of its primary responsibility."

As to the paragraphs in the memorandum on procedures for enhanced collaboration, they were unfairly overshadowed in our previous informal discussions by the differences that arose over the earlier paragraphs. The procedures, when implemented, should help to reduce future frictions and substantially improve the quality of the institutions' advice to members. The exchange of information, views, and possibly staff can only make each institution richer in knowledge and wiser in judgment and advice. Hence, I fully support all the measures suggested in this section. However, there may have to be a mechanism to help determine what is a "major issue" that warrants a consultation and an agreement between the Bank and the Fund. Otherwise, difficulties may arise again.

Each institution has the primary responsibility for many issues and problems. Concentrating on these areas, while enhancing collaboration between the two institutions, is the best investment that can be made at this time, and I therefore endorse the memorandum.

Mr. El Kogali made the following statement:

I note the Managing Director's efforts to achieve an understanding on collaboration between the two institutions. As a practical matter, collaboration between the two institutions may be helpful. The appropriate relationship should be determined on the basis of the guidelines for collaboration, in the light of each country's circumstances.

It is essential to underline the obvious fact that the two institutions were established to serve the interests of the member countries. The Fund and the World Bank have separate roles and independent mandates. However, with the evolution of the world economy, which is now very different from what it was when the Bretton Woods conference took place, the areas of the countries' economies covered by the Fund and the Bank have increasingly overlapped. It must therefore be recognized that there is a problem in delineating development matters that should be the primary responsibility of the Bank from balance of payments policies where the Fund has primary responsibility. The purpose of Bank-Fund collaboration should be to render the best professional advice and financial assistance to member countries. There is nothing wrong with different but professionally sound advice. Surely it would be in the best interest of the country authorities to have different professional judgments before reaching their own decision on their structural adjustment program; their judgment should be as important as that of the Fund or the World Bank. As the two institutions collaborate, they must work within their separate mandates; and cross-conditionality of all forms should be avoided so that the programs and disbursements of one institution are not constrained by the other. The general policy issues should reflect fully the country's objectives and priorities as perceived by the authorities.

We see no need to formalize any specific procedure for collaboration. The ad hoc consultations and sharing of professional experience that have taken place should continue as and when necessary. As to improved collaboration to support adjustment programs, the Fund and the World Bank should operate within their respective mandates. In particular, Fund primacy is acknowledged in the areas of the exchange rate, adjustment of balance of payments disequilibria, and stabilization programs, while Bank primacy is acknowledged in development programs and priorities. To the extent that paragraphs 9, 10, 11, and 12 restate this understanding, we fully endorse the need to enhance collaboration. The common ground, or gray area, covering the structure and functioning of institutions, domestic savings, external financing, and debt require a much more sensitive and careful approach to collaboration.

With regard to paragraphs 19 and 20, we see nothing wrong in principle with the two institutions consulting one another before responding to a country's request as long as this does not lead to cross-conditionality.

The serious external debt crisis facing low-income countries falls in the gray area and thus requires the assistance of the Fund and the World Bank working together. We therefore welcome the recommendation in paragraph 22 to establish a joint task force.

With regard to paragraph 23, we hope that the new collaborative approach will soon eliminate the problem of overdue obligations to the Fund and obviate the need for these concerns. Meanwhile, we agree that one institution should consider a country's arrears to the other institution, but only to the extent that they have implications for the country's ability to meet its obligations to the former. In other words, overdue obligations to the other institution should not be used as a punitive tool when one institution is considering a country's request, especially as the financial resources of the two institutions are of a different nature, implying different considerations in their provision.

As we have advocated institutional independence, we support the recommendation in paragraph 24 regarding the institutions' ultimate responsibility. However, we do not see what purpose paragraph 25 serves in light of what has been said in the preceding paragraph on the need to avoid cross-conditionality and the understanding that each institution must proceed according to the standards laid down in its Articles of Agreement and the policies adopted by its Executive Board. Of course, we welcome informal discussions that will help to bring about a convergence of views.

We support paragraph 26, especially with regard to working out an effective strategy for solving the debt problem or mobilizing resources to support a country's adjustment effort.

Secondment of senior professional staff members should be carried out to enrich their experience and to provide a wider appreciation of the problems of development and adjustment.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/49 (4/28/89) and EBM/89/50 (5/3/89).

4. LAO PEOPLE'S DEMOCRATIC REPUBLIC - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1989 ARTICLE XIV CONSULTATION

1. The Fund takes this decision relating to the Lao People's Democratic Republic's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1989 Article XIV consultation with the Lao People's Democratic Republic, in the light of the 1989 Article IV consultation with the Lao People's Democratic Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Lao People's Democratic Republic imposes restrictions on the making of payments and transfers for current international transactions, subject to approval under Article VIII, Section 2(a), in the form of restrictive features under bilateral payments arrangements with Fund members, requirement of prior authorization for invisible payments, and limitations on travel allowances. It also imposes multiple currency practices, subject to approval under Article VIII, Sections 2(a) and 3, arising from a dual exchange rate system and a requirement of margins for the opening of letters of credit. The Fund approves the maintenance of the multiple currency practice arising from the requirement of margins until the completion of the next Article IV consultation with the Lao People's Democratic Republic or April 30, 1990, whichever is earlier, and urges the authorities to remove the other exchange restrictions and multiple currency practice as soon as possible. (SM/89/74, 4/25/89)

Decision No. 9140-(89/50), adopted
May 2, 1989

5. ALGERIA - TECHNICAL ASSISTANCE

In response to requests from the Algerian authorities for technical assistance in the fiscal field, the Executive Board approves the proposals set forth in EBD/89/121 (4/25/89).

Adopted May 1, 1989

6. BHUTAN - TECHNICAL ASSISTANCE

In response to a request from the Managing Director of the Royal Monetary Authority of Bhutan for technical assistance in the banking field, the Executive Board approves the proposal set forth in EBD/89/124 (4/26/89).

Adopted May 1, 1989

7. STAFF COMPENSATION - SALARY STRUCTURE AND 1989 ADJUSTMENT

1. The Executive Board approves the adoption of the salary structure for Grades A1 to B5 set out in Table 10 of EBAP/89/85 (3/30/89) with effect from May 1, 1989.

2. Salary increases averaging 8.8 percent will be granted to Fund staff with effect from May 1, 1989.

3. The cost of the increases under paragraph 2 above is estimated to amount to $14,000,000 for FY 1990, and accordingly appropriations for the Administrative Budget for FY 1990 shall be increased as follows:

Budget Category	Approved Budget	Additional Appropriations	Revised Budget
1. Personnel Expenses:			
A. Salaries	$110,370,000	$8,200,000	$118,570,000
B. Other personnel expenses	51,600,000	5,800,000	57,400,000
		$14,000,000	

The revised FY 1990 Administrative Budget will be $255,820,000. (EBAP/89/85, Sup. 3, 5/1/89; and Cor. 1, 5/16/89)

Adopted May 2, 1989

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 88/161 and 88/162 are approved. (EBD/89/125, 4/26/89)

Adopted May 2, 1989

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/111 (4/27/89), EBAP/89/112 (4/28/89), and EBAP/89/114 (5/1/89) and by Advisors to Executive Directors as set forth in EBAP/89/78, Supplement 1 (4/28/89), EBAP/89/111 (4/27/89), and EBAP/89/112 (4/28/89) is approved.

APPROVED: November 17, 1989

LEO VAN HOUTVEN
Secretary