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Minutes of Executive Board Meeting 89/132

3:00 p.m., October 6, 1989

R. D. Erb, Acting Chairman

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	D. McCormack
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	M. Al-Jasser, Temporary
G. A. Posthumus	M. Eran, Temporary
K. Yamazaki	N. Adachi, Temporary

C. Brachet, Acting Secretary
J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant
M. Primorac, Assistant

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Also Present

IBRD: L. De Wulf, Africa Regional Office. E. Links, Principal Resident Representative for South Africa; M. Grote, Attaché for Finance at the Embassy of South Africa. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; C. P. Andrade, W. J. Byrne, J. R. Hill, J. M. Jiménez, J. Santos. Asian Department: P. R. Narvekar, Director; H. Neiss, Deputy Director; D. A. Citrin, L. D. Dicks-Mireaux, L. M. Koenig, J. Márquez-Ruarte, H. K. Pyo. European Department: K. B. Bercuson, B. J. Smith, J. R. Wein. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, Y. J. Cho, H. Hino, M. R. Kelly, N. Kirmani, A. K. McGuirk. Fiscal Affairs Department: J.-K. Chu, M. Katz, L. Garamfalvy. Legal Department: J. K. Oh, J. V. Surr. Treasurer's Department: D. Williams, Deputy Treasurer. Office in Geneva: J. P. Barnouin. Advisors to Executive Directors: F. E. R. Alfiler, J. Basiuk, M. Eran, Z. Iqbal, J.-L. Menda, P. O. Montórfano, D. Powell, R. Wenzel. Assistants to Executive Directors: H. S. Binay, C. Björklund, S. Chakrabarti, B. A. Christiansen, E. C. Demaestri, A. Y. El Mahdi, M. A. Ghavam, J. Gold, S. Gurumurthi, J. Heywood, L. Hubloue, M. E. F. Jones, K.-H. Kleine, C. Y. Legg, W. K. Parmena, Prince Philippe de Belgique, A. Rieffel, D. Saha, M. J. Shaffrey, C. C. A. van den Berg.

1. SOUTH AFRICA - 1989 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/89/131, 10/6/89) their consideration of the staff report for the 1989 Article IV consultation with South Africa (SM/89/166, 8/9/89; and Cor. 1, 8/10/89). They also had before them a background paper on recent economic developments in South Africa (SM/89/168, 8/15/89; and Sup. 1, 10/4/89).

Mr. Links made the following statement:

The discussion here today will certainly be of help to my authorities in the further formulation of appropriate policy. It has been emphasized by many Executive Directors that South Africa's short- and medium-term outlook is not at all healthy. The authorities are themselves aware of the conditions in the economy and are facing up to the challenges with very deliberate action plans in order to stabilize and restructure the economy. In the past, fiscal and monetary policies were invariably at odds in their effects on the economy, and this is a primary reason for the present state of affairs. But many times it was not the policies themselves that were unsound, but the lack of their rigorous application.

One such policy area that has been referred to by Mr. Monyake and others is inflation. Let me assure you that this is the concern also of the new Governor of the South African Reserve Bank, as is pointed out in my statement, and I quote from his annual statement: "Against this background there is a real danger that any further willingness to accept inflation as a consequence of the need for external adjustment...can only be harmful for sustainable economic growth. In the circumstances, it can no longer be regarded as appropriate to continue to accommodate price increases through large increases in Reserve Bank credit and in the money supply."

However, the recent past has seen a shift, not only in the macroeconomic policy mix, but also in the priorities of the socioeconomic policy applied to deal with the inequities in the South African society resulting from skew and unfortunate sociopolitical choices of the past. If one wants to evaluate the South African economy objectively, it becomes necessary to acknowledge these directional changes in policy, especially those affecting the underlying structure of the economy.

The progress that has recently been made in correcting the skew funding policies in education, housing, health, and social pensions is very encouraging. It is especially gratifying to report to the Board that, after the many questions raised today about the labor market, all remaining statutory discriminatory provisions in the labor market have been scrapped (see page 82 of the background paper), thereby enhancing the geographic and upward mobility of labor irrespective of race. But having removed discriminatory legislation in the labor market, the nonracial employment policies had still to be put into practice. For example, the color bar has now been removed in the mining sector, and the first black holder of a blasting certificate assumed duty as a miner on December 5, 1988. Since then, some 130 black mine workers have gained blasting certificates (see the Corporate Report on the Chamber of Mines, Financial Mail Supplement, September 29, 1989). Let me point out another example, referred to this morning, with respect to education: the education budget comprised 19 percent of the 1989/90 budget, and health 10 percent, as against 16 percent for defense. Furthermore, the education and health budgets are allocated to the various population groups with the aim ultimately to achieve equity for all individuals in the shortest time possible.

Whereas in 1975/76 the budgetary outlays on white education still commanded a 70 percent share of the total vote on education, this has substantially dropped, to 41.6 percent for 1988/89. Outlays on black education have, similarly, experienced a marked reversal. During the 1975/76 financial year, the share of expenditure on black education was a meager 11.5 percent, but this was subsequently increased to 39.6 percent for 1988/89. This in itself is a strong and clear indication that structural reforms are firmly entrenched in our sociopolitical policy matrix, and it needs to be evaluated against the very limited resource base--as outlined in the staff report and in my statement.

In the area of social pensions, it is, for instance, the deliberate policy of the Government to grant the same annual nominal increases in pensions to every person irrespective of race, which should narrow the existing gap in a reasonable time. Here again, the change in the different population groups' percentage share in the social pension vote is quite illuminating. Blacks' share in this particular vote increased from 19.7 percent in 1975/76 to 49.4 percent in 1988/89, whereas outlays on whites dropped from 53.6 percent to 22.7 percent for the same two years, respectively.

These strides in correcting existing imbalances in the field of socioeconomic expenditures, which to some might not be of major importance, must however be seen in the proper context. South Africa is a developing country, and its latest achievements in structural adjustment must be compared with the rest of Africa. In this regard, I would like to quote, for example, the so-called physical quality of life index (PQLI) for South Africa in relation to 56 countries on the African continent and its surrounding island states. The PQLI, with ratings from 1-100, is derived from the adult literacy rate, infant mortality rate, and life expectancy at one year of age. It was developed in the

1970s for the Overseas Development Council as a measure of the extent to which basic human needs are being met in a society. As early as 1980-82, South Africa was ranked third with an index rating of 75, after Mauritius and the Seychelles with index ratings of 84 and 79, respectively.

The background paper also points to other social areas of concern that this Board has questioned this morning in particular, but also over a number of years. Examples like the scrapping of job reservations, the scrapping of required licenses to conduct business of an informal nature, the opening of free trade zones, free settlement areas, the right to own land, increased labor mobility, and legalized black trade unions all seem part of normal economic life, yet these changes affected the lives of millions of people and again represent great strides toward fully normalizing economic activity within South Africa over the recent past, re-emphasizing the return in South Africa to the neglected virtues of an unfettered market economy.

But, as Mr. Monyake said, we are still far away from catching up with the backlog, let alone coping with the increased pressures in the social areas, and this is frightening. The remaining problems that the authorities have to face, having recently embarked upon this new course of socioeconomic structural adjustment, have shifted from the political sphere of convincing the electorate of the need for reform or to move from the status quo, to the serious economic problem of how to fund these adjustments with scarce internal resources, as was pointed out by Mr. Dawson. Allow me to point out a few of these glaring problem areas.

First, the pressures for equal access to education have been explosive in their growth, especially in the case of the black population. Whereas there were just under 50,000 (20 percent of the total) black post-high school students in 1980, there will be 550,000 (81 percent of total) in 1990 and this figure will even double by the turn of the century. The exponential growth in terms of physical needs and teaching is overwhelming.

Second, with population growth still at 2.7 percent, the strain on resources to provide medical care is growing faster than the economic resources.

Third, the scrapping of influx control in 1986, which is to be lauded, brought a surge of people to the cities in search of a living wage and a better standard of living, which added to the pressures on the social services in the cities. Consequently, South Africa has become the country with the highest rate of urbanization in Africa, making the pressures or urban renewal and development in the next decade huge. It is estimated that 250,000 houses will have to be built each year until 2010 to meet the backlog and keep up with the population increase. Some of the solutions for this problem are sought in speeding up the provision of serviced land; encouragement of self-help housing; permission for informal settlement; and squatter upgrading. Also, sales of government-owned stock of black housing are now beginning to be substantial, and mortgages are being granted to blacks at the rate of more than R 100 million per month. The building of houses for sale to blacks by the private sector has increased tenfold since 1985.

Coping with all these demands has not been easy. What is sometimes not appreciated fully is that political reforms have economic and financial implications. It goes without saying that in South Africa, at least, reform cannot be successful unless it is supported by an expanding economy. Although some of the liberalization has a positive effect on the economy, others have overstrained the resources. It is in this regard that the normalizing of South African society, which is the wish of everyone here and surely the ultimate goal of the Government, is predicated on substantial economic opportunity and growth.

But, it was also mentioned that South Africa's internal economic policies have spillover effects in the region. We are aware of this, and the South African Minister of Finance has again, at last week's Annual Meetings, stressed the Government's willingness to cooperate on a bilateral and multilateral basis in the region. In fact, there are various avenues through which South Africa has already moved steadily in extending its linkage with the economies of the region. Not only in the fields of transport, but in other areas like research and education, South Africa has expertise to share. Why is it that, in the field of transport alone, South African Transport Services handled more than 4.3 million tons of goods for neighboring countries last year and that there are about 12,000 units of rolling stock on the lines of their railways?

But it is especially in the area of electrification that South Africa has for a while now realized that it needs to develop good links with its neighbors. The South African Electricity Supply Commission (ESCOM), with its resources and its technical know-how, already produces 60 percent of Africa's electricity and could assist neighboring states in their utilization of their own energy resources.

Although South Africa at present provides its own energy needs, and is an energy exporter, there would be distinct advantages for us in helping neighboring states to develop their own energy resources and then buying their surplus energy, thus proving them with valuable foreign exchange.

These and other examples of regional cooperation would go a long way toward addressing the ills of the region while at the same time assisting growth in South Africa to cope with the demands of the future, as outlined earlier.

To cope with the stated challenges in the domestic economy as well as that of a regional nature, South Africa realizes that the ball is in its court. We cannot, however, quickly undo the past, any more than we can quickly relieve or surmount international pressures and restraints on growth.

In addition to our own concerted efforts, we do, however, want to solicit the support of those outside South Africa, including this Board, that have an interest in seeing the problems of the country and the region resolved in the best possible manner.

I conclude my statement hoping that this Board will appreciate the difficult position South Africa finds itself in and I assure the Board that we will do our utmost in resolving the outstanding issues speedily.

The Acting Chairman then made the following summing up:

Directors had praise for the frank and illustrative analysis provided in the staff report and were in general agreement with the staff appraisal. Directors noted that economic activity had been sustained during the past year. Despite a tightening of policies, though, excess demand pressures had intensified. As a result, already high inflation had recently tended to increase, becoming dangerously embedded in the economic system, while the external current account surplus, needed to finance sustained capital outflows, had declined. The exchange rate and international reserves position had come under downward pressure.

Directors observed that the authorities were faced with the need to reduce pressures on prices and the balance of payments, while unlocking the potential for growth and employment creation of an economy beset by regulatory distortions. Directors were of the opinion that overcoming the immediate difficulties and improving economic prospects over the medium term required both a strengthening of macroeconomic policies and the introduction of basic structural reforms. More fundamentally, vigorous action to eliminate the system of apartheid was considered to be the key to durably improved economic performance. Directors expressed the hope that the newly elected Government would take the needed initiatives.

Directors noted the policy actions taken since early 1988 to cool the economy. There were early indications that demand growth was beginning to slacken. At the same time, it remained unclear whether the slowdown was developing quickly enough to ensure that the current account surplus would remain large enough to fund expected capital outflows without intensifying inflationary pressures. Directors stressed that the authorities should not hesitate to tighten monetary policy further if excess demand pressures persisted.

Directors believed that fiscal policy should also play a stronger role in alleviating demand pressures and setting the stage for an improvement over the medium term in the growth potential of South Africa. In that connection, Directors considered that the authorities' goal of reducing the budget deficit to 3 percent of GDP could be more ambitious. They noted that the 1989/90 budget provided for a broadly unchanged deficit, and suggested that the Government should aim at making a significant positive contribution to national saving in order to offset at least part of the fall in overall saving and investment that had been observed in recent years. The reduction in the budget deficit should come primarily from the expenditure side through efforts to contain inefficient spending, including, for example, reductions in the large and overlapping government structure and bureaucracy. At the same time, Directors agreed that increased efforts were in order to address the urgent educational, housing, and welfare needs of the poorest segments of the community. In that context, Directors generally agreed that a broadening of the revenue base was needed. The planned introduction of a VAT in 1991 was thus warranted, although concern was expressed about its distributive effect in the absence of other measures.

South Africa's racial policies were, Directors noted, at the heart of many of the country's economic problems, including a severe balance of payments constraint and the inability of output to grow at its true potential rate. It was stressed in this respect that structural adjustment measures should address the root causes and not the symptoms of South Africa's severe economic difficulties. The staff's reports had documented progress in recent years in partly dismantling the web of restrictions impeding economic opportunities and growth in the black community. Substantive further efforts, however, were needed, in particular, to eliminate present rigidities in the labor market--an area where, it was acknowledged, some headway was being made; to improve income distribution; and to increase the supply of skilled labor, especially through a more focused provision of education.

Directors considered that a number of other rigidities in the South African economy, including those resulting from the regulatory environment, which had become even more extensive recently, also ought to be addressed. The import surcharge and export assistance schemes were additional sources of distortions. Some Directors also expressed concern at the adverse impact of the policies followed by South Africa on neighboring countries.

Directors renewed previous requests for the authorities to make available more detailed underlying statistics, including, for example, on energy imports and consumption, and on employment and unemployment.

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

2. <u>KOREA - 1989 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1989 Article IV consultation with Korea (SM/89/194, 9/12/89). They also had before them a background paper on recent economic developments in Korea (SM/89/196, 9/20/89; and Sup. 1, 9/27/89).

Mr. Kwon made the following statement:

I convey to the staff my Korean authorities' gratitude for a well written, high quality paper. They attach great importance to the regular policy dialogue with the staff and are in broad agreement with the thrust of the staff appraisal.

As the staff report rightly points out, while growth has been impressive in recent years, the challenge now confronting the Korean economy is to achieve a better balanced and, hence, more sustainable pace of activity.

Since 1987, economic policy has focused on exchange rate adjustments aimed at correcting the external surplus, supported by the pursuit of appropriate demand-management policies and structural reforms in all sectors of the economy. The vigorous implementation of these ambitious adjustment policies has been accompanied by a significant political shift in favor of greater democratization.

A substantial exchange rate adjustment has been achieved. Between May 1988 (the date of the 1988 Article IV consultation) and end-July this year, the won appreciated by 18 percent in real effective terms, reflecting a 17 percent appreciation in the nominal effective exchange rate (in effect, a return to pre-Plaza Accord levels). Significant increases in nominal wages in excess of productivity gains, driven in large part by widespread industrial unrest, have further eroded Korea's earlier gains in international competitiveness.

Substantial progress has also been made in the area of structural reform. One remarkable achievement was the elimination of all remaining restrictions on current payments in the context of Korea's acceptance of the obligations of Article VIII, effective November 1, 1988. The process of trade liberalization has also been intensified, and, with regard to capital transactions, the authorities have announced a plan to gradually internationalize the Korean stock market, with improved access for foreign investors by 1992, while also adopting measures to ease and simplify procedures on overseas direct investment by Korean residents. Financial sector policies have emphasized the need for progressive deregulation of interest rates, while relying more on indirect control over monetary aggregates.

On the fiscal side, the authorities undertook in January 1989 the first stage of a tax reform program designed to increase the equity and neutrality of the tax system. This reform included an increase in basic exemptions from individual income taxes, a shift to a more progressive rate scale, reductions in excise taxes, and the abolition of several corporate tax deductions and exemptions.

More recently, the authorities have undertaken an in-depth study of the exchange rate arrangements, and have concluded that these should be modified, where appropriate, to allow the exchange rate to better reflect market forces. On September 20, as a first step toward the development of a more active domestic foreign exchange market (considered a necessary precondition for adapting the existing exchange regime), the authorities liberalized commercial banks' selling and buying rates based on the Bank of Korea's benchmark rate. Depending on circumstances at the time, the authorities hope to be able to introduce, some time next year, a new benchmark rate based on the weighted average of interbank rates.

These adjustment policies, combined with the effect of prolonged labor disputation, have resulted in a significant slowing of economic activity and a sharp reduction in the external surplus.

Sluggish export performance--reflecting, inter alia, exchange rate developments--contributed to a marked slowdown in output growth in the first half of 1989, although GNP remained 6.5 percent above the corresponding period of 1988. Taking into account some anticipated seasonal pickup in activity in the second half of the year, output growth for 1989 as a whole is expected to be around 6-7 percent.

Meanwhile, the current account deficit of $140 million in August was the first such monthly deficit since February 1986. The cumulative surplus of $2.7 billion for the first eight months of the year represents a reduction of $5.2 billion compared with the same period of 1988, largely reflecting developments in the balance of trade.

Taking into account normal seasonal patterns, these developments appear broadly consistent with the staff's full year estimate of $6.2 billion--compared with $14.2 billion for 1988.

Since the completion of the Article IV consultation discussions in July, my authorities have finalized the 1990 budget and submitted it to the National Assembly for approval, together with a supplementary budget for 1989. The National Assembly is due to consider both proposed budgets by early December 1989.

The proposed supplementary budget for 1989 aims at addressing many of the unexpected social demands that have emerged as a result of the changing political and social environment. It involves increased expenditures of 14.7 percent for the General Account--largely on account of increased support for low-income housing projects, structural adjustment measures for medium- and small-size industries, and local government primary and secondary education expenditures--and a further 27.7 percent for the special accounts of the Central Government. Excess 1988 revenue collection will be used to fully fund the supplementary budget, allowing the overall deficit to remain around 0.8 percent of GNP for 1989.

The FY 1990 general budget assumes real GNP growth of 7.5 percent, alongside a continuing current account surplus of around $7 billion. It envisages an increase of 19.7 percent in expenditures as compared with the FY 1989 original budget (or 4.4 percent compared with the proposed FY 1989 supplementary budget), while preserving the ratio of expenditures to GNP at a relatively modest 15.1 percent.

Recent Budgetary Trends

	1982	1983	1984	1985	1986	1987	1990
Outlays growth (%)	16.1	8.8	11.2	14.5	14.1	4.3 (19.6)	19.7 (4.4)
Outlays/GNP	17.6	15.8	15.2	15.0	14.6	14.0 (16.1)	15.1
Tax/GNP	18.2	17.2	17.0	17.6	18.3	18.2	17.6

Note: Figures in parentheses include FY 1989 supplementary budget.

Increases in tax revenues are expected to largely offset the growth in expenditures, notwithstanding anticipated revenue losses resulting from tax reforms implemented in 1988 and 1989. No change is therefore expected in the size of the 1990 general budget deficit as a share of GNP, i.e., about 0.8 percent.

The 1990 budget has been designed to meet underlying socioeconomic objectives; reduce social and economic disparities among sectors and regions; improve the stock of human capital and social infrastructure; enhance the quality of life and social equity; and support the transition toward a more open and market-oriented economy. Together with the 1989 supplementary budget, it should provide some further stimulus for economic activity without adding to inflationary pressures.

The Korean economy is undergoing perhaps one of the most rapid periods of adjustment in recent world economic history. My authorities fully appreciate the necessity of pursuing a more sustainable and better balanced path of economic growth, and of restructuring the economy to meet the changing environment. Nevertheless, this process involves serious social and economic tensions.

The recent downturn in economic activity has rekindled popular fears that the economy may be heading toward a period of stagflation, similar to that experienced during the early 1980s. There remains considerable uncertainty regarding the outlook for wages and domestic inflation. In these circumstances, my authorities are inclined to adhere to the current prudent policy stance, while closely monitoring economic developments.

Fiscal and monetary policies will continue to be geared to the task of controlling inflationary pressures while ensuring adequate liquidity to preserve a sustainable level of economic activity. Appropriate demand management, supported by a flexible exchange rate policy, will continue to help bring about the necessary adjustment of the external account. Nevertheless, given the Korean economy's vulnerability to external shocks, my authorities believe that maintaining a reasonable surplus on the current account will remain a prudent policy objective for the foreseeable future.

In this connection, my authorities are in full agreement with the staff's view that, given the magnitude of the adjustment already achieved and in prospect, further appreciation of the currency does not seem required at this point. They also welcome the staff's recommendation that, in the near term, the nominal value of the won be kept stable in terms of a basket of trading partners' currencies. I should also emphasize that my authorities remain fully committed to a continuing agenda of structural reforms, including market-opening efforts, consistent with medium-term policy objectives.

As to the staff's medium-term forecasts, my authorities consider the baseline scenario to be broadly in line with the economic objectives envisaged in the Sixth Economic Development Plan.

The staff report contains the explicit judgment that Korea's remaining import restrictions cannot be justified on balance of payments grounds--no doubt, a reference to the GATT balance of payments consultation for Korea scheduled for late October.

While I generally welcome the clear expression of staff views in Article IV staff reports, there is a need for caution when those views impinge on relationships between the Fund and other institutions, such as the GATT. It is the Fund's view that must be conveyed to the GATT, and that view can be determined only by the Executive Board. The prior circulation of staff views--and the staff report is widely circulated among member countries--can be expected to prejudice GATT discussions, particularly should that view not be endorsed by the Board. There is a related issue of equal treatment of all members; I believe that there is no precedent for the approach adopted in this report. These are procedural issues, which should be carefully considered if not by the Executive Board, then by the CGATT.

The procedural issues aside, my Korean authorities are fully aware that the removal of the remaining import restrictions on agricultural products is in the long-term interest of the Korean economy. This will, however, need to be done at a pace that recognizes political realities and the structural problems confronting the agricultural sector. It will also need to avoid undue hardship for low-income farmers. My authorities would expect such relevant concerns to be taken into account and properly reflected when the Fund presents its view to the GATT.

Mr. Yamazaki made the following statement:

We welcome this opportunity to look into the excellent performance and successful adjustment of the Korean economy. Over the past decade, Korea was one of the most heavily indebted countries in the world, and priority had to be given as a matter of course to external debt management. However, the impressive turnaround of the economy has dramatically changed the economic and political circumstances surrounding the Korean economy. The challenges now facing the economy are quite different from those of a few years ago. Needless to say, Korea's success is due in part to the Fund's assistance in the form of a series of stand-by arrangements. Korea has also benefited from the spillover effect of the intensified policy coordination among major industrial countries. However, the authorities must also be given major credit for their accomplishments. Thus, as this chair reiterated on previous occasions, Korea should not be overburdened because of its successful management of the economy.

It is also true that the authorities' future task will be not only to sustain Korea's excellent economic performance, but also to contribute to the further development of the world economy, since Korea will continue to take advantage of sustained world economic growth. In this context, we are very much encouraged by Chairman Lee's speech at the 1989 Annual Meeting, in which he reiterated Korea's commitment to discharge its international responsibilities to the best of its ability. We also welcome Korea's acceptance of the obligations of Article VIII as evidence of that commitment.

Korea now faces medium-term challenges and short-run risks. As to the latter, high capacity utilization, coupled with substantial wage settlements, led to increasing inflationary pressures in 1988. However, the policy measures taken by the authorities to reduce foreign balances have alleviated these pressures, and the risk of inflation has been successfully contained. However, since the surplus on the current account exceeds the nonmonetary capital outflows and domestic demand remains robust, the authorities should take a cautious stance in monetary policy. As the staff suggests, it would be appropriate to bring monetary expansion to the lower part of the target range.

On the other hand, there is a perceived risk of a stall in economic activity due to the sharp decline in foreign balances. Thus, fiscal and financial policies have to be geared to a moderately accommodative stance. However, excessive stimulus might rekindle inflationary pressure and lead to a renewed wage-price spiral. The authorities are therefore encouraged to make efforts on the supply side rather than on the demand side. While we welcome the progress made by the authorities in expanding market mechanisms in the economy, we see considerable scope for further actions. In particular, various tax incentives, as well as regulations, might have impeded the appropriate allocation of resources. Bolder actions, including a larger privatization program, might be essential. The authorities should also streamline the financial market expeditiously.

As to the medium-term challenges facing the authorities, external adjustment clearly remains the major challenge. The efforts made by the authorities have brought the economy onto a path of sustainable growth. The medium-term projections prepared by the staff seem to validate the effectiveness of the authorities' present policies. According to the baseline scenario, the impressive negative contribution of the foreign balances in 1989 would be transitional and the economy would record balanced growth thereafter. Needless to say, there are downward risks, which are illustrated in the alternative scenario. I have nothing to add to the staff paper on this point. On the contrary, I would like to make some sanguine arguments. A further strengthening of the economy would facilitate its structural transformation. The reallocation of production plants overseas, as well as changes in import patterns, might give further impetus to external adjustment. However, in order for such an optimistic scenario to materialize, the authorities should continue to make efforts to liberalize trade. In addition, we encourage the authorities to accelerate the liberalization of exchange transactions. The increasing capital outflows--direct investment and portfolio investment--would undoubtedly contribute to further adjusting the economy, as well as stabilizing the currency. On a related topic, the authorities are encouraged to rely on general policy instruments rather than to focus on addressing bilateral imbalances through specific discriminatory measures such as diversifying or switching the sources of imports.

Since I tend to be optimistic about external adjustment, I endorse the staff's recommendation on exchange rate management in the short run. Past experience shows a relatively long-term lagged effect of currency adjustment on the trade account. In our view, the significant exchange rate adjustment that has already taken place will continue to have an effect. In this connection, we would welcome the staff's comments on the magnitude of the J-curve effect that must have taken place last year and early this year. However, I do not mean to play down the importance of external adjustment in Korea. Therefore, we urge the authorities to monitor the situation of the external balances carefully, without pre-empting a target for the current account surplus, simply because we believe that it is difficult to determine the sustainable level of balance of payments, which, in any event, can easily change.

In brief, the authorities are to be commended for their truly excellent adjustment efforts. The present policy stance points to the right direction for future successful adjustment. We encourage the authorities to continue to adopt outward-looking policies.

I wish to put several questions to the staff in order to have a better understanding of the success of the Korean economy. First, we are impressed by the rapid increase in private savings, which are now at a high level. The supplement to the background paper provides a helpful background explanation of the recent rise in private savings. However, we would be interested in further comments from the staff. In particular, the staff may wish to comment on projections on the future trend in private savings; the staff attributes the rise in the savings rate to the rapid increase in household income during 1986-88. Moreover, since the figures on private savings in Table III of the Appendix to the background paper include public enterprises, and the real activities of the private sector are blurred, we would like the staff to present the figures for private savings excluding public enterprises. We also wonder whether the typical life-cycle model works in an economy like Korea's, where a household typically consists of several generations; we recognize that the coefficient of the ratio of population aged 15-64 to the total population was statistically significant in Table I of the Appendix to SM/89/196, Supplement 1.

Second, there is a relatively large discrepancy between GNP by expenditure and GNP by industrial origin. We would appreciate the staff or Mr. Kwon's explanation of the background.

Third, Korea's competitive position, as measured by relative export unit values, has shown less variation than when measured by other indices. We wonder whether there is a time lag between the measure of relative export unit values and relative consumer prices or relative unit labor costs. We would welcome the staff or Mr. Kwon's comments on this point.

Mr. Dawson made the following statement:

I agree with Mr. Yamazaki's comments to the effect that the performance of the Korean economy is both a tribute to economic policies of the Korean authorities themselves as well as a testimony to the benefits that can be gained from close collaboration between the Fund and individual countries.

At the previous Article IV discussion with Korea, this chair expressed strong concerns about the Korean economy in three areas: exchange rate policy; fiscal policy and domestic savings; and trade policy. Since then, there have been considerable changes in the Korean economy. While my authorities continue to have concerns about the same areas, current trends clearly are pointing in the right direction, namely, toward a more sustainable external balance.

Welcome changes in fiscal policy over the past year are reflected in the shift back to an overall budget deficit this year. In particular, we welcome the tax cuts and tariff reductions. We also welcome the inauguration of new social security programs.

I note that the staff has reservations about the adoption of a supplemental budget this year; but we do not entirely share these reservations. As pointed out in Mr. Kwon's opening statement, the supplemental budget is fully funded by excess 1988 revenues.

I also note that the Sixth Plan envisages an increase in tax revenues on the order of 2-3 percent of GDP. It is not clear to me that this outlook is consistent with the overall objective of reducing the role of the public sector and bringing domestic savings down to a more sustainable level. I would appreciate comments from the staff or Mr. Kwon on this matter.

I believe that the current monetary policy stance is appropriate. We are less concerned than the staff about the target range for M2 growth. We welcome the elimination of direct credit controls at the end of 1988 and we would appreciate having the views of the staff and Mr. Kwon on prospects for terminating controls that were reimposed at the beginning of 1989.

The staff discussion on the external accounts refers to the projected drop in the current account surpluses in 1989 and 1990 as "worsening" of the external balance. It may be more appropriate to view this trend as an "improvement." My authorities view the surplus of $6 billion this year as still large for a country with a standard of living as moderate as Korea's. Of even greater concern is the reference in Mr. Kwon's statement to the 1990 surplus rising to $7 billion compared with the staff projection of a deficit declining to $5 billion. We would appreciate a reconciliation of those figures.

The staff has recommended that the nominal effective exchange rate should be kept stable over the near term. We are not comfortable with this position; some further appreciation may have to be considered. As the staff points out, larger surpluses will tend to exacerbate trade tensions, as we all know too well.

We are especially interested in the reference by Mr. Kwon to the work of a governmental task force on reform of the exchange rate system. We are pleased that the authorities have already concluded, on the basis of work completed so far, that the system should be more market determined, and that modest steps in this direction have already been taken. We also believe that the system should probably involve a looser link to the U.S. dollar. I would appreciate having the views of the staff and Mr. Kwon on this matter.

In the area of structural policies, the first stage of tax reform is welcome, and we urge the authorities to accelerate the subsequent stages.

We also welcome the limited steps taken since the end of last year to decontrol interest rates and begin the process of liberalizing the equities market. We agree with the staff that there remains considerable scope for liberalizing domestic financial markets and external capital transactions. But appropriate recognition of this by the Korean authorities would be appreciated.

We continue to place importance on privatization of public enterprises.

The second five-year tariff reduction program is welcome, but the authorities should implement this program at a faster pace. We fully agree with the staff that remaining restrictions on agricultural imports constitute substantial distortions and should be phased out rapidly.

In addition, we fully endorse the staff's view that quantitative import restrictions maintained by Korea cannot be justified for balance of payments reasons. We hope that the staff paper submitted to the GATT Balance of Payments Committee will present this conclusion in the clearest possible terms. We strongly encourage the Korean authorities to "disinvoke" the balance of payments justification when they meet with the GATT Committee later this month.

We agree with the staff that the medium-term target for the current account of a 2-3 percent surplus relative to GNP is on the high side. Can the staff confirm our understanding that maintaining this target would make Korea a net creditor before the end of 1990? Given the current standard of living in Korea, it is hard to understand the rationale for using resources to finance growth outside of Korea.

I have not commented explicitly on the additional material provided in the supplement, but I appreciate having this information and encourage the staff to explore in depth similar issues during next year's consultation. It will perhaps be particularly useful to examine agricultural policies in greater detail.

Mr. Grosche made the following statement:

I commend the authorities for the way they managed the economy in times of fundamental change toward a more democratic society and a more open and market-oriented economy. The appreciation of the won and the comprehensive program of trade and domestic market liberalization have set in motion a welcome correction in the external accounts. The sharp decline in external demand together with a skillful use of fiscal and monetary policies assisted the authorities in containing inflation.

We congratulate the authorities for their market-opening efforts. Together with the other measures taken to reduce the current account surplus they will also contribute to forestalling an escalation of international trade tensions. Lately, Korea has done quite a bit to foster an open multilateral trading system. In addition, we expect that Korea would not continue now to justify remaining import restrictions on balance of payments grounds. This discontinuation would have a welcome side effect for the Fund, relieving it from the need to make statements on this issue to the GATT.

In my capacity as Chairman of the Board Committee on Liaison with the CONTRACTING PARTIES to the GATT, I wish to comment briefly on Mr. Kwon's statement. On the last page of his statement, he questions the inclusion in the staff report of the staff's view that Korea's import restrictions can no longer be justified on balance of payments grounds. I fully agree with Mr. Kwon that it is the Fund's view that must be conveyed to the GATT, and that this view can only be determined by at least a majority of Directors in this Board. However, the purpose of the staff report is to lay down the issues--not only this type of issue, but also other policy issues as well--for proper Board consideration. The Board certainly is free to accept, modify, or reject the staff's view as it sees fit. Mr. Kwon sees the danger that the staff report, circulated among member countries, might prejudice GATT discussions, particularly should the staff view not be endorsed by the Board. I acknowledge that he has a point here, and that care has to be taken in formulating the staff report. In this particular case, however, the staff was explicitly asked by the CGATT in June to consult the authorities in the context of the Article IV consultation discussions on the Fund's preliminary view that import restrictions can no longer be justified on balance of payments grounds, and to come up with a clear position in the staff appraisal. By the way, in June, the CGATT and the Board authorized the Fund representative in Geneva to make the preliminary view of the Fund on this issue known to the respective GATT body, and I believe that no one will be surprised to learn from the staff report how the staff has maintained the view of the Fund.

I checked whether there have been precedents for the staff to present similarly strong positions on this issue. I was told that the staff reports for both Japan in 1963 and Spain in 1973 expressed a quite explicit view that restrictions for balance of payments reasons were no longer justified. I should add that in the past few decades a member in a strong balance of payments position has only very infrequently continued to invoke GATT provisions to justify restrictions on balance of payments grounds; hence, the opportunity for the Fund or the Fund staff to express a view of no balance of payments justification has not arisen recently.

Regarding procedural issues related to GATT and equal treatment of all members, the CGATT, at its June meeting, asked the staff to look into the issues and to come up with procedures to better ensure that the staff will undertake consultations with the authorities prior to making statements in staff reports. I received a note from the staff on procedures, which I will distribute shortly. In sum, I believe that, after having discussed the issue, the treatment in this particular case was consistent with the results of the discussion of the CGATT in June.

As to economic policies in Korea, I am in broad agreement with the staff's concise analysis and economic policy recommendations. No doubt, Korea is going through a difficult phase of adjustment. The key policy issue now is to strike a balance between the need to maintain a healthy expansion of domestic demand and the need to contain price pressures. The authorities are moving in the right direction. No drastic action seems to be required. Stop-and-go policies should be avoided. A steady hand is warranted particularly in view of the many uncertainties about the economic prospects in the near term.

Against this background, I endorse the staff's call for caution against switching to an overly expansive fiscal policy. I share the authorities' concern for the welfare of their population, and I do recognize the need for a wider dispersion of the benefits of Korea's rapid growth. But a tangible fiscal demand impulse could increase inflationary pressures and trigger higher wage demands. I am afraid that the supplementary budget recently submitted to the National Assembly for approval adds too big a boost to expenditure, increasing total outlays by 2.1 percent of GNP.

The projected growth rate of 7-7.5 percent in the baseline scenario is quite respectable. As to the social objectives, care should be taken first to avoid inefficient resource allocation. The budget should not be overburdened with welfare expenditure items that generally limit the flexibility of fiscal policy. The budget should and cannot bear the whole burden of correcting income disparities. I, therefore, admire the Government's boldness in supporting revolutionary tax and land reform steps in the National Assembly that should fundamentally alter the country's internal economic status, reduce social instability, and prevent the wealth gap from widening--all this without much affecting the expenditure side of the budget.

As to monetary policy, I endorse the staff's recommendation to aim at the lower end of the target range for monetary expansion. Indeed, I wonder whether monetary policy should not be more ambitious, given the projected rates for GDP growth and the GDP deflator. More generally, however, it appears that monetary policy has been quite successful in sterilizing the monetary impact of the external surplus, although at a cost for the country's financial institutions. In this connection, the authorities' intention to continue their efforts to develop the financial sector and to further liberalize interest and exchange rates is welcome.

As to the latter, I find myself closer to Mr. Dawson than to the staff, who finds that, at this stage of the adjustment process, no further appreciation appears to be necessary. In our view, exchange rate policy should continue to underpin the adjustment process, if necessary. The adequacy of exchange rate policy, therefore, should be monitored closely. In any event, a devaluation to counter a slowing down of economic activity would not constitute an appropriate policy response, given the need to contain inflation and to foster external adjustment.

With respect to the external adjustment, I, too, wonder about the appropriateness of the authorities' medium-term current account target. The pursuit of such a target might actually hinder the further opening up of the economy to foreign competition and Korea's full integration into the international trade system. The authorities' impressive record of adjustment, as reflected in the significant improvements in the fundamentals, particularly the external debt situation, should encourage the authorities to remove the remaining trade restrictions and fully liberalize exchange rate policy.

In conclusion, I endorse the staff appraisal and wish to express my admiration for the authorities' successful economic policies.

Mr. Enoch made the following statement:

As previous speakers have noted, the performance of the Korean economy over the past year has been very satisfactory, as the authorities have successfully implemented a far-reaching--and perhaps unique--adjustment program. The authorities' achievements appear all the more remarkable when one considers the range of their objectives, namely, to reduce the rate of growth of demand and the country's large current account surplus, while increasing social expenditures.

That these sometimes conflicting objectives have simultaneously been met owes a great deal to the central role that the exchange rate has played in the adjustment process. In particular, the authorities' decision to allow an appreciation of the won has induced a sharp reduction in Korea's external surplus and has permitted a shift in the composition of demand away from net exports within the context of a more sustainable overall rate of growth. The authorities' exchange rate policy has also reinforced the impact of macroeconomic tools at a time when inflationary pressures have been increasing. The fact that, during this difficult transitional phase, real per capita incomes have once again grown strongly further underlines both the impressive resilience of the Korean economy and the authorities' judicious and skillful economic management.

There are now two main issues facing the authorities. First, has the danger of overheating been successfully removed? Second, how can the authorities' medium-term objectives best be realized?

As to the near-term situation, I share the staff's view that there is considerable uncertainty at present about the extent of the recent economic slowdown. It is not clear whether the fall in GDP growth this year has been due to a reduction in demand or to the short-term disruption to supply caused by the widespread labor unrest at the start of the year. The staff estimates that manufacturing production was reduced by roughly 8 percent in the first five months of the year through the direct effect of the strikes. In contrast, the staff projects growth in the second half of 1989 of 9 percent at an annual rate. The projections of 5-6 percent for this year as a whole and 7 percent next year are not evidence of a dramatic slowdown. Indeed, the most recent statistics issued by the Korean Economic Planning Board revealed that leading economic indicators rose 1.8 percent in August from July, indicating a clear revival in the momentum of growth.

A cause for concern for Korea in this context is the very high level of wage settlements. Negotiated wage settlements in the manufacturing sector were running at 19 percent in June, significantly higher than the increases seen in mid-1988. It is difficult to see how wage increases of this magnitude can be reconciled with the authorities' inflation forecast for 1989, particularly given the current tightness in the labor market, reflected in the very low rate of unemployment. Further appreciation of the won might be helpful in seeking to contain these inflationary pressures. Certainly, any depreciation could be extremely damaging in terms of validating wage increases and setting the stage for a further round of claims.

A third cause for concern in present circumstances is the accommodating stance of both fiscal and monetary policies. After the fiscal surplus recorded in 1988, the authorities have slackened the reins in the current year with a fiscal stimulus amounting to 1.5 percent of GNP. In addition, a supplementary budget, containing further expansionary measures, is now under consideration. Given the uncertainty surrounding the extent of the current slowdown, the authorities might be well advised to avoid any further relaxation of policy at this stage. Indeed, the stimulus already seen may prove to have been excessive. For example, given the strong recovery in investment spending in the second quarter of this year, the authorities' decision in June 1989 to introduce a temporary tax credit for investment might have been unnecessary.

Monetary policy may well also have been too accommodating, although to some extent this can be attributed to the weakness of monetary instruments. In particular, it has proved very difficult to sterilize fully the monetary impact of the surplus on the balance of payments. As a result, broad money growth has remained high despite the recent strength of the public finances. The current M2 target range already looks to be more accommodating than was originally intended. And, while the staff recommends that the authorities should seek to keep the growth in M2 down toward the lower end of this target range, I understand that the Minister of Finance recently announced his intention to allow monetary growth to fluctuate at the higher end, between 16-22 percent.

I would be interested to know whether the staff has considered how monetary policy could be strengthened in Korea.

Presumably, as long as the authorities continue to aim for a surplus on the current account, the problems of sterilizing external flows will remain. Does this suggest that it might be prudent for the authorities to aim for a fiscal surplus over the medium term, or, alternatively, to keep the growth in bank credit to the private sector below the rate of growth of the economy? Over the medium term, it should be possible to increase the leverage of interest rate policy and open-market operations by strengthening the competitiveness of the banking sector and deregulating the primary bond market. In addition, it might make sense for the authorities to issue bonds of differing maturities; at present, it seems that nearly all government paper carries a maturity of just one year.

Looking more generally at the authorities' medium-term objectives, it is encouraging to note that they remain strongly committed to the achievement of price stability. However, it is not clear in what time frame this objective is to be met. And, as I have suggested, it is possible that, in the absence of well-developed financial markets, the goal of price stability may not be compatible with the authorities' desire to maintain a surplus on the current account. This factor adds to concerns already voiced by Mr. Dawson and Mr. Grosche that the authorities' strategy of seeking to achieve a current account surplus of 2-3 percent of GNP over the medium term may not be the most appropriate course for the economy.

The staff's baseline scenario suggests that Korea can expect to enjoy a sustainable growth rate of 7.5 percent per year over the medium term, provided that current inflationary pressures can be reduced. This would be an extremely favorable outcome, and one which would provide the best possible backdrop for the authorities' attempts to promote a broader dispersion of the benefits of recent economic success. However, its realization will depend to a large extent on the continued pursuit of supply-enhancing and market-opening measures designed to strengthen both the confidence and the efficiency of Korea's private sector.

It is therefore particularly important that, during the present transitional phase, the authorities should, as far as possible, avoid substantial recourse to direct controls, which might provoke uncertainty about the future direction of policy. It was therefore worrying to read in the staff report that in a number of areas the authorities have chosen to use quantitative controls or direct measures to reduce inflationary pressure. For instance, it is unfortunate that the authorities decided to reimpose direct credit controls in early 1989 to contain monetary expansion, particularly since these controls had been only recently abandoned. A more fruitful step might have been to deregulate deposit rates and to limit the obligation that has been placed on the banking sector to make credit available on favorable terms to smaller enterprises. Similarly, it is not clear that the introduction of a national wage council or a national minimum wage will improve the workings of the labor market over the medium term.

The need to avoid short-term policy measures that might be inconsistent with the authorities' medium-term objective of reducing government intervention is further illustrated by the authorities' active use of fiscal policy as an instrument of demand management. The authorities have several important longer-term objectives, particularly in the field of social expenditure and tax reform, and it is important that fiscal policy be framed with these objectives in mind. But if tax rates or allowances are viewed by the authorities primarily as an important tool of demand management, it may be difficult for them also to achieve their medium-term objectives by implementing supply-side tax reform.

If progress in some areas has been uneven, it is clear that in other areas the authorities have implemented structural reforms with determination. Most notably, a key element in the authorities' adjustment program has been their commitment to trade liberalization, which has seen the elimination of virtually all restrictions on imports of manufactured goods, and the beginning of a new phase of tariff reform. As in many other countries, progress on liberalizing agricultural imports has been less vigorous despite the welfare losses arising from the remaining restrictions. I hope that further liberalization can be pursued in this sector over the coming year alongside the implementation of the authorities' Rural Development Plan. External liberalization can have a major impact in meeting the aspirations of the Korean people. More generally, I agree with the staff's view that, given the strength of Korea's external position, there can be no balance of payments justification for the maintenance of quantitative import restrictions under Article 18 of the GATT. I fully endorse all the comments made on this subject by Mr. Grosche. I would hope that the authorities will be prepared to disinvoke Article 18, removing the need for the Fund to make a determination against Korea. Korea's acceptance of Article VIII status in the Fund in the past year was most welcome, and a disinvoking of Article 18 of the GATT would be further evidence of Korea's emergence in the world economy.

Korea's medium-term prospects remain very bright, provided that the current inflationary pressures can be reduced. If anything, these pressures may be somewhat stronger than the authorities presently perceive. This underlines the need for caution in the framing of macroeconomic policy, and boldness in the pursuit of further liberalization and reform. Over the past few years, the authorities have shown themselves to be equal to the challenges confronting them. I have every expectation that, over the next year, they will be able to steer the economy onto a sustainable, low-inflation, high-growth path that will permit a continued increase in living standards and allow the authorities' social objectives to be achieved.

Mr. Cirelli made the following statement:

During the past few years, Korea's economy has shown remarkable resilience as well as the capacity to adapt quickly to a changing environment. Since 1985, the export-led expansion strategy has enabled the country's authorities to shift their concern from the reimbursement of their heavy external debt to the persistence of a large external surplus. The recent developments described in the report demonstrate once more the authorities' ability to react promptly.

Indeed, the appreciation of the won and the progressive opening of the economy resulted this year in a dramatic decrease in the external surplus. Large wage increases have also contributed to the reorientation of the economy toward domestic markets. Thus, it is important to note the sharp contrast between the outcome of 1988 and the first results of 1989.

It is now clear that the problems facing the authorities have changed. The first problem confronting the authorities is of a short-term nature and consists of mounting inflationary pressures. An important medium-term question is the need to adopt an adequate strategy, primarily led by domestic demand, to ensure a growth-oriented path, and, in this connection, the medium-term scenarios developed by the staff clearly show the importance of the objective of price stability.

Significant uncertainties will dominate short-term developments, and I support most of the staff's recommendations on major policy issues. I would add, however, that economic policies should be influenced less by short-term considerations and should be formulated to a greater extent in a medium-term framework in order to stabilize anticipations. This policy stance should clearly apply to exchange rate policy, domestic demand management, and structural reforms.

The active exchange rate policy conducted by the authorities has played a major role in diminishing the substantial current account surplus, and we commend the authorities for the policy they have pursued in this area. Given the substantial decline in competitiveness, we share the staff's view that a new appreciation of the won should be brought to a halt, and that, in the short term, the currency should be kept stable in nominal effective terms. As stressed by the staff, this implies that the won should in fact be pegged to a basket of currencies and not only to the U.S. dollar. This move is particularly important because a depreciation of the dollar would intensify internal inflationary pressures.

Moreover, given the inflationary expectations, I agree with the staff that it would be dangerous to validate wage increases by depreciating the currency. Furthermore, if the external adjustment process should come to a halt, a further nominal appreciation of the currency should be considered. In any event, this matter will have to be kept under close review by the authorities.

In this context of exchange rate stability, demand-management policies will have to find a delicate balance between sustaining domestic demand and dampening inflationary pressures. In the area of fiscal policy, I endorse the authorities' objective of improving the quality of life by developing welfare programs and social infrastructure. At this stage of Korea's development, an increase in expenditure above the nominal GNP rate of growth seems appropriate, especially as the ratio of expenditure to GNP is still low compared by international standards.

However, I share the staff's view that the authorities should avoid adding a substantial stimulus, given the strength of internal demand. In this area also, a medium-term perspective seems warranted and a broadly neutral stance should be adopted, which implies increasing revenues to finance further expenditure. We welcome the measures taken by the authorities to reform the tax system, as they should increase the equity and neutrality of the system.

The large external surpluses have put a heavy burden on monetary policy. With the decreasing balance of payments surplus, the authorities should regain some room for maneuver. I broadly agree with the staff that a more restrictive stance of policy action could be appropriate and help to subdue inflationary pressures. This approach could exert some upward pressure on the exchange rate, however, and I wonder what course of action the staff would suggest in such an eventuality.

Structural policies will play an important role in consolidating a more inward-looking growth process and in improving the quality of life and social equity. I endorse most of the staff's recommendations on this matter and will mention only two areas. First, market-opening measures have been fundamental in the process of reducing the external surplus. Some very significant efforts have recently been made, and the authorities should be commended for this policy. We agree with the staff, however, that the remaining restrictions substantially distort the resource allocation process. Given the strength of the external position, these restrictions should be eliminated. Second, the deregulation of the financial system should be pursued, particularly with a view to enhancing the efficiency of monetary policy.

We commend the Korean authorities for having accepted the obligations of Article VIII. We are impressed by Korea's recent performance and have no doubt about the authorities' ability to face the challenges ahead.

Mr. Fernández Ordóñez made the following statement:

I join previous speakers in expressing our admiration for the extraordinary development of the Korean economy. Many of us had the opportunity to see it during the 1985 Annual Meeting. Since then--in just four years--GDP has increased by 50 percent. Until the recent slowdown, developments in employment, exports, the fiscal accounts as well as in many other variables were certainly impressive. Even the recent reduction in growth and in the external surplus can be considered as positive developments, as the staff rightly says, for they permit a more sustainable economic performance.

It has been said that now that the Korean people have achieved great economic success, the Fund is recommending that they do the opposite of what they did to achieve that success. It seems paradoxical, and not only this institution, but also the Korean authorities are well aware that, if they do not open the country's economy, do not deregulate and privatize, and do not reduce economic disparities, they will not achieve sustainable growth in the future. Therefore, we support the thesis of the staff report--which does not differ much from the vision of the Korean authorities--about which economic policies are needed at this stage.

We wish to be sure that the recommendation of the staff to keep the exchange rate of the won stable is accompanied by a recommendation to keep quickly reducing external protection. The staff is concerned about the possibility of validating high wage settlements through exchange rate policy. However, the most rapid way to counteract those pressures is to open the productive sectors to international competitiveness.

Like Mr. Dawson and other speakers, we do not understand the rationale behind the authorities' position on a target of a current account surplus in the medium-term scenario. If the liberalization of foreign investment works, a current account deficit would be a more adequate target, given the current stage of Korea's development.

I wish to take this opportunity to draw attention to the treatment of real estate in staff documents in general. In this case, the staff report, as usual, limits itself to describing the explosion of prices and the reaction of the authorities to the so-called speculation without giving any kind of judgment about these developments. With very few exceptions, this is the usual practice in Article IV consultations. However, given the political impact of developments in this sector and the mountains of irrational regulations in this field in most countries of the world, we should devote much more attention to housing and urban policies than we do now.

The labor markets prospects are not as clear as other aspects of the outlook for the economy, perhaps because not much space is devoted to this question in the staff papers. To begin with, we do not see a clear assessment of the effects on prices and competitiveness of the recent sharp increase in wages. In general, it seems that this is the field where the Korean authorities are less successful, and even though the point of departure is very comfortable, a failure of income policy, coupled with social unrest, could cause the current economic situation to deteriorate seriously and rapidly.

Finally, I welcome and wish to stress the importance of the policies aiming at improving social equity. They are important purely as a matter of justice and to gain the public support that, in a democracy, is essential if sound economic and financial policies are to be maintained for a long time.

Mr. Feldman made the following statement:

After several years of impressive growth, Korea is undergoing a pronounced and difficult economic adjustment process that is very well described in the staff report. During the past two years, adjustment policies in Korea have been based on currency appreciation, import liberalization, and financial restraint. Distributive policies have relied mainly on fiscal policies and some structural reforms. The growth of output and exports has slowed markedly; in fact, real GNP, on a seasonally adjusted basis, did not grow at all, and export volume declined by about 4 percent during the first half of 1989.

As the staff and Mr. Kwon point out, competitiveness has declined sharply, setting off a process of sizable external adjustment. The negative effects on economic activity have, in turn, reduced the demand for labor. However, in a period of political liberalization, intense union militancy, labor disruptions, and substantial changes in relative prices, the risks of inflationary pressures have not entirely subsided.

Although pointing out the existence of serious risks and uncertainties, the staff sees the present economic slowdown as an adjustment toward a less rapid, but better balanced and more sustained, rate of growth. In our view, the situation is less clear, and perhaps involves large and unpredictable risks. Seeking a fairer and more egalitarian society while moving to a weaker competitive external position is perhaps a rather risky policy mix; in fact, this simultaneity may at a certain stage prove inconsistent or conflicting, as Mr. Enoch remarked. In particular, the appreciation of the won since end-1987 could have gone too far too quickly and its impact probably had not yet been exhausted; lagged effects might still be in the pipeline and may eventually emerge, which could lead to a further deterioration of export performance and, in general, worsen the external balance. On the domestic side, we, like the staff, see considerable uncertainties regarding the extent of the slowdown in activity, the underlying strength of domestic demand, and the timing of an eventual recovery. Moreover, the shift in resource allocation and in economic activity from export-led growth to a relatively domestic market-based growth could reduce the overall productivity of the economy, increase labor market tensions, and fuel inflationary pressures. In our view, the average productivity of the economy could decline if productivity in the export goods sector is higher than productivity in sectors producing for domestic consumption. Labor market tensions could, in turn, increase if the production oriented to domestic markets is more labor intensive than the production of exportable goods. These risks might even increase the natural difficulties in assessing whether the wage settlement process will respond suitably to the cyclical slowdown. Perhaps the staff would like to comment on this matter.

Given recent economic developments and the risks and uncertainties that I have described, we agree with the staff that now the main policy issue for the Korean authorities is how to react to the weakening of the export performance and economic activity. If the appreciation of the won since the end of 1987 has played an important role in weakening export performance and economic activity, it seems straightforward to state that exchange rate policy should remain at the core of the economic strategy.

Financial policies will also be an important ingredient both to help achieve medium- and long-term objectives of price stability and economic growth and to compensate for eventual unfavorable effects of the exchange rate policy on domestic demand in the short term.

Regarding exchange rate policy, we agree with the staff that it seems appropriate to stop the appreciation of the won. The magnitude of the ongoing adjustment clearly justifies such a decision. Although we understand the risks associated with attempting, at this point, to restore past levels of competitiveness, the authorities should be prepared to reverse the recent exchange rate policy, if necessary, not just to re-establish economic growth and a solid external position, but perhaps also to return to the more export-led pattern that Korea has so successfully implemented in recent years. Of course, the danger of an intensification of inflationary pressures, mainly by affecting expectations, calls for cautious management of the exchange rate. All these things considered, we favor keeping the stability of the won in real effective terms in relation to a basket of currencies of trading partners. We agree with the staff that this would avoid tying the won to one major currency during a period when international currency alignments do not appear to be fully settled.

On the continuing rapid shrinkage of Korea's external indebtedness, we wonder, as we did during the previous Article IV consultation with Korea, about the convenience of such a policy, especially during 1988, when, as Chart 4 in the staff report suggests, international interest rates, adjusted for exchange rate variations, were negative. Perhaps the staff or Mr. Kwon would like to comment on this issue.

On fiscal policy, we believe that, if a reversal of exchange rate policy becomes necessary, financial policies would need to be extremely restrictive. In particular, a restriction of domestic credit expansion would be called for both to compensate for monetary expansion stemming from the external surplus and to avoid a surge of inflationary expectations.

We agree with the staff that fiscal policy, while seeking to support the objective of price stability, should assign an increasing priority to the goal of improving the living standards of the population. In this connection, the shift in expenditure priorities and the reform of the tax system envisaged in the 1989 budget are positive steps.

Korea has done a great deal in the area of structural reform. There is, however, considerable room in which to improve resource allocation by deepening those reforms. The staff has elaborated on these issues in its report and background paper. We would only like to emphasize the need for additional market opening measures, particularly the need to liberalize agricultural imports, and we encourage the Korean authorities to speed up this process. We understand the political sensitivity of this issue and its sectoral impact, but we believe that greater progress in this area would imply a significant step toward the solution of the external difficulties of the developing world. It could also improve resource allocation and help increase real wages and the standard of living in Korea.

We agree with the staff appraisal. The present difficulties should not overshadow Korea's impressive economic performance during the 1980s. The difficulties, however, should not be underestimated, and a careful implementation of policies will be required. Korea's economy is in a strong position to face current difficulties, and, as the staff points out, the Korean authorities have an admirable record of successfully confronting these kinds of difficulties. We have no doubt that present challenges too will be met skillfully.

Mr. Jalan made the following statement:

Korea is a shining example of what can be accomplished by a happy blend of private initiatives and public policy. Not so long ago, Korea was a low-income country and a net importer of capital. Today, it enjoys one of the highest incomes in the developing world and is emerging as a net exporter of capital. The staff report has rightly observed that "in the wake of every challenge the Korean economy has emerged both stronger and more resilient." We congratulate the authorities for these achievements.

We broadly agree with the staff appraisal of short-term and medium-term prospects and the current policy priorities. We fully support and endorse the priority being given to equity aspects in Korean economic policy at the present stage. In particular, we welcome the tax reform program and the initiatives taken to reduce disparities among regions and different sections of the population. Successful implementation of these policies is vital to the maintenance of social, economic, and political harmony. We hope that the current program will continue to give high priority to the social objectives, if necessary through some adjustment in tax rates, so that fiscal balance is maintained. After more than 25 years of continuous and high growth, Korea is now in a position to turn its attention to the pressing social concerns.

My second point relates to the projected trend in national savings. The medium-term scenario envisages a sharp drop in the savings rate from about 38 percent of GNP in 1988 to 30.9 percent by 1994. I would welcome staff comments on whether this is a desirable development. In this connection, I would like to recall an interesting comment of the U.K. Chancellor of the Exchequer at the Annual Meeting. He pointed out that the main problem for the world economy is the inadequacy of savings and the capital shortage, rather than the distribution of surpluses and deficits among countries. This observation, if correct, has profound implications for the Fund's stance on economic policies in different surplus/deficit countries.

In the trade area, the staff asserts that the remaining restrictions--mostly on agricultural and fishery products--cannot be justified for balance of payments reasons; in any event, these restrictions tend to distort resource allocation. In principle, we agree with the staff and would encourage the authorities to reduce import restrictions. However, we also sympathize with the Korean authorities, who feel that complete elimination of restrictions would have to be achieved gradually in order to prevent economic disruption and unemployment. In Korea, a significant proportion of the population is dependent on agricultural employment, and, unlike some other surplus countries, in Korea the bulk of the income of the rural population is from farm activities. Also, Korea's record in respect of agricultural protectionism compares favorably with that of several industrial countries. The agricultural import liberalization ratio in Korea rose from 56 percent in 1980 to 72 percent in 1988, and is expected to go up to 85 percent by 1991. This pace of change does not seem unreasonable.

I agree with the staff that, in the present circumstances, further appreciation of the Korean currency is not required. However, I am a little puzzled by the staff view that the exchange rate should be stabilized in nominal effective terms and not in real effective terms. If the rate of inflation in Korea is higher than that of its trading partners, and the exchange rate target is fixed in nominal terms, this will lead to an effective appreciation of the currency. On the other hand, if the inflation rate is broadly the same as in other countries, setting the target in terms of real effective rates will not pose any problems. Generally, the view taken by the Fund has been that exchange rate targets should be set in real terms and not in nominal terms. I would welcome some further staff comments on why, in the case of Korea, the staff prefers the exchange rate target to be fixed in nominal effective terms and not real terms.

It is understood that the authorities are considering replacing M2 by some other monetary aggregate as a target variable. In view of the experience with monetary targeting of this type in some countries, I would welcome Mr. Kwon's and also staff comments on whether or not it would be better to target on interest rates through more aggressive open market operations and greater use of discount rate policy. Variation in interest rates could be used to influence the demand for and supply of liquidity in the system in the light of changes in other macro-economic variables. If this is feasible, then one can dispense with the targeting of any particular variant of monetary aggregate.

Mr. de Groote made the following statement:

The Korean case is one of the most fascinating to come before this Board, because it shows that unsustainable surplus situations need correction, just as unsustainable deficit situations do, although the constraints to adjust are obviously more indirect and the policy decisions are therefore in a sense more difficult to implement because they have to result from voluntary action rather than be imposed by a crisis situation.

An impressive set of policies has been adopted by the Korean authorities to offset the inflationary impact of excessive export-oriented growth and to avoid retaliatory measures in foreign markets. The orientation of these policies seems correct: the appreciation of the won and the elimination of export subsidies will act on the relative prices of protected and unprotected sectors, and thereby give an increasing role to domestic demand in the formation of national income.

The most interesting aspect of this reorientation toward domestic demand is the decision to develop a national welfare system and to devote an increasing part of public resources to regional development. This policy option demonstrates that the redistribution of the benefits of income growth over all income groups and in all areas, through the organization of a social solidarity system, is not only a collective and political priority, but also the appropriate means for ensuring durable external adjustment. On the occasion of the discussions of adjustment policies in countries in the opposite position of Korea's, I have submitted several times that a less distorted income pattern is the underlying condition for a durable correction of external deficits, especially in the sense that capital outflows are a response to the fear that tax increases or social upheavals will have to correct the income distribution pattern. Today's case illustrates that an appropriate reorientation of income from the import sector to the satisfaction of domestic welfare needs is also a condition for correcting unsustainable surpluses: balanced income growth between external sector and domestic needs is needed to guarantee the sustainability of balanced income growth.

It is remarkable that the Korean authorities believe that these required changes in society can take place over a short period. A sound basis for the success of such a change is given by the radical transformation of the Korean economy in about two decades and by the evenness in the distribution of income, which can be regarded as the main cause of Korea's extraordinary growth performance. The smoothness of this transformation will also depend on the degree of political consensus, which might in turn be favorably influenced by the establishment of a generalized welfare system. Another precondition continues to be the participation of all segments of public opinion in the political decision-making process.

Among the various policy measures already implemented by the Korean Government, the appreciation of the won is certainly the one that was most strongly recommended by this Board. I agree with the staff that the present position of the rate seems appropriate, and I had some difficulty in following Mr. Enoch when he suggested that recent wage increases might give an additional reason for a further appreciation of the won. At least from a strictly mechanistic viewpoint, I would have expected the opposite relationship to prevail, although I admit that an appreciation could help to control further wage demands and inflationary pressures. I would like to be counted among those who believe that the rate should be assessed in real effective terms. In any event, an essential point is the commitment of the Korean authorities to continue to implement a flexible rate policy according to the evolving position of the current account.

My questions on the chances for the program to be successful bear on three issues: interest rates and the effectiveness of financial intermediation; the reaction of neighboring countries to the continuous penetration of Korea's exports, and the need to incorporate more advanced forms of technology in the ongoing transformation of the economy.

Interest rates have traditionally been very high in Korea; at present, they exceed 10 percent in real terms. About 40 percent of production results from the activity of small and medium-scale enterprises. They have little access to the banking system, which seems to be used mainly by large enterprises. A large part of financial transactions is therefore disintermediated through the so-called unorganized markets; the monetary authorities themselves have at their disposal only limited means for implementing monetary policy objectives through the indirect controls that are required in more advanced financial systems. Such a situation is compatible only with exceptionally high growth rates. Now that a much lower rate of expansion is forecast, the present level of interest rates might create a major cash flow problem for enterprises, threaten the financial soundness of the banking sector, and negatively affect investment. Therefore, is it not desirable to accelerate the process of liberalizing the capital markets and increasing the freedom of capital inflows?

My second concern has to do with the acceptance in the region of the implications of the ongoing transformation of the Korean economy. Are neighboring developing countries ready to accept the penetration of Korean products with an increasing value-added content? Are these countries taking over, under competitive conditions, the industries that move out of Korea because of their high degree of labor intensiveness, and do they develop a demand for Korea's growing industrial exports? What are the implications of Korea's ongoing changes for Japan's evolution? Is Korea's ambition to develop capital-intensive industries compatible with Japan's own position in the area?

A third area of concern is the growing need for Korea to rely on higher forms of technology and research in order to support the reorientation of production in the direction of more capital-intensive processes. Is it possible to initially rely on imports of such technologies and on their financing through the balance of payments, or should the process be accompanied by a more rapid development of local expertise? Is the decentralization of the decision-making process not a precondition for such development?

When Korea was a member of our constituency, in the beginning of the 1960s, GNP per capita was around $125. Now it is more than $4,000. Korea thus remains for the whole of the developing world the example of what can be achieved through energy and the good use of external capital. The extraordinary results of the past allow us to expect that Korea will succeed in meeting the current challenge of giving to its further development the strong roots of more advanced forms of production and of a reorientation to the internal market of the benefits of growth.

Mr. Fogelholm made the following statement:

I am in broad agreement with the thrust of the staff's assessment and recommendations. I, too, wish to commend the Korean authorities for the policies they have pursued since the previous Article IV consultation. The adjustment of the foreign exchange rate and the virtual elimination of restrictions on manufacturing imports are particularly noteworthy in this regard. I also commend the overall accomplishments of the Korean economy during the 1980s. The economy is, relatively speaking, in an enviable position for meeting future challenges, including the proclaimed social objectives of present economic policies, which I certainly endorse.

The crucial question at present is how to respond to the substantial slowdown in adjustment that has taken place in the Korean economy. In the staff's view, the slowdown this year has been basically transitory, stemming from an extraordinary increase in imports and the impact of labor unrest on exports. However, the staff also makes reference to exceptional uncertainties surrounding this development.

One such uncertainty is the magnitude of possible lagged effects of the currency appreciation that has taken place. There is also uncertainty regarding future wage developments. In these circumstances, I believe that the authorities are correct in adhering to their present policy stance, which seems to be cautious enough in its anti-inflationary approach. In particular, I agree with the staff's recommendation that, at this stage, the present nominal exchange rate should be kept unchanged. I listened with interest to the discussion thus far on whether the exchange rate goal should be real or nominal. In my view, with the present inflation in Korea, which exceeds world inflation, it would actually result in more pressure toward depreciation rather than appreciation. Hence, I do not agree with Mr. Jalan on this point. However, I concur with other Directors that developments in this area should be closely monitored, and that further steps should be taken if the current account surplus starts to rise again. Judging by the latest figures--those for August--on industrial output and domestic sales, the economy shows clear signs of recovery, which implies that there should be no reason to fear, at least for the time being, that the economy is heading toward a more permanent slowdown.

The fiscal policy stance in 1989 has been expansionary. In light of the projected growth of domestic demand, and the need to contain inflationary expectations, I agree with the staff that more substantial fiscal stimulus should be avoided. Thus, I welcome the fact that the proposed supplementary budget for 1989 will be fully financed by excess revenue collection, thereby leaving the budget balance unchanged.

I hope that adherence to the recommended prudent fiscal policies and containment of monetary expansion at the bottom of the target range will contribute to the re-establishment of sustainable wage developments. Without a reduction in cost pressures, investment--and subsequently the medium-term growth prospects--will be hampered. In this context, I note with interest the authorities' proposal to form a national wage council to establish future wage guidelines. It would be interesting to hear comments either by the staff or Mr. Kwon regarding the possible effectiveness of such a council in light of the growing independence of the Korean labor movement.

In the structural field, I welcome the steps taken and planned to further liberalize the economy. Market-opening efforts affecting imports of manufactured goods have been implemented, and in the financial sector interest rate regulations have been abolished. Nevertheless, some financial regulations remain on interest rates and credit. Further liberalization in this area would give a boost to the formal financial sector, spur competition, and improve resource allocation.

The staff's view on Korea's import restrictions and their relation to the GATT Committee on Balance of Payments is clear and unambiguous. While acknowledging the present uncertainties about economic developments, I agree, in principle, with the staff that the remaining import restrictions, which largely relate to the agricultural and fisheries sectors, can no longer be justified on balance of payments grounds. Of course, the speed of liberalization will, in effect, also depend on other considerations, such as social factors and the pace of structural change in these sectors.

Mr. Kyriazidis made the following statement:

This year's consultation report demonstrates once more both the skill of the Korean authorities in economic management and the resilience and ability of Korean entrepreneurship. The report paints a rather encouraging picture of the results achieved by Korea under the recently undertaken efforts to reorient the growth pattern of the economy. In fact, there are consistent signs that the heavy dependence of Korea on exports is gradually diminishing, and that policies in the next few years will be geared more to the achievement of domestic objectives.

The issue at this stage is how to combine short-term macroeconomic policies with long-term structural reforms. This is an important question, since inappropriate demand and external policies might act as a drag on long-term structural developments in the Korean economy. In offering my comments, I will therefore focus on the relationship between macroeconomic and structural policies first; I will then discuss some particular aspects of the structural reform policies.

In the field of macroeconomic policies, the staff offers three main suggestions to the Korean authorities. First, the staff suggests that fiscal policy should stimulate domestic demand mildly during the next year, in order to compensate for the decreased impulse of exports on growth. I fully agree with this view, since it is necessary to stimulate adequate demand in the nontradables sector to achieve the necessary restructuring of supply. However, I would stress the need to accelerate the trend toward public expenditure that is oriented toward achieving social goals. According to the data provided by the staff, central government expenditure on social items such as education, health, social security, housing, and community services accounted for 31.8 percent of total central government expenditure in 1984. Expenditure devoted to such items, as a percentage of total expenditure, remained virtually stable in 1988 and is expected to increase by only 1.9 percentage points in the 1989 budget. More resolute action in reshaping expenditure priorities is necessary at this stage, especially if structural issues--such as income distribution among different sectors of the economy, and regional development--are to be addressed successfully. In this respect, I fully endorse the remarks by Mr. de Groote and Mr. Fernández Ordóñez. Such reshaping should not be difficult to achieve in a situation in which total expenditure has been expanding at rates well above 10 percent per year.

The staff also suggests that exchange rate depreciations should be resisted. Apart from being unjustified and even counterproductive on macroeconomic grounds, depreciations would make the governmental commitment to pursue domestic-oriented policies less credible. The loss of credibility would be particularly severe abroad and might have unwanted repercussions on bilateral relations with some foreign governments. Indeed, the present level of the won might still result in a very large current account surplus. On the other hand, I am not very happy with the staff's recommendation that the authorities should pursue a policy of nominal exchange rate stability vis-à-vis a basket of currencies. This policy would be appropriate if we were to assume the maintenance of a significant inflation differential leading to a parallel appreciation of the won or alternatively a significant increase in fiscal stimulus that could alter substantially the savings investment balance. As this does not seem to be the case, I doubt whether the staff's recommendation on exchange rate policy is fully consistent with the staff's view that the targeted surplus on the balance of payments should be lowered.

Some further appreciation of the exchange rate should not be ruled out by the authorities at this stage, especially if the fundamentals continue to show their present strength. Moreover, the commitment on the part of the Government to accept some appreciation of the exchange rate would help to contain cost and price pressures as well as enhance the credibility of the Government during the forthcoming effort to liberalize exchange markets. This structural measure will require the full confidence of both domestic and foreign investors in medium-term exchange rate policy.

In line with this reasoning, I agree with the staff that the objective of achieving a current account surplus in the range of 3 percent of GDP in the medium term should be revised downward, given the improved external position of the country. I certainly agree with the authorities that a comfortable reserve position is necessary to manage the transition to a market-determined exchange rate. Nevertheless, one should not forget that in 1988 the accumulation of reserves by the Bank of Korea was substantial despite the considerable reduction of the external debt. Furthermore, the liberalization of external capital transactions now under way applies mainly to inward financial capital movements and outward direct investments, whereas no major change is envisaged in the field of outward financial movements. This limited liberalization of external capital transactions does not require, as a full capital movement liberalization would, prior accumulation of a very large cushion of reserves.

As to problems more directly connected with structural reform issues, I note that during 1988 and 1989 the authorities have strengthened their efforts at import liberalization, removing part of the import restrictions and reducing the level of tariffs. We welcome this important development, since on previous occasions we have stated that market opening measures should have been the most important instrument for achieving a more balanced pattern of growth in Korea. However, the increase in the percentage share of imports for domestic consumption and capital goods for domestic use recorded in 1988 cannot be regarded as striking; the share increased from 24.9 percent of total imports in 1987 to 26.8 percent in the first half of 1989. The modest increase has occurred even though contingent factors, such as tariff cuts and lower consumption taxes on durables, have encouraged a postponement to 1989 of the purchase of imported items. I would greatly appreciate staff comment on this point.

Regarding industrial policy, it is encouraging to note that specific measures have been taken to increase the amount of finance available to small and medium enterprises. It is also of great importance that specific measures have been adopted to check a further expansion of large industrial conglomerates. I am certain that beneficial effects of a more liberal industrial policy will also be felt in the field of income distribution, which is a recent preoccupation of the authorities. At the same time, I wonder whether the policy of reducing industrial subsidies has progressed further during the past year. I would welcome the staff's comments.

In conclusion, Korea implemented significant liberalization measures in 1988. The country has also accepted the obligations of Article VIII. I am confident that the present policy momentum will continue in the near future, in such a way that the country will be able to respond fully to the new challenges posed by the virtual completion of its development stage.

Mr. Ghasimi made the following statement:

We welcome this opportunity to discuss recent economic developments in one of the relatively rare success stories among the developing countries. As it appears from the staff report and Mr. Kwon's statement, Korea is a valuable case of successful growth-oriented adjustment. During the past three years, real GDP expanded at a rate exceeding 12 percent a year and unemployment declined gradually to a historical low level. However, the most remarkable achievement was recorded in the external sector of the economy, where the authorities proceeded, thanks to an export drive strategy, to build up rather large current account surpluses and to dramatically reduce the external debt.

The Korean economic expansion was however difficult to sustain without exacerbating labor market conditions and causing the emergence of inflationary pressures. The developments led the authorities to initiate in 1987 a comprehensive restructuring program aimed at lessening the heavy dependence of the economy on exports, sustaining domestic demand, and moderating inflationary pressures. To this end, the authorities adopted tight fiscal and monetary policies in order to contain inflationary pressures. These policies were also accompanied by an appreciation of the won and substantial progress toward import liberalization and financial deregulation. As a result, and following a weakening of the export sector, GDP growth slowed in 1989, the current account surplus fell from 8 percent of GDP in 1988 to 3 percent of GDP in 1989, and domestic demand remained strong.

In these circumstances, and in view of the deterioration in the country's trade performance, the most challenging task now facing the authorities is to resist the temptation to slow or reverse the restructuring of the economy. In this respect, we agree with the staff that "the present economic slowdown is an adjustment, albeit painful, toward a less rapid, but better balanced and more sustainable rate of growth."

In particular, we encourage the authorities to persevere in opening further the economy and to implement the second five-year tariff reduction program. Simultaneously, Korea's market-opening efforts should be matched by a reduction of protectionist measures by its major trading partners. We encourage the authorities to further diversify their trade relations, since more than half of Korean imports and exports are concentrated in two markets.

On fiscal policy, the authorities' continued emphasis on price stability is quite appropriate. In addition, we support their desire to improve the living standards of the population. Indeed, the promotion of a wider dispersion of economic growth's benefits among different regions and categories of population is a commendable objective in the pursuit of balanced growth and greater social equity.

We commend the Korean authorities for their acceptance of the obligations of Article VIII.

Mr. McCormack made the following statement:

The changes taking place in Korea are indeed impressive. The authorities are in the midst of a difficult and complex transitional process. However, like previous speakers, we would like to stress that, although difficult choices need to be made, the authorities are working from a very solid economic base. Theirs are indeed the problems of success, the magnitude of which was usefully described by Mr. de Groote.

As the staff paper indicates, the major policy issue facing the authorities concerns the pace and orientation of the adjustment process. It has become increasingly evident that the highly interventionist, outward-oriented policies that so rapidly propelled Korean economic development in the past, may not serve to ensure prosperity in the future. Moreover, the slowing of foreign demand and the unwillingness of major trade partners to incur ever larger trade deficits vis-à-vis Korea means that Korea has little alternative but to reorient its development strategy toward domestic-led growth. Recently, these pressures have been reinforced by social and other domestic political developments.

In the past few years the authorities have embarked on an ambitious program of reforms in many areas of economic policy. Facilitated by an exceptionally rapid expansion, the authorities began a process of liberalization to promote a more sustainable, less export-dependent pattern of development. Such a reorientation remains vital to Korea's longer-term economic prospects and interests and should not be allowed to be compromised or delayed by short-term economic difficulties. Indeed, the recent weakening of the external balance and the consequent slowdown in the overall pace of economic expansion can be regarded as appropriate in current circumstances. Several years of above potential growth has led to an acceleration in inflation, and, despite the recent slowdown, cost pressures persist. These factors are evident from a further tightening of labor market conditions and the rise in unit labor costs (in spite of rapid productivity gains). In this context, we agree with the staff that monetary expansion should be brought closer to the lower end of the 15-18 percent target range in 1989. In addition, we are concerned about the supplementary budget, and the general expansionary stance of fiscal policy.

Furthermore, the decline in the current account surplus in the first quarter of 1989, although significant, is at least partly attributable to some temporary factors. These factors include the reduction in January 1989 of tariffs on imports (which encouraged importers to delay their orders until after the new tariffs were introduced), and the impact of labor disputes on the timing of export shipments. In this connection, we agree with the staff and previous speakers that remaining import restrictions cannot be justified on balance of payments grounds. On the other hand, as long as Korea accepts the rules of the international trading system, and perseveres with the market-opening steps, foreign pressure on the authorities to eliminate the current account surplus within a fixed period would not be justified. In fact, we tend to disagree with the idea of setting any specific medium-term target for the current account balance in these circumstances.

With regard to exchange rate management, the authorities should allow market forces to play the dominant role, even if that implies a further appreciation from the current level. Like Mr. Dawson and Mr. Grosche, we are less inclined than the staff to suggest that further appreciation does not seem required at the present stage. Rather, market forces should be allowed to prevail.

A more flexible attitude to the exchange rate has been an essential element in resisting a pickup in inflation, and such flexibility will continue to be needed if monetary policy is to succeed in bringing inflation down. Equally important, the currency appreciation has facilitated the transfer of resources from the external to the domestic sector. In addition, it has helped the authorities to defuse pressures for retaliatory action by countries experiencing a trade deficit with Korea.

It is our understanding that there is some discussion about giving the Bank of Korea more autonomy vis-à-vis the Ministry of Finance. This step seems to be timely, given the planned substantial expansion of government spending. Fiscal expansion could compromise efforts through monetary policy to achieve price stability. Moreover, as financial markets become more sophisticated in the process of deregulation, attempts to harness or subordinate monetary policy to fiscal policy aims will tend to become less and less tenable. In such circumstances, a strong and independent central bank would facilitate the maintenance of monetary policy credibility and price stability. I acknowledge, however, that judgments on this subject depend on a number of institutional and country-specific considerations. I would welcome any comments from the staff or Mr. Kwon on this issue.

Ms. Eran made the following statement:

The growth performance of the Korean economy in recent years is no doubt remarkable, and I join previous speakers in commending the Korean authorities on their achievements and on their swift response to the tightening labor market and inflationary pressures when, in 1987, they undertook a comprehensive adjustment program. The program was aimed at reducing the economy's heavy dependence on exports, cutting the external surplus, and moderating inflationary pressures. However, as the adjustment efforts seem to have taken hold--as reflected in the slowdown of output and exports and the decline in the current account surplus in 1989--the central policy issue is now described as "how to respond to this sharp slowdown in output and exports." But was this slowdown not the goal of economic policy in the first place?

The staff encourages the authorities to persist with the thrust of the present policy strategy, and I agree. Since current developments are precisely the intended outcome of this strategy, it seems too early to make a turnaround. However, in comparing the two medium-term scenarios I cannot help but conclude that the real cost involved in not following strict policies at this juncture is not that high: the rate of growth would drop, in the medium term, from 7.5 percent to 6.8 percent, and the current account surplus would increase from 2 percent to 2.2-2.6 percent of GNP. The "alternative scenario," I feel, could fulfill almost any country's dream.

What does seem to give room for worry, though, is the labor market. The staff report refers in a number of places to the tight labor market and to exceptionally large recent wage increases; there also seems to be an implicit suggestion that the market has not yet reached equilibrium. I would be interested to hear the assumptions regarding wages behind the two scenarios, and how sensitive the results would be to changes in these assumptions. I would also welcome clarification by the staff regarding the financing of the surplus budget. A number of Directors endorsed the use of the excess tax collection in the previous year to finance the increase in expenditure. But if the taxes were collected last year, does not their use this year simply amount to inflationary financing?

Structural policies in Korea seem to deal mostly with distributional aspects of national income. In this connection, it is of course the prerogative of the Korean Government and people to set priorities. As to the efficiency of production, Korea appears to have come a long way toward liberalizing its various markets; and, as Mr. Enoch and Mr. Jalan noted, in hesitating to liberalize agricultural imports Korea is by no means unique. It seems obvious that, in view of the high level of foreign reserves and the strength of the external sector, these import restrictions can no longer be justified on balance of payments grounds. However, I wonder whether the pronounced progress that Korea has already made in this area could not somehow be reflected in the Fund's communication to the GATT.

Finally, like Mr. Dawson, I wonder whether it is appropriate to refer to Korea's current account, with its intentionally reduced surplus, as "worsening." Also, I believe that neither exports, nor an external sector that still generates a surplus of 3 percent of GNP, could properly be labeled "weak."

Mr. Hon made the following statement:

This Article IV consultation takes place at an important juncture in the development of the Korean economy: the comprehensive adjustment program initiated in 1987 to achieve a more balanced growth has begun to take hold, and its powerful impact is being fully felt. I am pleased that during the difficult transitional period of the past year the authorities' policy actions were broadly in line with the Executive Board's recommendations, and that their outcome was, in general, satisfactory. Therefore, I agree with the staff that the present policy stance should be maintained.

The immediate concern is how to deal with the slowdown in the growth of the economy. I believe that there is enough momentum in consumer demand, which is supported, in particular, by the lagged effect of the wage increase during the past year. The growth in private investment remains healthy, and the temporary investment tax credit scheme should help sustain its growth. In sum, I agree with the staff that the growth in domestic demand will more than compensate for the withdrawal of, or the reduction in, stimulus from the external sector; as a result, the growth of the economy should be sustained. The outlook for inflation, however, remains uncertain. While inflationary pressure has been moderated by the slowdown in the economy, the cyclical behavior of wage demand could not be ascertained. It is therefore reassuring to note that the authorities have recognized the risk in this area and have made moderating inflation their primary concern in formulating their policy.

While agreeing with the general policy stance, I would like to comment briefly on several specific policy issues. The authorities are to be commended for taking advantage of the rapid economic growth in the past three years to effect a turnaround in the fiscal balance. I am pleased to note that the authorities are able to stabilize the expenditure/GNP ratio while restructuring the composition of expenditure to achieve the expressed social goals of improving the quality of life by realizing a wider dispersion of benefits arising from economic growth. On the impending supplementary budget to provide stimulus in response to the slowdown in the growth of the economy and to address rising social demands, I tend to agree with the staff that caution should be exercised so as not to add to inflationary pressures. In this connection, I am glad to note from Mr. Kwon's opening statement that the supplementary budget will be fully funded by the excess revenue collections of 1988.

On monetary policy, I agree with the staff that as prospects of slower growth in the economy have become more apparent, the monetary target for 1989 appears to be rather accommodative. I would therefore like to join the staff in encouraging the authorities to restrain monetary growth to the lower limit of the set target.

I share the belief that the appreciation of the won so far has produced the desired results, and that it is time to take a pause to assess the achievement while continuing to monitor closely the evolution of the external adjustment.

On structural policies, I am pleased to note that good progress has been made in achieving the authorities' social goals. With the most recent reform in the interbank market to enhance competitive foreign exchange trading, an important first step has been taken in the liberalization of the financial markets. However, considerable scope remains for further liberalization in this area to match the growth and the stage of advance of the Korean economy. On the other hand, the progress in domestic market opening has been remarkable, and I endorse the authorities' endeavor to further reduce the average tariff to 8 percent by 1993. I also noted the progress that has been made in the liberalization of agricultural imports; in this connection, I urge the authorities to speed up the implementation of the Comprehensive Rural Development Plan to raise farm efficiency and to diversify farm incomes so as to pave the way for a further liberalization of agricultural imports.

Mr. Al-Jasser made the following statement:

The Korean authorities are to be commended for the orderly economic adjustment process. It is gratifying to note the effectiveness with which they have acted, despite labor disruptions, to substantially reduce external surpluses without significantly compromising their internal economic objectives and while keeping protectionist threats at bay. Their efforts to open up their trade markets are commendable and could serve as an example for other member countries.

Korea is approaching a critical juncture in formulating policy strategy for the medium term. Its economy is a maturing one that is no longer heavily indebted or dependent upon external financing to fill the savings-investment gap; nor is it in need of government support and protection against foreign competition. Moreover, domestic pressures for enhancing equity and welfare have grown, and, if not handled carefully, they could disrupt the noninflationary growth and healthy external balance. There is also recognition that a larger component of future growth should emanate domestically, lest protectionist pressures abroad weaken the growth process. The tight labor market will continue to put pressure on prices and wages and, thus, affect competitiveness. Moreover, the adjustment process of the past two years, which resulted in reduced external competitiveness and financial restraint, may not be sustainable for a longer period owing to its adverse impact on economic growth.

In this context, the policy strategy needs to not only reverse the recent sharp downturn in growth without igniting inflationary pressures, but also strengthen the basis for more broad-based growth in the medium term. I am in broad agreement with the staff's prescription for addressing the former through containing monetary expansion with only a moderate support for domestic demand through fiscal stimulus. I support the staff's position that further fiscal stimulus through a supplementary budget should be avoided, so as to ensure the provision of adequate resources to the private sector. However, I am concerned about the pace at which Korea's external competitiveness has been allowed to weaken; the won has appreciated in real effective terms by about 30 percent since mid-1986. While this policy has supported the short-term adjustment process well, it may have also adversely affected medium-term growth prospects. I consider that the staff recommendation to maintain the nominal effective value of the won in the near term is reasonable. I encourage the authorities to pursue stability of the real effective exchange rate to avoid any further erosion of external competitiveness. After all, there is nothing wrong with a moderate current account surplus, as long as it is allowed to be recycled through capital flows. Moreover, I do not see any overriding reasons to discourage accumulation of current account surpluses by Korea, as long as they reflect economic fundamentals. In this context, I, like Mr. McCormack, believe that an early shift allowing market forces to determine the level of the exchange rate is highly desirable. Hence, I note with satisfaction that Korea recently decided to introduce some competitive foreign exchange trading.

In the medium-term context, the policy stance should aim at achieving the baseline scenario. The continuation of the international and market orientation of the economy, especially in determining interest and exchange rates, and the privatization of the public enterprises, will go a long way in this process. However, it would be helpful if fiscal policy became more neutral with respect to resource allocation. To the extent possible, any increase in welfare expenditures should be met by shifting expenditure priorities rather than through additional revenue measures. I am confident that the authorities will avoid introducing rigidities in the budget process through an increase in welfare expenditures. It is to be hoped that the moderation of economic growth will discourage wage and price pressures.

Korea has made good progress in liberalizing its import regime. Given the strength of the economy and its demonstrated ability to use financial policies in correcting external imbalances, there is little reason to retain the remaining import restrictions on balance of payments grounds. Therefore, I urge the Korean authorities to speedily eliminate these restrictions. It is also incumbent upon Korea's trading partners to dismantle restrictions against its exports. I am pleased to note that in early 1989 the new safeguard procedures replaced the surveillance import list and adjustment tariffs. The staff should comment on the experience with these procedures. Are they consistent with GATT rules?

Mr. Fayyad made the following statement:

Korea's economic achievements since the mid-1980s have been widely acknowledged. Certainly not least impressive among those is the remarkable efficacy with which this country has managed to avoid becoming a part of the international debt problem. And just as Korea's experience in growing out of indebtedness continues to provide some valuable lessons for countries facing similar problems, its experience under the adjustment program initiated in 1987 with the aim of reducing the economy's heavy reliance on exports and cutting the external surplus while spreading the adjustment gains, thereby reducing social disparities among sectors and regions, is also being watched closely by the international community. It is of course clear that the adjustment effort has taken hold, as reflected in the marked decline in the growth of output and exports, as well as the sharp decline in the current account surplus. But, as noted by the staff, there is considerable uncertainty about the extent of the slowdown, the underlying strength of private domestic demand, and the timing of the expected recovery.

Given this uncertainty and the abruptness of the downturn in exports and economic growth, the apprehension and fears referred to by Mr. Kwon regarding the nature and duration of the current transitional phase are understandable, particularly when viewed in the context of the remarkable growth of the Korean economy in recent years. However, while these fears should not be dismissed as too alarmist, the thrust of the staff's policy advice, particularly in counseling caution in assessing the scope for countercyclical policies and maintenance of a stable exchange rate in nominal effective terms, would seem to be reasonable.

The reasoning underlying the staff's judgment regarding the exchange rate policy stance is convincing, and I would like to underscore the risk of validating cost and price pressures that attaches to seeking stability in real effective terms. I have listened with interest to the debate on the policy, and presumably one's position depends on one's view of the world. In this connection, my position is like that of Mr. Fogelholm. The answer to the policy question depends on whether one believes that, in the short run, a policy of nondepreciation is more effective in disciplining wage settlements than other exchange rate policy prescriptions.

We note the authorities' broad agreement with the thrust of the staff's policy recommendations and welcome the continued emphasis of their fiscal and monetary policies on the need to control inflationary pressures while preserving a sustainable level of economic activity. We also welcome their commitment to press ahead with their structural reform effort, as well as the high priority they attach to improving welfare and the quality of life through a wider dispersion of the benefits of Korea's rapid growth.

The staff's conclusion to the effect that Korea's remaining import restrictions are not needed for balance of payments reasons seems justifiable. We, of course, fully acknowledge the progress already made and appreciate the sociopolitical concerns associated with those restrictions and with too rapid a pace of liberalization. We encourage the authorities to seek alternative means of addressing those concerns. At the same time, we attach great importance to dealing with trade restrictions in an evenhanded manner.

The staff representative from the Asian Department commented that, in the short term, substantial additional fiscal stimulus beyond that provided by the present 1989 budget could exacerbate inflationary pressures and adversely affect the outcome of the wage negotiation process that was due to start in the spring of 1989. It was true that the supplementary expenditures were to be financed by funds saved in 1988, but, as had been noted by some Directors, there would be no difference in terms of the macroeconomic effect of the extra expenditures: the extra expenditures would be covered by deposits released by the Central Bank and would thus have the same monetary effect as any other bank financing.

Therefore, although the extra expenditures in 1989 would, in an accounting sense, be financed by the carryover from 1988, in a macroeconomic sense the financing of the extra expenditures would still be inflationary.

As to the longer term, the staff continued to feel that commitments to substantial recurrent expenditures on social welfare, however justified, could introduce undesirable rigidities in budgetary policy, the staff representative went on. The authorities clearly recognized that point. Part of the increased expenditure on social welfare over the medium term would come from other categories of budgetary allocations, but the authorities knew that the available resources would not be sufficient, and they were planning to increase taxes. In the staff's view, it would be better to keep spending under check instead. But if an expenditure increase was to occur, the staff would prefer to see it paid for out of taxes and not out of borrowing or some other inflationary financing. Experience in other countries showed that efforts at holding the tax base low did not necessarily result in a smaller public sector but, instead, in a larger fiscal deficit.

Several speakers had mentioned that an important question was the appropriate monetary policy for Korea in the medium term, the staff representative recalled. The Korean economy was obviously undergoing rapid change and would continue changing through the ongoing financial and foreign exchange market reforms, but there were clearly a number of requirements for any monetary policy in Korea. First, direct credit controls would have to be reduced. The authorities had reduced those controls in the past but had recently been forced by circumstances to reimpose them. In that connection, it was important to emphasize that, in the past two years, the Korean economy had recorded unprecedentedly large external surpluses. The policies under Korea's successive stand-by arrangements with the Fund had been designed to deal with a balance of payments deficit; thus, the authorities had been ill-equipped to deal with the actual substantial inflow of money. Of course, the staff would have preferred not to see controls reintroduced, but the staff recognized that such controls might well have been difficult for the authorities to avoid. The staff certainly hoped that the authorities would be in a position to eliminate the controls at some later point.

Of course, another essential element in any reform of the monetary policy apparatus was the relaxation of controls over capital flows, the staff representative continued. Any steps in that area would be part and parcel of the foreign exchange market reform that the authorities wished to undertake. In that connection, the authorities had recently issued a preliminary report that had recommended, inter alia, allowing competitive forces to develop somewhat further before turning to a broader reform of the system. The authorities foresaw taking that step sometime in 1990 if conditions permitted; accordingly, the benchmark exchange rate would be determined by market forces rather than by a calculation made at the Bank of Korea on the basis of either currency baskets or policy intentions that were influenced to an important extent by concerns about capital flows.

In countries like Korea, where inflationary pressures were intense, targeting nominal interest rates would be a dangerous policy, the staff representative considered. In the staff's view, targeting on real interest rates was not possible.

In assessing exchange rate policy in Korea, it was useful to note that the nominal effective exchange rate had remained broadly constant in recent months, the staff representative commented. The won had been pegged to the U.S. dollar essentially since April 1989, and the nominal effective rate had moved up and down somewhat, in line with the movements in the U.S. dollar vis-à-vis other currencies.

One of the questions at hand was whether there should not be either an appreciation or depreciation of the exchange rate, the staff representative went on. To some extent, the difference of opinion on that matter underscored the uncertainties about the economic situation in Korea. The staff thought it prudent to propose a standstill in the rate--a kind of wait-and-see approach--because of the trend in the current account. However, it was important to recognize that the staff proposal was two-pronged: it did not involve only maintaining stable nominal effective rates in the short term; the staff had also proposed that the appropriateness of the exchange rate level should be reviewed periodically in light of the movements in competitiveness and the evolving economic prospects, particularly in respect of the current account and the pace of the accumulation of foreign reserves. The staff thought that it was important to look at the real exchange rate and competitiveness; but the authorities should not mechanically apply a real effective exchange rate rule, which might force depreciations at a time when inflationary pressures were intense, thereby adversely affecting inflation performance in two ways: directly, because of the price effect; and indirectly, by generating the expectation that, if the export sector was being protected in some way, then perhaps labor should be protected as well. Accordingly, an exchange rate policy aimed at the real exchange rate would not help the wage bargaining process. While the staff's position on the desirability of a movement in the exchange rate had not changed, the staff had noted that, because of the inflation differential, there would likely be a real appreciation of the won if the staff's recommendation to maintain the nominal exchange rate was followed.

With respect to the J-curve effect in Korea, about 87 percent of the increase in the current account surplus in 1988 was due to price effects, as broadly defined, the staff representative said. In 1989, only about 12 percent of the decline was due to the J-curve effect.

On the question of the differences between the behavior of export unit values and the consumer price indices, it was true that the effective exchange rate, measured in terms of export unit values, had increased by less than other indicators, the staff representative remarked. However, during the depreciation of the won from mid-1985 through 1987, the indices on export unit values had fallen by less than the consumer price indices.

The staff intended to study, to the extent possible, the issue of land prices in the coming period, the staff representative said. That issue was clearly a difficult one. Land price increases could be characteristic of a price bubble, something that was difficult for the staff to analyze. In assessing the land price situation in Korea, it was important to bear in mind that the economy and personal income and wealth were growing fairly rapidly. The resultant increase in purchasing power naturally tended to encourage an increase in land prices.

Korea was likely to become a net creditor in 1990/91, the staff representative noted. At the present stage, the staff would not attempt to assess the consequences of that development.

One speaker had asked whether Korean residents had prepaid debt in 1988, when interest differentials apparently had not been an incentive to prepay, the staff representative recalled. In that year, the exchange rate was appreciating, there was a perception that the rate would continue to appreciate, and the rate of return in U.S. dollar terms on investments in Korea had approached 25 percent. Hence, there had been no incentives for prepaying debt during 1988, and prepayments had in fact declined. In that connection, another relevant factor was that some capital inflows had occurred; they had been recorded under the category of "other items."

Savings increased substantially in 1985-88, by about 8 percentage points of GNP, the staff representative commented. Part of that increase was due to the lagged adjustment of personal consumption to the rapid growth in disposable income. In the coming period, as the growth of disposable income slowed, the savings rate would probably decline substantially, although it would still exceed the rate of 1985.

The question had been raised why the ratio of imports to GNP was not projected by the staff to change much, the staff representative recalled. The answer essentially was that import prices in won were falling while the GNP deflator was rising. In volume terms, imports were increasing about three times as much as GNP--a substantial rate of increase.

In the staff's view, monetary policy in Korea had been handled appropriately, the staff representative from the Asian Department said. The institutional arrangements that should be the framework for the formulation of monetary policy had not been an issue during the consultation discussions with the authorities, and the staff had not discussed those arrangements in any great detail with the authorities. However, a draft bill pertaining to those arrangements had recently been approved by the Government and would eventually be sent to the National Assembly. Apparently the Bank of Korea was not very pleased with the proposed bill, which would continue to give the Ministry of Finance substantial control over the Bank of Korea. That issue had not been discussed in depth, and the staff did not have any firm views at present.

The staff representative from the Exchange and Trade Relations Department said that Mr. Grosche's remarks on the issues related to the

GATT consultation were very much in line with the staff's understanding of those issues. At its meeting in June 1989, the CGATT had expressly agreed that, for the purpose of the Fund's statement on Korea to be made to the GATT Balance of Payments Committee, the staff should raise the issue of the maintenance of import restrictions for balance of payments purposes in the staff's consultation discussions with the authorities. In the meantime, the staff was instructed to transmit to the GATT the Fund's preliminary view that Korea's import restrictions could no longer be justified on balance of payments grounds. The staff had done so and had subsequently expressed its view on the same issue in the staff appraisal of the report for the 1989 Article IV consultation with Korea to provide a basis for a confirmation by the Fund of its earlier view. A staff view on a country's balance of payments need to maintain exchange and trade restrictions was also consistent with the Fund's surveillance mandate. The view to be forwarded to the GATT Balance of Payments Committee would certainly be the view of the Fund as expressed by the majority of Executive Directors, but the staff believed that its reports for Article IV consultations should present the GATT-related issues concerned, as well as other policy issues, for the Board's consideration. The Board would then of course make its own judgment.

With respect to the procedural issues in connection with similar cases in the future, in the light of the June 1989 decision of the CGATT, the staff had introduced procedures to better ensure that the staff would undertake consultations with the authorities and make its views known in the relevant staff reports, the staff representative explained. The staff believed that the treatment of the issue of restrictions in the context of the Fund's consultation with the GATT in the staff report for the 1989 Article IV consultation with Korea was consistent with the results of the discussion of the CGATT in June.

In the past few decades, there had rarely been cases in which a member with a strong balance of payments position had continued to invoke GATT provisions to justify maintaining restrictions, the staff representative from the Exchange and Trade Relations Department said. Hence, the need for the Fund staff or the Fund to express a view of no balance of payments justification had not arisen recently. The last such case was Spain in 1973. As to the issue of precedents, the staff reports for Japan, in 1963, and for Spain, in 1973, had discussed quite explicitly the issue of the need for restrictions for balance of payments reasons.

Mr. Kwon commented that he had not intended to suggest that the language on the GATT-related issues discussed in the staff report had never been used in Article IV papers in the past, although such precedents as existed were very limited and somewhat outdated. His point was that, as he understood it, there had been no prior case in which symmetrical language had been used for countries that had a weak balance of payments and therefore retained import restrictions on balance of payments grounds. The problem in the present case was the staff's use of language that reflected a legalistic approach by the GATT rather than the Fund's normal and general approach to such issues.

A number of Executive Directors had mentioned that fiscal policy should avoid creating further inflationary pressures and should contribute to more balanced and sustainable economic growth, Mr. Kwon remarked. His authorities attached great importance to containing inflationary pressures, and priority would therefore be given to that objective in the conduct of fiscal and monetary policies. Nevertheless, as he had noted in his opening statement, there had been increasing social demands as national income had grown and the political environment had evolved. In 1988, tax revenue collected had exceeded the budget estimate by more than 16 percent, which had naturally tended to increase political pressures on the Government to address the social demands. The supplementary budget for 1989 would be funded entirely by the excess revenue collections. Thus, the supplementary budget's impact on domestic inflation was expected to be minimal. The 1990 budget had also been formulated on the basis of the increased social demands.

A number of Directors had raised the question of whether, in view of the present stage of development of the economy, Korea should maintain a surplus in the balance of payments, Mr. Kwon commented. That question was difficult, but it should be considered in the context of the sustainability of the current account deficit that Korea had experienced until 1985. Korea had a very small land area, a poor natural resource base, and a large population, making Korea one of the most densely populated countries in the world. In those circumstances, Korea would seem to have no other choice but to pursue its economic development strategy in the context of outward-looking and export-oriented growth. In other words, Korea must export in order to be able to import needed materials. Thus, the economy was highly vulnerable to external shocks. As Directors had noted, it was only four years ago that Korea had faced a high level of external debt, and the level still remained high in absolute terms, although it had been reduced substantially in recent years. Any severe changes in import prices, or international interest rates immediately affected the current account of the balance of payments. For those reasons, his authorities believed that it was prudent to maintain a modest surplus in the balance of payments for some time, so that any future external shocks could be absorbed without causing a severe impact on the domestic economy.

A related question was whether the projected $7 billion surplus in 1990 was consistent with the medium-term objectives, Mr. Kwon continued. That figure was merely one of the assumptions made for the purposes of formulating the 1990 budget. When the budget was formulated in July and August, there had been a general expectation that the current account surplus for 1989 would be more than $8 billion, and the authorities had naturally assumed the surplus for 1990 would be somewhat smaller.

As he had noted in his opening statement, during the period between the previous consultation and the end of July 1989, the Korean won had appreciated by 17 percent in nominal effective terms, while the U.S. dollar had appreciated by 20 percent and the Japanese yen and German mark depreciated by 4.4 percent and 1.6 percent, respectively, Mr. Kwon said.

At present, the won was pegged to a weighted currency basket, and the exchange rate of the won could move in either direction, depending on exchange rate movements of the major currencies in the basket. If the exchange rate of the won was to reflect correctly the changes in exchange rates of major currencies in the period in question, the won should have depreciated substantially instead of appreciating. Moreover, the expected current account surplus for 1989 of $6.2 billion represented a reduction of 1.3 times from the surplus registered in 1988 in absolute terms and 2.8 times in terms of the percentage of GNP. That reduction might well have been one of the most rapid one-year adjustments in recent world economic history. Therefore, the Korean authorities saw no convincing arguments that Korea should do more at the present stage.

The Korean economy was undergoing rapid adjustment in 1989, Mr. Kwon commented. At the present stage, the authorities needed to see whether the economy was behaving in a sustainable manner; thus, a prudent but flexible policy stance was called for. His authorities were fully aware of that situation and would continue to pursue appropriate adjustment policies that would ensure more sustainable and balanced growth.

The Acting Chairman made the following summing up:

Directors noted that, after three years of impressive growth, the Korean economy appeared firmly embarked on a process of adjustment toward a more sustainable growth path and a more sustainable external payments position. Owing primarily to a considerable weakening of net exports, output growth was slowing and the current account surplus was declining sharply. Directors commended the authorities for the policy strategy implemented since 1987, which had supported this adjustment and had also contained price pressures. They found appropriate, in particular, the emphasis on the nominal appreciation of the won, the domestic structural reforms, the acceleration of market opening, and the underlying fiscal and monetary restraint. While recognizing that the present transition period was difficult, Directors urged the authorities to persevere with their policy strategy. The achievement of durable adjustment would lead the way to a stronger and more balanced economy. Any marked departure from the present policy strategy would impede the domestic and external adjustment process, rekindle inflationary pressures and protectionist sentiments in foreign markets, and adversely affect economic prospects in both the short and medium term.

Directors agreed that the substantial nominal appreciation of the won since 1987 had been a necessary part of the adjustment process. At the same time, most Directors considered that, in light of the magnitude of the adjustment currently underway, further appreciation did not appear warranted at this point. In this regard, they noted that the full impact of the appreciation and of the high wage settlements in 1989 on Korea's external competitiveness may not have yet taken effect. Some Directors, however, considered that it was premature to regard Korea's present level of external competitiveness to be consistent with appropriate external adjustment, thus indicating that some appreciation of the won may be appropriate. In this connection, Korea's external current account target was questioned as to whether it was consistent with Korea's stage of development and the need for adjustments in world payments balances. All Directors agreed that it would be important for the authorities to review the appropriateness of the level of the exchange rate periodically in light of the evolving economic situation and the external adjustment prospects.

Turning to fiscal and monetary policies, Directors agreed with the authorities that price stability should remain the key policy priority. Some Directors, however, noted that the current sharp decline in external demand would help to subdue wage and price pressures and provide some room for fiscal and monetary policies to support domestic demand. Thus, in this context, support was expressed for the recent fiscal actions and there was some support for monetary targeting in the upper part of the target range. Other Directors, however, pointed out that the scope for expansionary fiscal and monetary policies was limited because of the risk of exacerbating inflationary pressures. These Directors recommended that monetary growth be contained to the lower part of the official target band and that the authorities avoid adding substantially to the fiscal stimulus. They noted that such a policy stance would also continue to provide scope for adequate growth in credit to the private sector.

Directors commended the authorities' recent efforts to reduce government intervention in the Korean economy and to rely increasingly on market mechanisms. In particular, they were pleased to note Korea's acceptance in November 1988 of the obligations of Article VIII. Directors also welcomed the wide range of measures that had been taken to enhance welfare and the quality of life. Overall, these policies would facilitate a more efficient allocation of resources and also achieve higher living standards and greater social equity. Directors observed, however, that, notwithstanding recent progress, considerable scope for further market liberalization remained. The scope for reform in domestic financial markets was large, and Directors encouraged the authorities to press ahead with proposals to enhance the influence of market forces on interest rates and exchange rates and liberalize external capital transactions. They also felt that more emphasis should be placed on indirect instruments of monetary control.

In the area of import liberalization, Directors welcomed the authorities' commitment to the opening of domestic markets, as evidenced by the intensification of liberalization efforts during 1988 and 1989. Directors observed that the remaining restricted import items comprised mainly agricultural and fishery products. Directors urged the removal of these restrictions, and pointed out that the elimination of these substantial distortions without undue delay would be to Korea's benefit. Directors further observed that Korea's restrictions on imports could not any longer be justified on balance of payments grounds in light of Korea's strong balance of payments and reserves position. In this connection, they noted the remarkable ability that the Korean authorities have demonstrated in the past in dealing with balance of payments problems through appropriate adjustment policies.

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

3. EQUATORIAL GUINEA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Equatorial Guinea (SM/89/173, 8/15/89). They also had before them a background paper on recent economic developments in Equatorial Guinea (SM/89/187, 8/29/89).

Mr. Santos made the following statement:

My Equatorial Guinean authorities would like to express their appreciation to the staff for the constructive discussions held in Malabo in the context of the Article IV consultation. They agree with the thrust of the staff appraisal and have no major difficulty in accepting the staff's recommendations.

The economic and financial performance of Equatorial Guinea in 1988 reflects a combination of various factors--notably, unfavorable weather conditions, deteriorating terms of trade, and weaknesses in the institutional and administrative capacity that hamper policy implementation. As a result, some objectives of the authorities' medium-term program could not be achieved. Real GDP is estimated to have stagnated in 1988, and the internal and external financial situation remained difficult.

In the real sector, there are indications that economic activity weakened in 1988, owing to the shortfall in timber output and the fall in the world market prices of logs. It is estimated that timber production declined by 15 percent due to excessive rainfall, which damaged the logging roads. Coffee production also experienced a drastic fall of some 47 percent in 1988. Cocoa production, however, improved significantly, responding to the measures introduced in the context of the rehabilitation program for the cocoa sector and a period of favorable weather conditions preceding the heavy rains. Despite this progress, the output of cocoa remained below expectations.

Against this background, the authorities adopted in April 1989 a package of measures to stimulate production. In the timber sector, measures aimed at lowering the costs of production and marketing include a 16 percent cut in the price of diesel sold to producers, and a substantial reduction in the reference prices used for determining export taxes. In addition, the road system and the port at Bata are being rehabilitated. In the cocoa sector, the authorities' efforts are geared toward raising productivity via better techniques for controlling disease and rodents, which account for a loss of 25 percent of total crops each year, as well as the provision of fertilizers and fungicides at lower costs. The authorities are also considering a reduction in the charges and fees paid to the Chamber of Commerce and exemptions from export taxes, among other measures. These measures, together with a return to normal weather conditions, should help the economy to register positive growth in 1989 and next year.

In the fiscal sector, a combination of internal and external factors, including the unexpected decline in timber production and exports as well as additional budgetary outlays for the resettlement of the Equatorial Guinean nationals arriving from neighboring countries, contributed to the less than envisaged performance in this sector. My authorities are aware that the strengthening of the fiscal position of the country is crucial to the success of the ongoing adjustment process. To this end, they have adopted a series of remedial measures. On the revenue side, customs and tax administration, as well as the collection of tax arrears, have been strengthened. Other measures include a 25 percent surcharge on imported consumer goods, increases in the rates of the domestic sales tax, the general income tax, the tax on business, and the property tax. Moreover, in May 1989, the surcharge on consumer goods was increased, and new taxes were introduced on imported goods in transit (3 percent) and re-exports (2 percent). In addition, revenue collection from the logging companies will be closely monitored. On the expenditure side, the Government is aware that tight control of public expenditure outlays is critical. Thus, stricter guidelines were put in place on the Government's use of electricity, automobiles, and telecommunication services. Measures were also taken to limit expenses on official travel and diplomatic representations abroad. Furthermore, the Government has delayed the salary increase in the public sector and has frozen recruitment. The authorities believe that the implementation of these measures, combined with higher fishing royalties, will help to bring the fiscal deficit, on a commitment basis, close to the original target for 1989.

With regard to the reform of the banking sector, despite past delays in the liquidation of the two commercial banks, progress is expected in the near future. A single autonomous agency is being put in place to speed up the liquidation process. Furthermore, the establishment of another new commercial bank is expected before the end of this year and should help to promote competitive financial services and foster domestic savings.

In the external sector, the outcome for 1988 was less favorable than envisaged. The deterioration of the current account was attributed mainly to substantial increases in imports of consumer goods and nonfactor services related to technical assistance, interest payments, as well as lower earnings from major export products. In addition, net capital inflows were modest, reflecting amortization and subscription payments, and short-term capital outflows. For 1989, preliminary estimates indicate that the external position will continue to be under pressure, as the recovery in the volume of timber exports would be partly offset by a decline of some 16 percent in cocoa exports. The current account deficit, excluding official transfers, is expected to remain unchanged from 1988, at about 35 percent of GDP. In view of this situation and the relatively large debt burden, the authorities will take a prudent stance regarding external debt. The difficult medium-term prospects imply that they will continue to require exceptional financing at concessional terms.

Finally, it should be recognized that despite an extremely difficult external environment and limited human resources, the Equatorial Guinean authorities have made commendable progress in implementing structural reforms in 1988 and 1989. Their commitment to the medium-term objectives of the program has not wavered. It is their belief that the additional measures they have taken as well as the efforts they are making to improve the administrative capacity of the country will enable the economy to attain the targets set for the medium term.

Mr. Cirelli made the following statement:

This chair would like to take this opportunity to express its concern about Equatorial Guinea's present financial and structural imbalances. Ten months ago, the authorities embarked on an adjustment program that was designed to establish a sound basis for economic growth and to strengthen the balance of payments. They now have to face the consequences of serious slippages in policy implementation. Thus, despite strong support from the international financial community, most of the program objectives and benchmarks have not been observed. In this context, we welcome the measures recently adopted by the authorities in the budgetary area to bring the program back on track. However, the staff report as well as the medium-term prospects clearly show that there is no more room for complacency in implementing the program. With this consideration in mind, I will comment on issues that, in our opinion, deserve very close consideration, namely, budget and monetary policies and structural policies.

We agree with the staff that the authorities' fiscal target for 1989 is attainable by applying more stringent discipline. Implementing a comprehensive set of measures, as described in the report, is of the utmost importance in avoiding further slippages. On the revenue side, a significant reversal of the present decline in the ratio of revenue to GDP is urgently needed. *It is necessary to streamline the overall tax and* customs system with external technical assistance, particularly to stay in line with the target date of end-1989 for achieving the harmonization of the UDEAC tariff. On the expenditure side, the authorities' renewed commitment to quickly undertake the various different actions agreed with the staff is particularly welcome; we also welcome the authorities' commitment, mentioned in Mr. Santos's opening statement, to tighten future expenditures. We would like to stress that only through such a commitment could sufficient external assistance be procured for the country's adjustment program. We wonder whether the staff feels that, in addition to this fiscal package involving both new revenue and expenditure control measures, there is room in which to further improve program implementation, taking into account changes in the level and composition of public finance elements compared with the original program.

As for monetary and credit policy, we regret the delay in the banking sector reform, as it undermines the confidence of the private sector and precludes economic recovery. There is no doubt that a more competitive banking environment is needed at this stage, and we urge the authorities to pay closer attention to the overall rehabilitation of this sector.

In the area of structural policies, one cannot overemphasize the direct links between close monitoring of ongoing studies, and reforms to strengthen the external sector. Given the assumption of 10 percent annual growth of export earnings in 1990 and thereafter, it is essential to address structural impediments as soon as possible in order to reach sustainable growth. In this respect, delaying the ongoing studies is regrettable and might result in further strains on implementing the structural adjustment arrangement. In addition, the balance of payments scenario elaborated by the staff is realistic and demonstrates again the fact that the margin for maneuver will remain very slim in coming years.

In this connection, the conclusion of a new fishing agreement with the EEC, together along with assistance from the STABEX, will contribute to sensibly improving the overall financial position of Equatorial Guinea. My authorities are also ready to support the country's endeavors to reduce financial and structural imbalances. The medium-term framework of the program supported by the structural adjustment facility should provide an opportunity to undertake the needed corrective actions.

We urge the authorities to carefully assess all the elements of the present situation. We hope that such an assessment might induce them to control the uneven pattern of program implementation observed thus far. We support the proposed decision.

Mr. Fernández Ordóñez made the following statement:

In December 1988, when the Board accepted a request made by Equatorial Guinea for a first annual arrangement under the structural adjustment facility, we were convinced by the policies described in the medium-term policy framework paper, and we supported the program that was supposed to start in June this year. In the light of the performance described in the staff report, one could legitimately wonder whether this Board would have taken the same decision today.

It is true that certain external developments, described in the opening statement of Mr. Santos, negatively affected the recent economic results, but the serious slippages in policy implementation are disappointing, especially the deterioration in the fiscal accounts and the lack of progress in liquidating the commercial banks.

We welcome the announcement by Mr. Santos that the Equatorial Guinean Government is trying to put the program back on track, but we urge management and staff to monitor the authorities' actions closely and to impress on the authorities how crucial it is, if they do not want to lose their credibility with this institution, to implement fully the adjustment policies set forth in the policy framework paper elaborated last year, which in our view remain entirely valid.

As we stressed in December, in Equatorial Guinea, as in other similar cases, the lack of administrative capacity explains a great deal of what is happening in the country. We have to make a special effort in this field; in that connection, there can be no substitute for the multilateral institutions. There is no question but that Equatorial Guinea is going to need, in relative terms, a great deal of financial aid in the future, but these resources could be wasted if the Equatorial Guinean administration is not improved.

Mr. Dawson made the following statement:

We regret that Equatorial Guinea's economic performance has been disappointing in 1988 and early 1989. We understand that exogenous factors were partly responsible for this outcome. However, we are concerned to see that there have also been substantial slippages in the implementation of Equatorial Guinea's first-year structural adjustment arrangement, both in the exercise of fiscal restraint and in the pace of structural reform. Under the circumstances, we fully support the Fund's decision to delay discussion of a second-year structural adjustment arrangement until the first-year program is back on track.

Since we are in broad agreement with the thrust of the staff appraisal, I will only add a few points of emphasis. First, stronger action on the fiscal side in bringing current expenditures back under control and in improving customs and tax administration is clearly the key to the success of this program. The level of last year's central government deficit--three times the programmed level--is clearly unsustainable. Moreover, a lack of fiscal discipline can only undermine domestic and foreign confidence in the authorities' economic management and complicate the authorities' efforts to promote investment and obtain additional external financing. We welcome the measures that the Government took in May of this year to boost revenue and restrict expenditures, as well as indications in the staff report that it should be possible to limit the 1989 deficit to about CFAF 0.7 billion. Although a deficit of this magnitude would be larger than originally programmed, it would still represent a considerable improvement over last year. However, we understand that holding the 1989 deficit to this level may well require further restrictions on expenditures, as well as strict enforcement of the May 1989 measures. We would, therefore, urge the authorities to monitor fiscal developments carefully and take whatever steps are necessary to keep fiscal performance on track.

On a related issue, I note with some concern that Equatorial Guinea recently introduced an export subsidy to be distributed among a small number of licensed exporters of cocoa. This is an unwelcome development, in our view, despite the fact that the subsidy is being financed by foreign grants. The experience of many countries indicates that, once instituted, subsidies are difficult to remove, and often lead to an unexpectedly large drain on public finances. The fact that exporting cocoa is unprofitable at current world prices argues for more intensive efforts to reduce domestic production costs. In this connection, we welcome the steps being taken with World Bank assistance to rehabilitate the cocoa sector, and we would encourage further steps to reduce costs, improve yields, and guarantee individual property rights.

Second, the accumulation of domestic and external payment arrears is not an acceptable financing alternative. Moreover, since Equatorial Guinea has a very high level of external debt, and the medium-term scenario indicates that even with the successful implementation of the adjustment program, exceptional financing will be required, it will be very important to retain the support of the international community. This can best be done by bringing the adjustment program back on track and thereby strengthening the country's ability to meet its external obligations.

Third, there appears to be an urgent need for banking sector reform. We urge the authorities to expedite the liquidation of the two failed commercial banks. The establishment of an additional commercial bank on a joint venture basis would also be a positive development, provided that conditions are such that the bank operates on sound commercial principles.

Fourth, the staff report notes a number of severe data problems, such as sketchy GDP data, inadequate price indices, unreported expenditures, and underestimated payment arrears, which make it very difficult to assess the magnitude of Equatorial Guinea's imbalances, prescribe appropriate policy measures, and monitor program performance. Therefore, we urge the authorities to make every effort to improve the quality and timeliness of their economic data, drawing on external technical assistance as needed.

In conclusion, we hope that Equatorial Guinea's economic performance and the implementation of its medium-term structural adjustment program will improve to the extent that a second-year structural adjustment arrangement can be brought to the Board. However, this will require a sustained effort to control the fiscal deficit, as well as completion of the studies designated under the first-year program and formulation of the relevant structural reforms that those studies recommend.

Mr. Goos made the following statement:

I share the sense of frustration expressed by previous speakers about the serious slippages under the structural adjustment arrangement. These slippages are all the more unfortunate if one looks at the country's history of repeated poor program implementation. Economic developments were considerably complicated by exogenous factors last year; but I would have thought that the authorities would take these complications as a further sign of the urgent need to tackle the problems identified in the policy framework paper. Given the relatively low level of economic development, it is particularly regrettable that the authorities have not lived up to their structural reform commitments, which are clearly crucial for improving domestic savings and investment and, hence, for the country's growth prospects. Moreover, the renewed accumulation of external arrears is anything but conducive to building the confidence of external creditors and investors in the country's economic prospects.

The staff, therefore, is right in urging the authorities to bring their program back on track and in insisting on the implementation of prior actions in the crucial areas of adjustment and reform before considering further access to the structural adjustment facility resources. In the circumstances, prior actions are clearly in the interest of both Equatorial Guinea and the security of the Fund's resources.

In the latter regard, we are quite concerned about the reported intermittent arrears to the Fund in recent years. In view of this experience, the continuation of special arrangements to secure the timely repayment of Fund resources would appear appropriate if there is agreement on a second annual structural adjustment arrangement.

It is encouraging to note that the authorities have adopted additional fiscal measures with a view to narrowing the budget deficit to the original target, and I noted the expectation that the external current account deficit will converge with the original program assumptions by 1991. However, in the light of the substantial accumulation of domestic and external arrears and the prospect that additional arrears might arise next year, a faster pace of adjustment than is currently envisaged is called for in order to rectify the recent setbacks and to help restore confidence in the authorities' commitment to adjustment.

In this regard, I am concerned about the lack of specificity of the policy intentions for the coming year. It is understood that rapid progress, particularly in banking sector reform and in revising the investment code, is of crucial importance. With respect to the banking sector reform, I noted the prospect for the establishment of a second commercial bank, which certainly should help mobilize additional savings. However, considering the level of development of the economy, I wonder whether that effort should not be complemented by the establishment of cooperative credit unions on a local level, which could help familiarize broader segments of the population with the idea of saving on financial assets and could also improve the supply of credit to domestic activities. I also noted that the prospects for economic recovery are based predominantly on the production and export of timber. Given that--as I understand it--some two thirds of the country's forests are to be exploited for that purpose, there are of course concerns about the environment, which were recently emphasized by the Development Committee. Therefore, I hope that appropriate attention will be paid to reforestation.

The limited administrative capacity and the disappointingly weak statistical data base continue to be a source of major concern; they clearly hamper the effective design, implementation, and monitoring of adjustment measures. The slow progress, if any, discernible in this area is all the more regrettable because the country has been benefiting from considerable foreign technical assistance, including assistance from the Fund, for a number of years; one wonders about the authorities' willingness to implement the recommendations made in the framework of that assistance. The importance of genuine and rapid progress in improving the administrative capacity and the statistical data base can hardly be overemphasized.

I support the proposed decision.

Mr. Evans made the following statement:

My predecessors in this chair have generally refrained from commenting during recent Article IV consultations on Equatorial Guinea, leaving that task to other Directors more familiar with the country. However, two decades of mismanagement, and particularly the policy failings of the most recent period, should not go unremarked given the commitments that had again been made, the Fund resources involved, and, perhaps most important, the generous bilateral support again provided by friendly nations.

The policy failings are well documented in the staff report--which also acknowledges the contribution of exogenous factors to the unsatisfactory outcomes in 1988 and in 1989 to date. No further elaboration on those facts would seem required. When policy failure is as widespread as it is in this case, one should also ask whether the policy targets were too demanding. Such a question would seem particularly pertinent given the prior knowledge that existed of the weaknesses in Equatorial Guinea's administrative capacity. This issue is not addressed directly in the staff appraisal; rather, the staff concludes that the program can be put back on track--albeit with a policy performance that now must be even more demanding than the tests that have been repeatedly failed. I wonder whether the staff feels that this is really feasible, or whether some redesign of the program might be warranted; such a change could, of course, mean less progress on such fundamental and desirable aspects as poverty alleviation. There would seem to be a need for the authorities to be confronted more directly with such basic choices if any program is to have a chance of success.

On a closely related issue, the staff could usefully comment on whether there might be merit in encouraging greater use of technical assistance, given the country's clear lack of sufficient technical and administrative skills. The provision of further financial assistance would appear to be out of the question pending the establishment of some semblance of a policy track record.

Mr. Adachi said that he shared the concerns expressed by the previous speakers over the disappointing performance under the first-year structural adjustment arrangement. While he certainly sympathized with the authorities, he supported the staff's decision to delay further support under the structural adjustment arrangement, and he encouraged the staff to take relevant decisions in other cases without hesitation, if necessary. The present monitoring procedure might have some room for strengthening.

With respect to the policy issues, while he welcomed the supplementary measures adopted by the authorities, he fully endorsed the staff appraisal, Mr. Adachi stated. However, he wished to emphasize that the establishment of a solid performance record would be crucial for further adjustment and growth.

The staff representative from the African Department commented that the staff believed that the authorities should be able to reach the fiscal target for 1989 that was agreed during the Article IV consultation discussions. However, the situation was clearly very tight. There were very few options for the authorities on the revenue side. For example, in 1985, 23 percent of total revenues had come from the cocoa sector, but those resources had subsequently totally dried up. In addition, the timber sector was growing, but more slowly than it had during the past two or three years, and imports constituted, for various reasons, a diminishing tax base. Furthermore, it was important to bear in mind that the private sector in Equatorial Guinea was very small. Thus, since tax handles were simply not available in the country, the fiscal adjustment strategy in 1989 was based squarely on the expenditure side. The staff felt that that approach was feasible in view of the fact that the large expenditure overrun in 1988 had been due to exceptional factors, rather than factors that were built into the expenditure base. While the staff and the authorities believed that, barring any unforeseen developments such as those that had occurred in 1988, the fiscal target for 1989 was feasible, it was quite probable that a review and reassessment of the fiscal adjustment path for 1990 set out in the policy framework paper would be necessary. The staff would certainly consider that possibility in its future contacts with the authorities.

The staff and the authorities had not discussed the possibility of a cooperative system for extending the banking system including, perhaps, into informal channels, the staff representative said. The staff was not aware of any proposals in that area that were under consideration by the authorities, but the staff would wish to look into the matter. In that connection, the most important objective at present was to establish the second commercial bank to provide the kind of services that the economy needed.

A question had been raised about timber and the environment, the staff representative recalled. The staff report and background paper noted that the authorities were undertaking a census of the timber resources with the help of the UNDP. One of the objectives of the census was to identify the amount of the forestry resources that should be set aside to protect the environment and to provide for development in future years. Once the survey was completed, the authorities should have considerable additional information about the potential impact of forestry on the environment.

During its visit to Equatorial Guinea, the staff had met with a number of persons, from various agencies, who were providing technical assistance to the authorities, the staff representative remarked. It was clear that the country was already receiving considerable bilateral technical assistance and a great deal of multilateral technical assistance as well. Most of the assistance had been made available after Equatorial Guinea had joined the UDEAC and BEAC. The authorities should make better use of the technical assistance in order to not only strengthen policy implementation, but also develop the underlying statistical base.

Mr. Santos remarked that speakers clearly regretted that the authorities could not implement all the policy measures that were expected during the first-year structural adjustment arrangement. As Directors and the staff had stressed, there was a need to strengthen the adjustment effort before the second-year arrangement of the structural adjustment arrangement could be agreed. He had noted the willingness expressed by friendly countries to continue to support Equatorial Guinea's adjustment efforts with both financial and technical assistance. His authorities were fully aware of the weaknesses in the administrative structure and of the role that technical assistance could play in solving those problems and in developing an adequate statistical structure.

The Acting Chairman made the following summing up:

> Directors were in broad agreement with the thrust of the views expressed in the staff appraisal. While recognizing the negative impact of external shocks, Directors expressed deep concern and disappointment with the poor economic performance

during 1988 and the first half of 1989 under the program supported by an arrangement under the structural adjustment facility. They regretted that serious slippages in policy implementation had significantly contributed to the nonobservance of most program objectives and benchmarks. Especially disturbing was the sharp deterioration in the fiscal deficit, which resulted primarily from inadequate control over current expenditure. Directors also observed that progress had been slow in the area of banking sector reform, particularly with respect to the liquidation of the two insolvent commercial banks. Other structural reforms had also been delayed, as a number of key studies envisaged in the program had not been completed on schedule.

Directors urged the authorities to take the decisive steps necessary to put their program back on track as a prerequisite to continued support under the structural adjustment facility. In particular, Directors welcomed and urged the authorities to fully implement the fiscal measures adopted in May 1989, notably those aimed at bringing current nonwage expenditure under much stricter control. Directors emphasized the need for the authorities to maintain a cautious wage policy and to take steps to reduce cocoa marketing costs, so that the cocoa export subsidy could be eliminated as soon as possible. They also urged the authorities to render the revenue system more buoyant through the adoption of additional discretionary tax measures and improvements in tax administration.

Directors underscored the urgency of accelerating the pace of structural reforms. This was particularly critical for the banking sector, where the authorities were encouraged to speed up the recovery of assets and the liquidation of deposits, so that the two insolvent commercial banks could be liquidated as soon as possible. It was also recommended that the authorities move ahead to establish a second operating commercial bank with foreign participation and management, and interest was expressed in whether other financial institutional arrangements could be established to facilitate savings.

Directors noted that the limited administrative capacity and very weak statistical base were major impediments to policy formulation and implementation. They urged the authorities to make more effective use of the considerable technical assistance that is now already available to the country in the fiscal, development planning, and environmental fields. Technical assistance should be used to help build the underlying data base and to improve the cocoa sector.

A number of Directors expressed the hope that in the coming months Equatorial Guinea would implement policies that would provide the basis for a resumption of lending under the structural adjustment facility.

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

After a further brief discussion, the Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1989 Article XIV consultation with Equatorial Guinea, in the light of the 1989 Article IV consultation with Equatorial Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Equatorial Guinea maintains an exchange system which is free of restrictions on the making of payments and transfers for current international transactions other than for travel.

Decision No. 9268-(89/132), adopted
October 6, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/131 (10/6/89) and EBM/89/132 (10/6/89).

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

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT on Colombia, Ghana, and India to be held in Geneva during the week of October 16, 1989, as set forth in EBD/89/296 (10/2/89).

Adopted October 6, 1989

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

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT on Korea to be held in Geneva during the week of October 23, 1989, as set forth in EBD/89/297 (10/2/89).

Adopted October 6, 1989

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

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT on Brazil, Israel, Peru, and Sri Lanka to be held in Geneva during the week of November 20, 1989, as set forth in EBD/89/298 (10/2/89).

Adopted October 6, 1989

7. EUROPEAN INVESTMENT BANK - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the background papers on recent economic developments in Hungary (SM/89/76, 4/28/89) and Poland (SM/88/184, 8/18/88) to the European Investment Bank, as set forth in EBD/89/301 (10/4/89).

Adopted October 6, 1989

8. ASSISTANTS TO EXECUTIVE DIRECTORS - INTERIM COMPENSATION SYSTEM

The Executive Board approves, with one objection, the proposals recommended by the Committee on Executive Board Administrative Matters regarding a compensation system for Assistants to Executive Directors. (EBAP/89/233, 10/4/89 and Sup. 1, 10/10/89)

Adopted October 6, 1989

9. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/89/234 (10/4/89) is approved.

APPROVED: June 7, 1990

JOSEPH W. LANG, JR.
Acting Secretary